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## Roles and Reasonable Expectations of the Underwriter, Lawyer, and Independent Securities Auditor in the Efficient Provision of Verified Information: “Truth in Securities” Reinforced

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# ROLES AND REASONABLE EXPECTATIONS OF THE UNDERWRITER, LAWYER AND INDEPENDENT SECURITIES AUDITOR IN THE EFFICIENT PROVISION OF VERIFIED INFORMATION: 'TRUTH IN SECURITIES' REINFORCED

*Arnold W. Messer\**

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## I. INTRODUCTION

The oft-quoted purpose of the Securities Act of 1933<sup>1</sup> is to protect the purchaser of securities through the provision of "full and fair disclosure . . . and to prevent frauds in the sale thereof".<sup>2</sup>

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1. 15 U.S.C. §§ 77a-aa (1970) [hereinafter cited as the 1933 Act].
2. Preamble, 1933 Act, ch. 38, 48 Stat. 74; H.R. REP. NO. 85, 73d Cong., 1st Sess. 2, 3 (1933), S. REP. NO. 47, 73d Cong., 1st Sess. 1 (1933).

The 1933 Act and the Securities Exchange Act of 1934,<sup>3</sup> which increased the number of beneficiaries of the disclosure requirements, interact to form a semi-systematic<sup>4</sup> pattern designed to inform<sup>5</sup> the investor<sup>6</sup> of the danger or unfairness of the proposed transaction. The success of such a system in allowing the investor to protect himself against the making of bad bargains is dependent upon the information disclosed being the whole truth.<sup>7</sup> The financial statements contained in the issuer's registration statement must be certified by independent accountants<sup>8</sup> who have investigated and verified the financial records of the issuer<sup>9</sup> and who will themselves be liable under section 11<sup>10</sup> of the 1933 Act should the registration statement become effective with financial statements they knew or should have known were false or incomplete. The investor must, for the most part, rely on the issuer's word that the remainder of the registration statement, or the whole of the information disclosed in the course of an exempt sale, is true and complete.

The investor's receipt of the whole truth is thus dependent upon the ability of the issuer to perceive the nature and extent of the real problems facing it and whether any propensity it might have to conceal or misrepresent this information is offset by the checks

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See generally 1 L. LOSS, SECURITIES REGULATION 121-128 (2d ed. 1961, Supp. 1969) [hereinafter cited as Loss].

3. 15 U.S.C. §§ 78a-jj (1970) [hereinafter cited as the 1934 Act].
4. The 1933 Act and 1934 Act, unfortunately, do not act as a single integrated system and are badly in need of codification. See Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966). An effort toward codification is presently well underway. ALI FED. SEC. CODE (Tent. Draft No. 1, 1972); Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969).
5. "[T]here is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But 'The truth shall make you free'." 1 Loss 21. The disclosure requirement does more than inform the investor, it also acts as a deterrent to actions which one would not want made public. See L. BRANDEIS, *OTHER PEOPLE'S MONEY* (1914).
6. "Investor" is used here to mean, unless the context otherwise requires, any person who is contemplating buying, is offered, is actually buying, has bought, holds, contemplates selling, offers to sell or sells the security in question, even for speculative purposes.
7. Even a system of substantive regulation such as that which exists at the state level and most notably in California, to a large extent must rely on the issuer's word that the information provided is accurate and complete.
8. 15 U.S.C. §§ 77aa(25), (26) 1970; SEC Reg. S-X, 17 C.F.R. § 210 (1972). See generally L. RAPPAPORT, *SEC ACCOUNTING PRACTICE AND PROCEDURE* (3d ed. 1972) [hereinafter cited as RAPPAPORT].
9. SEC Accounting Series Release No. 90 (March 1, 1962).
10. 1933 Act § 11, 15 U.S.C. § 77k (1970).

imposed upon that issuer. These checks include, in addition to the issuer's own integrity, review of the registration statement by the Securities and Exchange Commission (the "Commission") and potentially massive liability.<sup>11</sup> Another check is supplied by certain other persons who may themselves be subject to liability for the issuer's misdeeds. There is absolute liability on those who offer or sell a security in violation of section 5.<sup>12</sup> Those who offer or sell or buy a security by means of material misstatements or omissions are personally liable unless they do not know and have no reason to know thereof.<sup>13</sup> Directors, certain officers of and underwriters for the issuer are each personally liable under section 11<sup>14</sup> for losses caused by sales based upon a registration statement which they know to contain material misstatements or omissions unless they have resigned or disassociated themselves from the issuer and informed the Commission that they would not be responsible.<sup>15</sup> Further, their ignorance of such improprieties will not avail them a defense unless they have made a reasonable investigation to discover them.<sup>16</sup>

If the investor is to be protected, then where the deterrent effect of the securities laws upon the issuer and underwriter is not sufficient, the responsibilities of the other persons involved in the sale of securities must be increased or additional persons must be found to accomplish this end. If the underwriter does not make a reasonable investigation, somebody else must. In connection with many of the transactions which come under the securities laws, the lawyer will usually be required, by the terms of the parties' contract or for the protection of his or her client or others, to give an opinion that the transaction does not violate the securities laws. The opinion, which becomes a condition precedent to the consummation of the transaction, is based upon the existence or non-existence of certain facts. The Commission is now attempting to hold lawyers to a duty somewhat analogous to that imposed upon an "expert" by section 11.<sup>17</sup> For many years the Commission has

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11. 1933 Act §§ 11-12, 17, 15 U.S.C. §§ 77k-l, q (1970); SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1972).

12. 1933 Act § 12(1), 15 U.S.C. § 77l(1) (1970).

13. 1933 Act § 12(2), 15 U.S.C. § 77l(2) (1970).

14. 1933 Act § 11(a), 15 U.S.C. § 77k(a) (1970).

15. 1933 Act § 11(b), 15 U.S.C. § 77k(b) (1970).

16. *Id.*

17. 1933 Act § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1970). In *SEC v. Spectrum, Ltd.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93, 631 (S.D.N.Y. 1972), the Commission unsuccessfully argued that a lawyer who writes an opinion in connection with the sale of a security is an "underwriter" of that sale.

contended that a lawyer has a duty to investigate his client<sup>18</sup> and now appears to take the position that if the client has committed a securities fraud, the lawyer will be liable as an aider and abettor where the fraud could have been uncovered by a reasonably thorough investigation or where the lawyer was in error as to the law unless he or she resigns and informs on his or her client.<sup>19</sup> The Commission is thus attempting to transform the attorney into a legal auditor; the counterpart of the accountant and the practical equivalent of the Section 11 "expert", whose duty it is to verify the information given to the public or the facts upon which an exemption from registration is claimed. This thrust raises important questions as to the investor's need for verified information<sup>20</sup> and, if such a need exists, by whom should it be filled and how. It is the purpose of this article to explore these questions and to offer an alternative method for supplying the investor with verified information.

## II. NEED FOR VERIFIED INFORMATION

Is there a need for verified information or is such an investigative process unnecessary in light of the Commission's review of registration statements and the deterrent effects of securities law liability? In addition to the audit of the financial statements, is there also a need for an audit of the other information by a person who, by withholding the necessary certification, could stop a fraudulent transaction before the investor is hurt? In answering these questions one must remember that the securities laws were designed to protect the public with the least possible interference with honest business.<sup>21</sup>

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18. SEC Securities Act Release No. 4445 (Feb. 2, 1962).

19. SEC v. National Student Marketing Corp., Civil No. 225-72 (D.D.C. filed Feb. 3, 1972). The SEC Complaint for injunctive and other relief is reprinted in full in BNA SEC. REG. & L. REP. No. 138 at D-3 (Feb. 9, 1972). See Karmel, *Attorney's Securities Laws Liability*, 27 BUS. LAW 1155 (1972) [hereinafter cited as Karmel]. Note, *Attorney's Liability—Advising, Abetting, and the SEC's National Student Marketing Offensive*, 50 TEXAS L. REV. 1265 (1972). See also Ruder, Wheat & Loss, *Standards of Conduct Under the Federal Securities Acts*, 27 BUS. LAW. 75 (Spec. Issue, Feb. 1972); Comment, *SEC Disciplinary Rules and the Federal Securities Laws: The Regulation, Role and Responsibilities of the Attorney*, 1972 DUKE L. REV. 969 [hereinafter cited as Comment].

20. The term "verified information" is used here to mean, unless the context otherwise requires, that information, including facts upon which an exemption from registration is claimed, the truth and completeness of which have been borne out by a competent and reasonably thorough investigation.

21. 1 Loss 127 (footnote omitted).

## A. THE NEED FOR PREVENTION

It is, of course, the *prevention* of frauds and securities act violations that is the primary concern.<sup>22</sup> It is very unlikely that once an investor has been defrauded he will ever recover the full amount of his losses. The investor may be reluctant to bring suit especially if his losses are comparatively small, because of the expense, time and unpleasantness involved. The proceeds to the investor of any recovery he is awarded will be reduced by the amount of attorney's fees. The use of the class action device has made litigation an economically viable alternative where the individual claims are small but there are many of them. Class action suits, however, tend to be protracted, complex and are often settled for a small fraction of the actual loss.<sup>23</sup> Moreover, proof of individual claims may be more expensive than the claim itself is worth.

The investor's loss is likely to extend beyond the price of the security and there is no provision for recovery of these damages.<sup>24</sup> Because the investor has purchased that particular security, he has foregone other, possibly profitable, opportunities. If the stock securities he purchased were used as collateral, their loss of value might have severe consequences.<sup>25</sup> In addition, the investor may later find himself, for unrelated reasons, in financial trouble from which he might otherwise have been able to extricate himself. There is also the need to protect the imprudent but by no means uncommon investor who, counting his profits before the returns are in, financially overextends himself.

To be sure, some of those investors who would be the most severely injured by these losses may be protected by stricter enforcement of suitability rules.<sup>26</sup> Nevertheless, the point remains that

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22. *Feit v. Leasco Data Processing Equip. Corp.*, 332 F. Supp. 544, 567 (E.D.N.Y. 1971).

23. *See, e.g., In re Four Seasons Securities Law Litigation*, BNA SEC. REG. & L. REP. No. 183 at A-12 (Jan. 3, 1973) (W.D. Okla.). Judge Thomsen approved settlement for 8% (\$8,000,000) of the claims because of the protracted and complex nature of the case and because there were few solvent defendants.

24. Consequential damages are recoverable where the plaintiff can establish "the causal nexus with a good deal of certainty." *Zeller v. Bogue Electric Manufacturing Corp.*, CCH FED. SEC. L. REP. ¶ 93,903 (2d Cir. 1973) at 93,623. This type of consequential damages includes money spent to investigate the issuer before purchase of its shares, beyond this, the strict causation requirement will make recovery very difficult.

25. Cf. SEC Rule 144(h), 37 Fed. Reg. 596 (1972).

26. *E.g.* CCH NASD MANUAL art. III, § 2, ¶ 2152. For a discussion of proposed additional suitability rules for the sale of the securities of an unseasoned issuer, see NASD, Notice to Members 73:17 (Mar.

much of any investor's loss will never be recouped. Moreover, the loss extends beyond the individual investor and his family. The economy suffers from the resultant misallocation of capital resources as does the honest enterprise to which that capital might otherwise have gone.

#### B. THE SECURITIES AND EXCHANGE COMMISSION

A brief sketch of the requirements for a registration statement and the procedure involved in processing it may be helpful in more fully understanding the amount of protection this process can afford the investor.<sup>27</sup> Each registration statement in addition to meeting certain general requirements<sup>28</sup> must be prepared according to the proper form<sup>29</sup> which is usually Form S-1.<sup>30</sup> The thirty-two classes of information and documents required solicit what might be called the primary disclosures. In addition to producing a portrait of the issuer and the details of the proposed sale, probes are sent into the classic areas of unfairness such as transactions between the issuer and its affiliates. The form also requires that the issuer submit, as exhibits, copies of its articles of incorporation, by-laws and other documents including material contracts and the opinion of counsel as to the legality of the issue under state law. Rule 408<sup>31</sup> solicits what might be called secondary disclosures: "such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they are made, not misleading."

The registration statement is processed at the Commission by one of the branches of the Corporate Finance Division. Each branch consists of security analysts, accountants, examiners and attorneys and has available for consultation a corps of experts including statisticians, engineers, geologists and valuation specialists. The branch is often familiar with the particular industry in which the issuer operates and with the typical problems that face members of that industry. The information supplied by the issuer is matched against this knowledge to check for deficiencies. The registration statement is also checked against the financial statements and the exhibits for internal consistency. If the registration statement is clearly deficient, the Commission might "bedbug" it, i.e.,

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14, 1973). The suitability rules are designed to prevent investors from taking on risks greater than they are able to reasonably bear.

27. See 1 Loss 272-283.

28. SEC Reg. C, 17 C.F.R. §§ 230.400, -.494 (1972).

29. *Id.*

30. 17 C.F.R. § 239.11 (1972).

31. 17 C.F.R. § 230.408 (1972).

send it back without comment, or if it suspects fraud, open an investigation. Most often, however, the Commission will send a letter of comment, suggesting that certain changes, usually in emphasis, be made. If the issuer does not comply with these comments, the Commission may refuse acceleration<sup>32</sup> or issue a stop order,<sup>33</sup> either of which would be fatal to most offerings. Because of the length of time involved, judicial review is of little use, and for all practical purposes the Commission has final say.

The examination has its limits. Although the Commission has the power to make field investigations, such investigations, partially because of the limited number of personnel, are rare. The Commission does have copies of officers' employment contracts, labor contracts, supply contracts, franchises, *etc.* which verify or contradict the claims made or indicate problems not mentioned in the registration statement. And if the issuer makes a positive statement, *e.g.*, that it is the largest in terms of sales in its industry, the Commission can and often does ask for verification. If, however, the registration statement is internally consistent and a misstatement or omission cannot be deduced from the documents submitted, that misstatement or omission will probably go undetected. The Commission must in these circumstances rely heavily upon the issuer's word and the deterrent effect of the securities laws. While the requirement that primary disclosures must be made makes omissions in that area more difficult, although not impossible, outright lies and misrepresentations may go undetected. Even harder to detect would be omissions in the area of secondary disclosures. How likely is it that the Commission would discover that a major customer which is a close corporation is in financial trouble or that a material setback has been suffered on a research program? Their knowledge in such cases may be wholly dependent on the fortuity of an anonymous tip.

In addition to the requirements of the 1933 Act, any issuer who applies for the listing of any class of its security on a national securities exchange<sup>34</sup> or who has more than one million dollars in gross assets and a class of equity security held by 500 or more persons<sup>35</sup> must also file a Form 10 registration statement<sup>36</sup> with the Commission. Those issuers and any issuer who has had a public offering within the year<sup>37</sup> must also file annual and other pe-

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32. 1933 Act § 8(a), 15 U.S.C. § 77h(a) (1970).

33. 1933 Act §§ 8(b), (d); 15 U.S.C. §§ 77(b) (d) (1970).

34. 1934 Act § 12(b), 15 U.S.C. § 78l(b) (1970).

35. 1934 Act § 12(g), 15 U.S.C. § 78l(g) (1970).

36. 17 C.F.R. § 249.210 (1972).

37. 1934 Act § 15(d), 15 U.S.C. § 78o(d) (1970).



riodic reports,<sup>38</sup> definitive copies of their proxy material<sup>39</sup> and certain informational reports.<sup>40</sup> These reports, except for the proxy material, are not sent to the shareholder although they are public information. The Commission's review of these Form 10 registration statements, annual and periodic reports, and proxy material is similar in nature to that given registration statements filed pursuant to the 1933 Act and is therefore subject to many of the same limitations. Because there are a great number of filing requirements under the 1934 Act the Commission does, however, have the advantage of being able to cross check these filings one against the others.

With some exceptions,<sup>41</sup> most notably a public offering pursuant to Regulation A,<sup>42</sup> there is no requirement that the Commission ever be informed of sales exempt from registration, much less review the disclosures made in connection with those sales. In the case of many of the securities so issued, the fraud will be completed and the damage done before the 1934 Act reporting requirements are applicable. Although the Commission has the power to and does investigate, and, if it believes warranted, will sue for an injunction, it must first have some knowledge of the transaction and its illegal nature. Unfortunately, such knowledge may come only sporadically and in the form of investor complaints, anonymous tips and perhaps even suspicious newspaper advertisements.

The Commission does perform a very valuable service to investors by making sure that the material information of which it

38. 1934 Act § 13, 15 U.S.C. § 78m (1970). The most commonly used forms are SEC Form 8-K, 17 C.F.R. § 249.308 (1972) (current reports); SEC Form 10-Q, 17 C.F.R. § 249.308a (1972) (quarterly reports); and SEC Form 10-K, 17 C.F.R. § 249.310 (1972) (annual reports).

39. SEC Rule 14a-6, 17 C.F.R. § 240.14a-6 (1972). A person making a request for tender of the securities of reporting companies must also file a report if that person would beneficially own more than five per cent of that security after consummation of the transaction. SEC Rule 14d-1, 17 C.F.R. § 240.14d-1 (1970).

40. *E.g.* SEC Form 3, 17 C.F.R. § 249.103 (1972) (initial statement of beneficial ownership of securities).

41. The Commission must be notified of sales made pursuant to SEC Rule 144, 37 Fed. Reg. 596 (1972). Notification would also be required, with certain exceptions, under proposed SEC Rule 146(h), 37 Fed. Reg. 26137, 26141 (1972).

42. 17 C.F.R. §§ 230.251-263. If the offering is over \$50,000, a notification on SEC Form 1-A, 17 C.F.R. § 239.90 (1972), containing an offering circular must be filed with the appropriate SEC regional office. SEC Rule 255, 17 C.F.R. § 230.255 (1972). Regulation A, in effect, is not an exemption but rather is a less burdensome form of registration. *See generally* 1 Loss 619-625.

is aware is so positioned, emphasized and explained in the prospectus or proxy that the investor who reads the prospectus or proxy will be made aware of that information and fully comprehend its meaning. The presence of the Commission and its energy in themselves reduce the patency, if not the amount, of fraud by increasing the risks perceived by those who contemplate transgression. The vast majority of registration statements and other documents filed with the Commission are submitted in good faith. Yet, in a small number of cases, blatantly fraudulent registration statements such as that of BarChris Construction Company<sup>43</sup> will be filed and become effective. The Commission cannot catch all securities sinners. In that respect its problems are not unlike any other enforcement agency's.

### C. THE DETERRENT EFFECT

The securities acts subject those who violate its provisions to heavy civil and moderate criminal liabilities. This "*in terrorem*" liability extends beyond the boundaries of corporate form to encompass controlling persons, certain officers, directors, underwriters, sellers and others. The deterrent effect of all criminal laws has been seriously questioned; deterrence appears to be a function of the perceived likelihood of being caught and prosecuted as much as the amount of the penalty.<sup>44</sup> Those who are outright swindlers usually believe they will not be caught. Moreover, criminal prosecution for securities fraud is usually reserved for the most gross abuses. In most cases the Commission will use the injunctive process, which carries quasi-criminal consequences.<sup>45</sup> Civil liability is the main threat, and prospect of personally having to refund a multimillion dollar stock issue is indeed frightening.

There are several factors, however, which either lessen or counteract this deterrent effect. The primary factor is the seemingly limitless optimism of the entrepreneur.<sup>46</sup> Because the measure

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43. *Escott v. BarChris Constr. Co.*, 283 F. Supp. 643 (S.D.N.Y. 1968). Cf. *SEC v. Equity Funding Corp.*, BNA SEC. REG. & L. REP. No. 197 at A-6 (April 11, 1973) (C.D. Cal.).

44. See generally H. PACKER, *THE LIMITS OF THE CRIMINAL SANCTION* (1968).

45. E.g. 1934 Act § 15(b) (5) (C), 15 U.S.C. § 78o(b) (5) (c) (1970) (giving the Commission power to revoke the registration of a broker who is enjoined); and SEC Rules of Practice 2(e) (3) (i) (a), 17 C.F.R. § 201.2(e) (3) (i) (a) (1972) (giving the Commission power to suspend, without a hearing, the privilege of practicing before it).

46. *THE REPORT OF THE SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 514 (1963) [hereinafter cited as *SPECIAL STUDY*].

of liability is basically the amount of the decrease in price of the security from the public offering price,<sup>47</sup> the issuer and others subject to liability have little to fear if the price of that security increases. Similarly, most of the injunctions sought by the Commission against officers and directors of an issuer have been in the wake of financial debacles. Most entrepreneurs are highly optimistic by nature. Generally, most have a large personal stake in the outcome of their enterprise and are thoroughly convinced that it will prosper. This assuredness of future prosperity—if enough capital can be raised—may lead him or her in his or her efforts to convince the underwriter or investor of the desirability of sharing in his or her venture by putting up the necessary capital, to consciously overstate the potential of that venture and either to ignore potential problems or dismiss them as trifling. This natural optimism and years of training to “think positive” may have a subtler effect: they may condition the entrepreneur psychologically to filter out negative input, making it impossible for him or her to realistically view or describe the enterprise.

The deterrent effect of civil liability is further counteracted when, combined with this overly optimistic view, the issuer perceives the information in question to be sensitive. The issuer may be perfectly willing to tell all to the investors but balk at disclosing that information to competitors or labor unions.<sup>48</sup> The information might also concern another corporation on which the issuer is to some degree dependent, and who can assert some pressure on the issuer not to disclose. The issuer may, for example, have confidential information that one of its substantial customers, a close corporation, is beginning to have serious financial trouble and that the customer has submitted false financial statements to its other creditors. The issuer, while believing that the customer might survive if it is given time to recover, knows that failure of that customer would have a material effect on the issuer's sales and earnings. The issuer will be extremely reluctant to make a disclosure which might very well precipitate that failure. Similarly, an issuer whose business depends on a license may be reluctant to make certain disclosure about its licensor, especially if that license easily could be terminated. This type of situation is made more difficult when an officer of such a customer or licensor sits on the issuer's board of directors.

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47. 1933 Act §§ 11-12, 15 U.S.C. §§ 77k-1 (1970).

48. SEC Rule 485, 17 C.F.R. § 230.485 (1972), does provide for confidential treatment and non-disclosure if the Commission determines that disclosure is not necessary for the protection of investors. However, an application for confidential treatment is rarely granted.

In cases such as the case of the troubled customer above, where there is a possibility of the occurrence of an event which would have a material adverse effect on the issuer, that probability must be disclosed if it is "material".<sup>49</sup> One verbal formulation of the concept of materiality, used in the context of measuring the materiality of facts relating to the possibility of an event, is a balance of

both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity.<sup>50</sup>

This formulation is probably similar to the intuitive calculation made by the entrepreneur in his decision of what information, if any, should be disclosed to the investor. But the same optimism which makes objectivity so difficult may lead an entrepreneur who is aware that there is some possibility of a devastating event, to undervalue the probability that that event will occur. Moreover, the entrepreneur may have the feeling that if his or her enterprise should ever fail, it will not be caused by the happening of that event. Even for those actions in which causation is not an element,<sup>51</sup> the necessary element of materiality may prove difficult if that event never did occur or occurred years later. The entrepreneur's biased, unrealistic, misrepresented belief in the non-occurrence of that event turned out to be correct. In this case the benefit of hindsight works for the defendant.

Management may also consciously choose to take the risk of violating the securities laws when it is desperate for new capital. The seemingly far off possibility of a law suit may be a small deterrent to one who sees his or her job or company in immediate danger. Indeed, few risks might seem too great to be taken to save a corporation which that person has spent much of his or her life building.

To be sure, these factors do not operate to the same degree on all of the officers and directors subject to liability under section 11. Persons named as about to become directors and "outside" directors are more capable of objectivity and, having a much smaller stake in the enterprise, are less likely to be willing to risk a law suit. On the other hand, although they are required to be diligent in their investigation of the company, their vigor still may be lulled by an enthusiastic and confident management. Where the director is on the board because of his skill as a scientist or technical expert,

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49. Cf. SEC Rule 408, 17 C.F.R. 230.408 (1972).

50. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

51. See 6 Loss 3880-83.

he may not only be incompetent to investigate the non-technical aspects of the company but may also be unaware of the scope of his responsibility under the securities laws as well. Many corporations do not have outside directors. The *Federal Securities Code* would make a valuable contribution by allowing the court to differentiate between standards to be applied to the inside and outside directors.<sup>52</sup> Until the courts do discriminate between inside and outside directors, it is understandable that those who are aware of the responsibility and potential liability involved are reluctant to become directors.<sup>53</sup> This is salutary in that the investor does not rely on the prestigious name of a director who will not direct, but, at the same time, any positive force such a director might provide is lost. In deciding whether to become a director, a person is well advised to consult with his own attorney and, if feasible, to have his own attorney conduct a due diligence investigation before the company publicly sells its securities.

Aside from the accountants and other experts, the section 11 party most likely to be objective and to induce full disclosure is the underwriter. The underwriter is in a position<sup>54</sup> to make a thorough investigation of the issuer. The underwriter's personnel and counsel generally should have the necessary knowledge of finance, accounting, general business matters and law to make a competent investigation. Unfortunately, this potential is not always actualized. In its *Special Study*, the Commission found that while some of the older, more established investment banking firms conducted a very careful due diligence investigation,

many of the newer underwriters were lax in performing their responsibilities to investigate issuers whose securities they intended to sell to the public.<sup>55</sup>

Many of these newer firms lacked experience and were often not familiar with the "complex controls governing underwriting."<sup>56</sup> Of the 503 underwriters who managed offerings of the common stock of an "unseasoned" issuer in 1961, 135 had no one on their staff with at least five years' experience and 57 had no one with

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52. ALI FED. SEC. CODE § 1403 (f) (Tentative Draft No. 2, 1973).

53. See, e.g., *Courts Faulted on Directorships*, N.Y. Times, April 7, 1973, at 43, col. 1. For a humorous but insightful account of the plight of a corporation seeking an outside director, see Farrell & Murphy, *Comments on the Theme: "Why Should Anyone Want to Be a Director?"*, 27 BUS. LAW. 7 (Spec. Issue Feb., 1972).

54. "Only the underwriter and the accountant are free to assume an adverse role. . . ." Comment, *BarChris: Due Diligence Refined*, 68 COLUM. L. REV. 1411, 1421 (1968).

55. SPECIAL STUDY, *supra* note 46, at 514.

56. *Id.*

more than two years' experience.<sup>57</sup> Of those 503 firms surveyed in 1961, 146 had nobody with over two years' experience.<sup>58</sup> The capital commitment of the newer firms was "usually minimal;" many were virtually judgment proof "and therefore less impressed by the sanctions of section 11."<sup>59</sup> Of that same 503 firms, 104 had an adjusted net capital of less than \$10,000.<sup>60</sup>

The *Special Study* was published five years before *Escott v. BarChris Construction Corp.*<sup>61</sup> was decided. That case held, *inter alia*, that underwriters had a duty to investigate and could not merely rely on the word of management. Predictably, conditions improved after that decision. However, as a result of its *Public Investigation in the Matter of the Hot Issue Securities Markets*,<sup>62</sup> the Commission concluded that some underwriters still do not conduct reasonable investigations.<sup>63</sup> Moreover, there is a wide disparity as to the quality of due diligence investigations conducted by underwriters.<sup>64</sup> This variation and uncertainty as to what is required further serves to lessen investor protection.<sup>65</sup>

The underwriter's lack of due diligence in the investigation of its clients may result from factors other than incompetence or indifference to civil liability. The underwriter might think it unnecessary or may be unwilling to question the word of a gentleman, especially in this industry which relies so heavily upon trust. The underwriter himself also may be overly optimistic and may not be immune to the feelings of optimism projected by the issuer and may thus relegate the investigation to a lower priority on its busy time schedule. Above this, while the underwriter is in some sense adverse to the issuer, it is hardly disinterested. There is, of course, the profit to be made from that underwriting. More than this, the number of underwritings managed by a particular underwriter is a source of prestige and a calling card for participation in the syndication of underwritings managed by other firms.<sup>66</sup> On the other hand, issues which are not successfully sold not only negate those effects but also make it more difficult to form

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57. *Id.* at 612.

58. *Id.*

59. *Id.* at 514.

60. *Id.* at 612.

61. 283 F. Supp. 643 (S.D.N.Y. 1968).

62. SEC Securities Act Release No. 5275, 37 Fed. Reg. 16011 (Aug. 9, 1972) [hereinafter cited as *HOT ISSUE INVESTIGATION*].

63. *Id.* at 16012.

64. *Id.*

65. *Id.*

66. Hayes, *Investment Banking: Power Structure in Flux*, 49 HARV. BUS. REV. 136, 146 (March-April, 1972) [hereinafter cited as Hayes].

syndicates for future issues as well. Salesmen may, particularly in a hot issue market, put considerable pressure upon an underwriter to supply them with additional securities to sell. This is strong incentive for the underwriter to resolve any doubts in its own favor.

As a result of the Commission's *Hot Issue Investigation*, the National Association of Securities Dealers, Inc. (NASD) commendably has proposed new rules and amendments to its Rules of Fair Practice. The proposed new rule<sup>67</sup> would require the managing underwriter to establish and maintain its own written policy of due diligence investigation procedures. The minimum procedure would consist of fourteen areas of investigation (fifteen in the case of tax-sheltered programs) and the maintenance of adequate records documenting that investigation. In addition, the managing underwriter would have to certify in the underwriting agreement, or, if none, in the Prospectus that such an investigation has been duly performed.<sup>68</sup> The NASD would also require that each member which is engaged in underwriting have a "Qualified Underwriter Principal"<sup>69</sup> (QUP) who would be responsible for organization and supervision of the member's participation in that underwriting. The QUP would be required to have at last three years' experience and pass an examination designed to test competency in "(1) accounting and financial analysis; (2) regulations of the Commission and NASD pertaining to securities distributions; and (3) preparation of registration statements."<sup>70</sup> The QUP would thus have the necessary experience and expertise to conduct the required due diligence investigation and to integrate the results of the investigation into the registration statement.

There is much to recommend strongly the passage of these proposed rules. The extent of the investigation required by section 11 is uncertain; courts can only assess the investigation made by the underwriter with the benefit of hindsight and may lack the expertise to set out specific, affirmative standards for such an investigation. The rules would set out uniform guidelines for such an investigation. Another contribution, of no less importance, is that the rules would affirm and give a positive definition

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67. NASD Rules of Fair Practice, art. III, § 35, NASD Notice to Members No. 73:17 (March 14, 1973) at 9. The proposed rule is set forth in an appendix to this article.

68. *Id.*

69. NASD Rules of Fair Practice, art. I, § 2(d) Sch. "C"(4), NASD Notice to Members No. 73:17 (Mar. 14, 1973) at 14. This proposal is set forth in an appendix to this article.

70. *Id.*

to the investigative role of the underwriter. Moreover, responsibility for supervision of that investigation would be placed upon specific qualified individuals.

There are, however, areas where the numerous requirements of the rules could be extended profitably. The rule would require that the underwriter give "consideration to the necessity" of hiring an outside consultant to conduct portions of the investigation where the issuer is a "promotional organization or engaged in marketing high technology or previously unmarketed products."<sup>71</sup> The utilization of a knowledgeable consultant in such circumstances would seem to be essential to an effective investigation. The QUP, if ignorant of the specific problems and pitfalls of a particular industry or situation, would not only not know what to look for but also would be unable to evaluate what he or she actually did find as well. Accordingly, the use of an outside consultant who is an expert in the issuer's field should be made mandatory under those circumstances, at least when no member of the underwriter's staff has the requisite expertise.

The first item of investigation merely requires "[r]eview by the underwriters' counsel of the issuer's corporate charter, by-laws, and corporate minutes."<sup>72</sup> The review required should be more extensive; it should be a complete legal audit, which would include review of the stock book, all contracts of the issuer with its management and affiliates, and all other material contracts, leases and franchises. The underwriter's review might also be expanded to include reasonable inquiries into the status of other corporations, if any, upon whom the issuer is dependent in terms of sales, backlog, supply or sub-contracting. Inquiry into the issuer's relations with its employees might also be appropriate.

A more fundamental criticism is that there is little guidance as to the extent and intensity of "review" or inspection necessary. While it is difficult to formulate what is basically a definition of reasonableness, especially in circumstances which may differ so greatly, certain procedures might be suggested. An inspection of the issuer's files might be appropriate with respect to a specific area which has not otherwise been documented. To further assure a more comprehensive investigation, NASD also might require that the member's written general investigative procedure be kept on file with the NASD or with the Commission and that a summary of the investigation carried out with respect to a particular registration be filed with the registration statement as an

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71. *Id.* art. III, § 35(a) (8).

72. *Id.* § 35(a) (1).



exhibit at least when the company is in the "promotional, developmental or exploratory" category.<sup>73</sup>

These rules, if passed, may add another arrow to the quiver of investor causes of action. The investor will have a cause of action against the NASD should the NASD fail to be reasonably diligent in enforcing the rules.<sup>74</sup> On the other hand, the status of the availability of private causes of action against NASD members for failure to comply with NASD rules is not clear.<sup>75</sup> In one circuit, apparently, a private right of action exists for a violation of any rule of the NASD which is designed to prevent fraud.<sup>76</sup> In other circuits, the decisive issue is likely to be whether the NASD rule is a substitute for a rule of the Commission<sup>77</sup> (upon which there is clearly a cause of action). The importance of verification in the prevention of fraud and the fact that the Commission, after its investigation, requested the NASD to promulgate these rules indicates that they may well be a substitute for direct regulation by the Commission. While this additional cause of action may offer little extra coverage beyond section 11 and Rule 10b-5, the rules may well serve to define the reasonable investigation required by section 11. A violation of the rules by itself may be the basis for a 10b-5 action.<sup>78</sup>

The actual effect of the proposed rules is uncertain. The rules proposed by the NASD will not negative the underwriter's, especially the managing underwriter's, incentives to violate the securities laws. Moreover, the person with final authority to decide whether that risk should be taken may not be the QUP. While the rules state that the QUP shall be responsible for the "organization and/or supervision," the certification is made by "the underwriter" and the person who conducted the investigation may not have control over whether that certification is given.<sup>79</sup> This is not to fault the rules; perhaps the only way to overcome the incentive to violate the securities laws is to put the investigation—and power

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73. Cf. Testimony of Howard D. Sterling, Esq., *HOT ISSUE INVESTIGATION*, *supra* note 62, Mar. 6, 1972. Mr. Sterling also points out that failure of the underwriter to perform a due diligence investigation may be in itself a material fact which must be disclosed.

74. *Baird v. Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

75. Comment, *supra* note 19.

76. *SEC v. First Securities Co. of Chicago*, 463 F.2d 981 (7th Cir. 1972).

77. *Colonial Realty Corp. v. Bache & Co.*, 358 F.2d 178 (2d Cir.), *cert. denied*, 385 U.S. 817 (1966).

78. *V. BRUDNEY & M. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE* 1088 (1972).

79. NASD Rules of Fair Practice, art. III, § 35(c), *supra* note 67, at 12.

of certification—in the hands of someone who does not face those temptations.

The liability for fraudulent sales of securities does not by any means end with section 11. Section 12(2) of the 1933 Act and Rule 10b-5 impose liability upon those “sellers” who sell by misrepresentation or omission. The courts have defined “seller” to mean not only those who pass title but also agents and aiders and abettors as well.<sup>80</sup> While this liability may deter the seller from making additional misrepresentations, in most cases of a registered offering the seller will be too far removed from the issuer to act as a check upon the issuer. The dealer or selling group member is also not free from temptation. The selling concession may comprise as much as sixty per cent of the underwriting spread and a successful selling effort may be doubly important to a selling group member who wishes a participation as an underwriter in the manager’s next syndicate.<sup>81</sup>

The liability for material misrepresentations or omissions imposed under sections 11 and 12(2) is to a degree—dependent upon the extent to which negligence is equivalent to fraud—duplicated by Rule 10b-5.<sup>82</sup> Notwithstanding the procedural advantages<sup>83</sup> of an action on Rule 10b-5, because the coverage is largely duplicative, it is doubtful that Rule 10b-5 provides much of an additional deterrent in that area. This is in contrast to the role of Rule 10b-5 as the major deterrent in the area of corporate reports, interim disclosures and insider trading. It is likewise in doubt how much extra deterrent is provided by state common law and blue sky liabilities.<sup>84</sup>

The results of the *Special Study* and the *Hot Issue Investigation* lead to the conclusion that investigation and verification of information are the key to the prevention of fraud and the protection of the investor. The underwriter bears primary responsibility for perfecting this protection. Investigative practices vary widely between underwriters and between underwritings. It may

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80. *E.g.* SEC v. North American Research & Development Corp., 424 F.2d 63 (2d Cir. 1970). See Ruder, *Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delicto, Indemnification, and Contribution*, 120 U. PA. L. REV. 597 (1972).

81. Hayes, *supra* note 66, at 144.

82. See, *e.g.*, Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961). But see 6 Loss 3886-88.

83. Possibly including a longer statute of limitations. But see 6 Loss 3898-900.

84. A state blue sky commissioner might refuse to permit sales in that state if the terms of the offering were unfair. *E.g.* UNIFORM SEC. ACT § 306(a); CAL. CORP. CODE § 25140 (West 1973).

be that the underwriter's investigation which would be required by the new NASD rule is an adequate balance of investor protection and burden upon business. However, this still leaves the investor dependent on the conscience and competence of the individual underwriter. Within the guidelines the underwriter may still be lax in its investigation, too readily satisfied with incomplete answers, and may semi-consciously close its eyes to problems. To the extent that the protection afforded by the underwriter's investigation proves to be inadequate, the question becomes how much more protection reasonably can be given to investors and by whom.

### III. LAWYER AS AUDITOR?

#### A. THE ROLE OF THE LAWYER

The lawyer, unlike the underwriter, is not free to be adverse to his or her client. The lawyer's duty to "represent his client zealously within the bounds of the law"<sup>85</sup> is not limited to a trial setting. The lawyer who negotiates for his client or who represents his client before an administrative agency must also be a zealous advocate, seeking to advance the lawful objectives of his client. In addition to arguing those inferences of fact and constructions of law which would allow the client to prevail, the lawyer should make full use of his skills in advocacy and bargaining to advance the client's cause. Nor is the duty of zealous representation limited to advocacy. As an advisor, the lawyer should "exert his best efforts to insure that the decisions of his client are made only after the client has been informed of relevant considerations."<sup>86</sup> The lawyer should not only inform the client of all relevant legal considerations but also should give his client the benefits of his other knowledge and experience as well. As a planner, the lawyer should do his best either to structure the transaction for the client so that it complies with the law and still accomplishes the client's objectives, or arrange or construct the legal framework through which the client's objectives may be accomplished.

The role of the securities counsel representing his client in a setting other than litigation is a complex one. He or she must act as independent expert, planner, advisor, negotiator, draftsman, and advocate, sometimes simultaneously. Simply stated, the law-

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85. ABA CODE OF PROFESSIONAL RESPONSIBILITY, CANON NO. 7 [hereinafter cited as CPR].

86. CPR, ETHICAL CONSIDERATION 7-8 [Ethical Consideration hereinafter cited as EC].

yer's realistic goal is to assist the client in complying with the securities laws and minimize the extent to which those laws interfere with the client's legitimate objectives. In essence, the lawyer must match his or her client's legitimate objectives and needs against the requirements of the securities laws. Where they conflict, the lawyer should ascertain and counsel minimum compliance or, if possible and necessary, abortion of the transaction. This function is made difficult by the securities laws' complexity and their lack of predictability.<sup>87</sup>

In a registration statement the client expects the lawyer to maximize the value of the Prospectus as both an insurance policy against future liability and as a selling document in addition to getting the registration through the Commission. The issuer wishes to hold negative or sensitive disclosures down to the absolute minimum, and the underwriter also wants a Prospectus that will be most useful to the salesman. "Within the bounds of the law" the lawyer should use his skills as planner, draftsman, negotiator, and advocate to accomplish these goals.<sup>88</sup>

The securities laws require that all material information concerning the issuer and the transaction be disclosed fully to the investor. While in most cases the materiality or non-materiality of a particular fact or item of information will be clear, in other cases it may present a difficult factual question on which reasonable minds will differ. Where the issue of materiality is unclear and the disclosure of the information may be detrimental to other legitimate interests of the client, the lawyer should explain the

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87. SEC, DISCLOSURES TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS at 56 (1969) [hereinafter cited as *THE WHEAT REPORT*].

88. This "maximization" is coming under increasing criticism.

In at least some instances, what has developed in lieu of the open disclosure envisioned by the Congress is a literary art form calculated to communicate as little of the essential information as possible while exuding an air of total candor. Masters of this medium utilize turgid prose to enshroud the occasional critical revelation in a morass of dull, and—to all but the sophisticates—useless financial and historical data. In the face of such obfuscatory tactics the common investor is almost as much at the mercy of the issuer as was his pre-SEC parent. He cannot by reading the prospectus discern the merit of the offering.

*Feit v. Leasco Data*, 332 F. Supp. 544, 565 (E.D.N.Y. 1971). The lawyer's leeway in this area may depend on the "degree" of materiality of the item in question and whether it is a general business risk. Compare *Feit v. Leasco Data* (clouded disclosure of \$100,000,000 of assets of acquired company in acquisition insufficient) with *Hohman v. Packard Instrument Co.*, 471 F.2d 815 (7th Cir. 1973) (clouded disclosure of risks of new product development held not misleading).

uncertainty and the risk to the client who must decide whether the item is to be included. If the client decides not to include the fact or item of information, the lawyer should abide by that decision if he or she can do so in good conscience.

Because of the expense involved and for other legitimate reasons the client may wish to sell securities without registration. The issuer's objective is to raise the needed capital with as much latitude as possible without violating the securities laws. The client might also be, technically, a controlling person of the issuer<sup>89</sup> who is unwilling to register his or her shares.<sup>90</sup> The lawyer's job is to find a way that the shares may be legally sold.

The securities laws were designed to protect the investor with the least possible interference with honest business.<sup>91</sup> The law must function to provide safeguards to the investor rather than to frustrate legitimate and socially desirable objectives. Where the objectives are legitimate, it is the lawyer's "positive duty to show the client how to avail himself to the full of what the law permits."<sup>92</sup>

The counselor's duty does not end with his responsibilities to his client. The lawyer is also responsible to society both as a lawyer and as a citizen. Moreover, the responsibility of the lawyer when he counsels a client is morally, if not legally, greater by virtue of his or her influence over the future conduct of the client. The lawyer as counselor may be faced with many situations in which difficult ethical questions arise. Unfortunately, very little attention

89. "Controlling persons" are deemed "issuers" for the purpose of determining whether the person who sold the security for the controlling person is an underwriter and therefore destroying the section 4(1) exemption. 1933 Act §§ 2(11), 4(1), 15 U.S.C. §§ 77b(11), 77d(1) (1970). A "control person" or "affiliate" is circularly defined as "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." SEC Rule 405, 17 C.F.R. § 230.405 (1972). The *Federal Securities Code* would eliminate the considerable uncertainty of operating under such concepts, by requiring that all persons who sell more than \$100,000 of the security in other than a limited offering (counterpart to the present non-public offering exemption) must file a "distribution statement." ALI FED. SEC. CODE §§ 227, 228, 253, 509 (Tent. Draft No. 1 1972). The concept of control would, however, be retained for other purposes, but certainty would be aided by rebuttable presumptions.

90. The *Federal Securities Code* would provide for registration by the issuer on demand of the shareholder unless waived by the shareholder. ALI FED. SEC. CODE § 501(b) (Tent. Draft No. 1, 1972).

91. 1 Loss 127 (footnote omitted).

92. CPR, EC 7-1, n.6 (footnote omitted) (referring to a tax lawyer).

has been given by the Code of Professional Responsibility (CPR) to the responsibilities of the lawyer to society and to the involved individuals in his or her role of giving an opinion. Indeed, if attention may be measured by the amount of writing on a subject, the scholars in the field of legal ethics virtually have ignored the lawyer's responsibilities in connections with his or her opinion until the matter was in the courts with two prestigious law firms accused of aiding and abetting the allegedly illegal and fraudulent conduct of their clients.<sup>93</sup>

#### B. LAWYER'S DUTY TO INVESTIGATE

A distinction should be drawn between the duty not to ignore obvious indications that a statement is false and the duty to investigate. If there are obvious indications that the client's statements are false the lawyer cannot close his or her eyes to those indications; such conduct is and should be tantamount to the knowledge required for the imposition of aider and abettor liability.<sup>94</sup> To have knowledge of a fact in this sense does not require that one be absolutely certain that the fact exists. In a criminal prosecution where knowledge is an element of the offense, such as aiding and abetting, "such knowledge is established if a person is aware of a high probability of its existence, unless he actually believes that it does not exist."<sup>95</sup> It is just as culpable to purposely avoid having knowledge as it is to have the knowledge itself. If a person has observed or been informed of those facts which constitute that high probability of the existence of another fact, he or she is

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93. SEC v. National Student Marketing Corp., Civil Action No. 225-72 (D.D.C. filed Feb. 3, 1972). Note 19 *supra*. The Canons of Ethics require that a lawyer not engage in conduct which he or she knows to be illegal. CPR, DR 7-102(a) (7). The lawyer is also required to disclose the fraudulent conduct of clients in the course of representation if the lawyer cannot convince the client to rectify the fraud. CPR, DR 7-102(b). However, the force of these provisions has been diluted by the opinions of the Bar. ABA Comm. on Professional Ethics, Opinions, Nos. 287 (1953) and 314 (1965). The Bar may be unwilling to enforce even these diluted standards. See Comment, *supra* note 19, at 975. While the Commission may disbar a lawyer for unethical conduct, SEC Rules of Practice 2(e) (1), 17 C.F.R. § 201.2 (e) (1) (1972), the procedure is clumsy. See Comment, *supra* note 19. Moreover, many of the formal rules of evidence, especially the hearsay rules, apply, and the limits on review of administrative agency determinations may not be applicable as this is not an area of administrative expertise. *Kivitz v. SEC*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,746 (D.C. Cir. 1973).

94. SEC v. Frank, 388 F.2d 486 (2d Cir. 1968).

95. *United States v. Sarantos*, 455 F.2d 877, 881 n.4 (1972), citing MODEL PENAL CODE § 2.02(7) (Proposed Official Draft, 1962).

said to have knowledge although it cannot be proven that he or she drew the obvious ultimate conclusion. Thus in *SEC v. Frank*,<sup>96</sup> the lawyer would have been found to have knowledge of the falsity if he had received information which he "could readily understand" and which indicated that "high probability" of the falsity regardless of whether he actually concluded that it was false. This is an equation with knowledge rather than an actionable duty of reasonable care and it is no less applicable to a lawyer than it is to anybody else.<sup>97</sup>

Once a lawyer has knowledge or its equivalent that a statement in a registration statement or offering circular is false or misleading, the lawyer proceeds at his or her peril. If the lawyer files the registration statement or offering circular without making sufficient further inquiry so as to reasonably and in good faith satisfy himself or herself that the statement is in fact true and not misleading, the lawyer will properly be liable as an aider and abettor if the statement was actually false or misleading. The extent of that inquiry will, of course, vary with the circumstances, but should probably include some independent verification. From a practical point of view, the inquiry should continue until enough substantive information supporting the truth of the statement is amassed to not only satisfy the lawyer that the statement is true but also to convince a jury that it was more likely than not that the lawyer actually, reasonably, and in good faith did, in fact, believe that the statement was true as well.

In the course of preparing a registration statement, the lawyer will have to gather certain information and documents concerning the issue. Part of this information to which the lawyer cannot shut his or her eyes, includes the contents of the articles of incorporation, by-laws, material contracts and other documents which the lawyer must father and file as exhibits.<sup>98</sup> Failure to look at these documents which constitute part of the registration statement, if not to read them, should be recklessness. If the contents of these documents or the lack of documents, especially the material contracts, indicate a high probability of the falsity of a statement in the main document which should correspond but does not, the lawyer should be found to have "knowledge". Thus, if the issuer is a manufacturer and the Prospectus falsely states that the issuer's only product is manufactured pursuant to an exclusive license and that contract, included in the exhibits filed with

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96. 388 F.2d 486 (2d Cir. 1968).

97. *Id.* at 489.

98. *E.g.* SEC Form S-1, Item 31(b), 17 C.F.R. § 239.11 (1972).

the Commission, is captioned "NON-EXCLUSIVE LICENSE," it would be difficult to believe that the lawyer did not actually know of the false statement in the Prospectus or if the lawyer did not know that he or she did not recklessly avoid knowing. The result should be different if, conversely, the contract were captioned "LICENSE" and there is a provision buried in the contract which could make the license non-exclusive under certain circumstances, which the lawyer negligently overlooked as he or she skimmed over the contract. The distinction is one of kind rather than degree, although it may blur somewhat in the practical application of the recklessness standard. The concept of recklessness marks somewhat of a departure from strict notions of scienter. The departure is necessary because of the difficulty of proving knowledge and the policy that disfavors avoiding knowledge. The *Federal Securities Code* would impose aider and abettor liability for persons who have "knowledge."<sup>99</sup>

An independent duty to investigate is the duty to independently verify information supplied by the client and to seek out additional information regardless of whether there is any indication whatsoever that the information supplied by the client may be false, misleading or incomplete. A duty to investigate could be directly imposed or indirectly imposed by removing the requirement of knowledge for aider and abettor liability. The latter course would be unfortunate. If such a duty of investigation is to be imposed it should be imposed directly and without confusing or torturing other legal doctrines.

There is nothing in the CPR that requires the lawyer to investigate the client for the benefit of third parties. To be sure, the lawyer has the duty to represent the client competently, which may include conducting an investigation of the client where that investigation is part of the client's legal or contractual investigation or necessary to establish a defense. That investigation is, however, made at the client's request. A lawyer represents, rather than inspects, the client. Hence, the CPR provides that where a lawyer is asked by the client to aid in the development and preservation of evidence of the client's state of mind and the lawyer is uncertain as to whether that state of mind actually exists, "he should resolve reasonable doubts in favor of his clients."<sup>100</sup>

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99. ALI FED. SEC. CODE § 1418(b) (Tentative Draft No. 2 1973). The "reason to know" language contained in that section was included by error. Conversation with Professor Louis Loss at the Harvard Law School, May 21, 1973.

100. CPR, EC 7-6. It might seem that in this respect lawyers are held to a lower standard than stockbrokers who are required to "know" their



The question is whether it should be the lawyer's obligation to insure that the investor receives verified information.<sup>101</sup> In this regard, it is relevant to consider the distinction between the lawyer and the accountant. As Karmel<sup>102</sup> correctly points out, the communications with the accountant are not privileged, the accountant must be independent and is an "expert" for purposes of section 11 liability. The client's confidential communications with the lawyer are privileged; the lawyer need not be independent and Congress did not choose to include the lawyer as an "expert" for section 11 purposes. The differences are more fundamental than these. The obligations of the independent public accountant are owed primarily to the public rather than to the client whom the accountant inspects and audits rather than represents. The accountant approaches a company under no pretense of allegiance to it; he or she is there to prepare an opinion, based on standardized criteria on which the public may rely.<sup>103</sup>

The opinion of the accountant may not be given without a reasonable investigation which goes beyond the records of the client. The accountant must observe the inventories and confirm the receivables where the amount of those assets is material.<sup>104</sup> If such an investigation cannot be made, the accountant may be unable to give an opinion. According to the Commission, the major purpose of the audit is to discover fraud and the accountant is directed to employ a high degree of "vigilance, inquisitiveness and analysis" in that regard.<sup>105</sup> "If the accountant is not satisfied with the results of his examination, he should not issue an affirmative opinion"<sup>106</sup> and a negative opinion ("nothing has come to my attention") is not acceptable.<sup>107</sup>

The lawyer is basically an advocate for his or her client. The lawyer leaves the advocate's posture when he or she gives an opinion. The opinion should be consistent with the lawyer's best

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customers. New York Stock Exchange Rule 405. See also SEC Rule 15b10-5, 17 C.R.F. § 240.15b-10-5 (1972). However, the know-your-customer rule is the result of the stockbroker's inherent conflict of interest with the customer whom the stockbroker serves as both a fiduciary adviser and a salesman. The rule is to protect the client from the stockbroker, not the public from the client. The lawyer has a duty to the client to understand the client's legal problems but this duty is not owed to third persons.

101. See note 19 *supra*.

102. Karmel, *supra* note 19, at 1163.

103. RAPPAPORT, *supra* note 8, ch. 5 at 8.

104. *Id.*

105. *Id.* ch. 5 at 9 (footnote omitted).

106. *Id.* ch. 24 at 47.

107. *Id.* ch. 24 at 46.

estimate of what the state of the law is and will be liable for negligence to persons who foreseeably relied upon the opinion. However, there is an element of trust in the attorney-client relationship. The most important purpose of the lawyer's participation is not to look to discover a fraud that most likely will not be present. It is to put forward the legitimate interests of the client. Must the lawyer also conduct an independent, vigilant investigation to discover fraud and not give an opinion until he or she has been *personally satisfied* after that thorough investigation that the facts are as the client states and that there is no fraud?

The Commission has stated its opinion and that it is not proper for a "responsible" lawyer

to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for a contemplated distribution *unless such counsel [has himself] carefully examined all of the relevant circumstances and satisfied [himself] to the extent possible, that the contemplated offering is, in fact, not a part of unlawful distribution.*<sup>108</sup> (Emphasis added).

Further, according to the Commission, where the lawyer knows that his or her opinion will be relied on as the "basis of a substantial distribution of unregistered securities," and he furnishes an opinion based solely on facts which he or she has made no attempt to verify, "a serious question arises as to the propriety of his professional conduct."<sup>109</sup> This goes too far. It is correct to the extent that a lawyer should not give a hypothetical opinion without clearly indicating that it is hypothetical. Where, however, the opinion clearly indicates that it expresses no opinion as to the "facts" recited therein, it is difficult to see how such an "opinion" could be relied on as to those "facts".

The hypothetical opinion does serve a useful function. Where the opinion is intended for the client's information or where both the client and the addressee of the opinion are familiar with the basic facts, an opinion as to the legal consequences of those facts is all that is necessary. There should be no need to force the client to pay the extra expense of an investigation. If the person requesting the opinion is not familiar with the "facts" and wishes some assurance that the facts are as stated, that person should not accept a hypothetical opinion or any opinion which is not based upon a reasonable investigation. If the brokers will not accept hypothetical opinions—and they should not unless they are confident of the facts—the client will have to request an opinion based on a reasonable investigation and that investigation will have to be

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108. SEC Securities Act Release No. 4445, 27 Fed. Reg. 1251 (1962).

109. *Id.*

conducted. Obviously, if an opinion recites that it is based on a reasonable investigation when in fact it is not, that would be actionable negligence<sup>110</sup> in a lawsuit by the broker against the lawyer. Moreover, an opinion which implies that it was based on a reasonable investigation e.g., "to the best of our knowledge"<sup>111</sup> should be held to the standard of reasonable investigation. The impropriety is not in the giving of a hypothetical opinion but in its use.

There should be little doubt that the Commission is quite correct in its position that a lawyer who knows or recklessly avoids knowing of a plan for an illegal distribution and who furnishes an opinion to aid that distribution is an aider and abettor regardless of whether the opinion recites the facts as hypothetical or recites that it is for the client's personal use only and not to be used as the basis for a distribution of unregistered stock. The Commission is also properly concerned over the lawyers who, knowing that they will not be aiders and abettors if they do not have "knowledge" and knowing that the client has not provided them with damning information the ignoring of which would constitute recklessness, cheerfully accept their fee not caring in the least whether the client is lying or whether an illegal distribution of securities based upon the hypothetical opinion is about to take place. It is one thing to say that a lawyer is not an investigative arm of the Commission and quite another thing to say that he or she may happily allow himself or herself to be "seized upon as an unwitting tool".<sup>112</sup> Is the injury caused by these types of hypothetical opinions compelling enough to force the alteration of the role of the lawyer by placing upon him or her an affirmative duty to investigate?

The injury caused by such opinions will decline, if it has not already, by virtue of the broker's increasing reluctance to accept, much less rely upon, a hypothetical opinion as the basis of an unregistered distribution. What was perhaps the most potent source of injury was removed by the repeal of Rule 133 which allowed securities obtained in a merger transaction to be sold without registration.<sup>113</sup> The sale of unregistered securities is not conditioned

110. Cf. *Reamer v. Kessler*, 233 Md. 311, 196 A.2d 896 (1964) (attorney failure to investigate for real estate opinion was negligence).

111. Fuld, *Legal Opinions in Business Transactions—An Attempt to Bring Some Order out of Some Chaos*, 28 BUS. LAW. 915, 922 (1973).

112. Cf. *SEC v. Spectrum, Ltd.*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93, 631 (S.D.N.Y. 1972).

113. SEC Rule 133, 17 C.F.R. § 240.133 (1971) was rescinded effective Jan. 1, 1973. SEC Securities Act Release No. 5316, 37 Fed. Reg. 23631 (1972).

upon the receipt of an opinion and such sales are made without such opinions. The opinion has no effect upon the civil strict liability imposed upon the broker and the person for whom the securities are sold if that sale violates section 5 of the 1933 Act.<sup>114</sup> Civil liability may be an ineffective deterrent against those who are judgment proof or who set out to swindle. These people use the opinion defensively in a criminal prosecution against them to establish good faith and a lack of knowledge of the illegality of the distribution. If the opinion clearly states that it expresses no opinion as to the truth of the "facts" recited, it should hardly serve a violator in his or her efforts to evade the law. To be sure, if the opinion does not clearly disavow certification of the facts, the defendant might successfully argue that he or she believed the opinion *did* certify the truth of the facts. This situation should be rare, however, because lawyers are usually quite careful in limiting their opinions. It would seem, on balance, that the potential injury is not sufficient to justify so drastic a change in the role of the lawyer.

The lawyer's opinion required for a registration statement is limited to the legality of the securities under state corporate law<sup>115</sup> and does not pass on the law or facts of the securities offering under the 1933 and 1934 Acts. The lawyer is not an "expert" for section 11 liability purposes. The opinion is not a part of the Prospectus but rather is included in the exhibits. The investor does not rely on the lawyer for assurance that all material information is included in the Prospectus. However, the lawyer is obligated to aid the officers, directors, or underwriter in establishing *their* due diligence defense. Moreover, the terms of the contract between the issuer and the underwriter will normally call for the delivery of an opinion by the issuer's counsel to the underwriters that the issuer is in compliance with the securities laws. Similar opinions are required in mergers and "tender offers". The Commission, apparently aware that there is no duty to investigate contemplated by the present securities laws,<sup>116</sup> has and probably will continue to focus on the opinion as a means of regulating the lawyer's conduct and to enlist the aid of the Bar in enforcing the securities laws.

To what investigative standard should the lawyer be held when

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114. 15 U.S.C. § 77e (1970).

115. SEC Form S-1, Item 31(b).

116. SEC v. Spectrum Ltd., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93, 631 (S.D.N.Y. 1972); SEC v. National Student Marketing Corp., Civil Action No. 225-72 (D.D.C. filed Feb. 3, 1972). National Student Marketing does not involve the duty to investigate.

he or she gives an opinion? The personal-satisfaction-after-vigorous-independent-investigation standard is not the standard upon which most opinions are based. In most cases opinions as to factual matters are given after a reasonable investigation which for most purposes includes only an examination of the documents required to be filed as exhibits and the minutes and stock books of the corporation. Counsel will usually send a questionnaire to officers and directors but for the most part will rely upon the answers given by management. There is no legal requirement that an independent audit be made. While this examination of documents may certainly uncover improprieties, many will go undiscovered. For the management intentionally seeking to defraud investors it may be relatively easy to falsify the minutes, stock book or material contracts to hide the fraud.

In most cases it will not be feasible for the lawyer to do more than examine the exhibit documents, the minute and stock books. While in many cases the lawyer will visit the premises or at least the main offices or plant of the issuer, he or she will usually not be competent to do such things as appraise the conditions of the issuer's machinery or assess the more technical aspects of the issuer's business. It would be impractical for the lawyer to attempt to go behind every contract to verify that it is what it purports to be. In most cases the registration statement is handled by special counsel, unfamiliar with the issuer. The lawyer must use his or her time efficiently and for the most part this means office rather than field work. Travel time is largely wasted time. In a very real sense, it would be a waste of valuable resources to force the lawyer to do the extra leg work.

The lawyer who does vigorously investigate the client and satisfies himself as to compliance can only further the legitimate goals of the client, except perhaps the client's of keeping fees to a minimum.<sup>117</sup> Many lawyers do make a vigorous investigation aimed at discovering improprieties and will not proceed with the offering or transaction, much less give an opinion, unless they are convinced that the client is telling the truth. The vigor of the investigation may be motivated by several factors. The lawyer may be very sensitive to the extent of the injury upon investors that

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117. The client may be expected to vigorously object when he or she is informed that a significant portion of the legal fees were incurred in the investigation of his or her honesty, a fact which most clients believe should be beyond question. Client's remarks such as "I thought you were on my side" indicate the resentment present when a person whom the client believed to be his or her advocate now appears to be a policeman.

could be caused by securities frauds. The lawyer may also be sensitive to his or her own possible exposure to liability which may run in the several hundreds of thousands of dollars or more. The lawyer may wish to protect his or her reputation from the damage caused by association with a fraudulent transaction. Some lawyers believe that the Commission keeps a "list" of the lawyers it can trust and another "list" of those which it cannot trust. Many lawyers jealously guard their image with the Commission.

However, even the most diligent of lawyers obviously can do only so much and will still have to rely heavily upon the documents and the word of the management in many areas. Time pressures, geography and the technical complexity of the operation may frustrate attempts at further investigation. Moreover, the personal satisfaction standard is impossible to enforce under the present laws because the main vehicle of that enforcement, aider and abettor liability, is predicated upon knowledge or recklessly avoiding knowledge of the fraud. Private enforcement is based on negligence which presently encompasses only a reasonable investigation rather than an audit and which in any event, is difficult to prove. The Commission itself phrased its warning in ethical rather than legal terms.

The Commission might promulgate a rule requiring that an opinion of counsel based on an independent audit be included in the registration statement. Such an audit would be impractical. Moreover, it is doubtful whether this comes within the scope of the Commission's authority over the securities bar and whether the Commission has the power to supersede the CPR. It is understandable that the Commission would hesitate to undertake the complex task of substantively regulating the securities bar. Such an opinion would also have the effect of making the lawyer an "expert" for section 11 purposes and "expertising" the Prospectus thereby placing a much lower standard on the other parties to the registration. It would also have the effect of significantly reducing the already declining number of lawyers willing to practice in the securities areas. The fees the lawyers who do practice in the securities areas will increase significantly both because of the extra liability and because of the supply of securities lawyers will diminish while the demand remains constant. If there are fewer lawyers doing the same total amount of work, the increasing time pressures will tend to lessen the effectiveness of an audit which is already impractical. Such a rule would also be unfair to the advocate and to the client.

To summarize, while the lawyer has no independent duty to investigate, a reasonable investigation of the client may have to be

made as the factual basis for an opinion. As a crude rule of thumb, a reasonable investigation should not force the lawyer out of the office except, perhaps, for an initial visit to the registrant's facilities if the lawyer is drafting a registration statement. Because of the impracticability of the audit, the law should find reasonable an investigation limited to those documents which the client must bring into the office. For a registration statement this would include the articles of incorporation, by-laws, material contracts required as exhibits, and the minute and stock books. For an opinion that the seller is not a control person, a reasonable investigation should include little more than examination of the issuer's last prospectus or annual report or, if none, telephone or written inquiries of the issuer. If special counsel is to give an opinion that the offer and sale is exempt under Section 4(2) from the registration requirement, the law should not require more than an inspection of the corporate documents, the disclosure document if there is one and inquiries of his or her client. The lawyer cannot reasonably supervise offers and sales in the field. If, in any of these transactions, the lawyer is put on notice that something is amiss, the investigation must continue.

In short, although the audit is the key to the prevention of fraud, realistically, the lawyer is not the one to undertake it. The conflicting interests probably would force a dilution of zeal in the representation as well as the audit. As the Commission has pointed out, the lawyer is not independent but is the client's "advisor, defender, advocate and confidant [and] enters into a personal relationship in which his principal concern is with the rights and interests of the client."<sup>118</sup> The Commission decided that it did not want lawyers to make the accounting audit but rather would require "for the benefit of public investors the detached objectivity of a disinterested person."<sup>119</sup> This case of the securities audit involves similar considerations. If such an audit is to be made, its value to investors should be maximized. This will not be the case if it is performed by a lawyer who is not independent, and, in many non-legal areas, is incompetent to make such an investigation.<sup>120</sup> To maximize its value to investors, the audit should be performed by an independent person and upon standards similar to those of the accounting profession.

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118. American Finance Co., 40 S.E.C. 1043, 1049 (1962), *quoted in* Karmel, *supra* note 19.

119. *Id.*

120. In addition to the lawyer's lack of non-legal expertise, the securities lawyer often lacks the expertise and facilities for investigation possessed by the trial lawyer.

## IV. THE INDEPENDENT SECURITIES AUDITOR

## A. THE BENEFITS

The *Special Study* and the *Hot Issue Investigation* quite clearly point out the need for a more thorough and effective investigation of the issue, especially in a first-time public offering. The proposed NASD rules would, if passed, aid in the fulfillment of this need. But they would not sufficiently fulfill the need for several reasons. The underwriter has conflicting interests, a natural tendency to rely on the issuer's word, and the understandable lack of objectivity on the part of someone who has already decided in favor of the issuer. All of these factors tend to cause a premature resolution of doubts in favor of the issuer, thereby preventing a thorough investigation, the essence of which is to follow up on the leads provided by the inconsistencies. If the issuer's enterprise involves highly sophisticated technology or is otherwise one of great complexity, the underwriter may not have anyone on its staff capable of making the investigation and might not seek the services of an expert in that field. More fundamentally, it may be difficult to condition psychologically as professional auditors persons with a salesman's orientation. And, unfortunately, the temptation to purposely leave a few ugly stones unturned still remains. This temptation would probably have its greatest effect on the small, new entrants into the industry who may be undeterred by the prospect of civil liability, willing to take additional risks to establish a reputation as an effective distributor. The underwriter might also be anxious to establish a reputation among prospective issuers that the underwriter is "easy to get along with."

In light of this, the benefits of the "detached objectivity of disinterested persons" would be substantial. If such an investigation is to be made, its value to the investor should be maximized. This could be accomplished by requiring that the investigation be made by a competent independent person in accordance with specific standards which would be set out. Such a person might be called an Independent Securities Auditor (ISA). The ISA would be required to certify that he or she properly had performed the investigation and to report whether he or she finds the statements in the registration statement to be accurate and complete. This would have the primary effect of assuring that the investigation had in fact been carried out. It would also do much to assure that the investigation was thorough. Because there would be uniform standards for the investigation the investor would be able to more fully understand the value and limitations of the protection afforded in any particular transaction. The quality of the investi-



gation would, to a large degree, be independent of the quality of the underwriter. Not only would the temptation not to investigate be removed from the underwriter but it also might find that hiring an ISA with an established reputation for tough investigating would be advantageous as a selling point.

The need for the ISA is especially acute in a parent-subsidary merger or other transaction where the same interest is on both sides. In such a situation the independent investigation is necessary to assure fairness as well as proper disclosure. In England, when a merger or take-over offer is not completely at arm's length, the *City Code* directs that "it is essential that competent outside advice be obtained in order to ensure, and to satisfy offeree shareholders, that their interests are fully protected."<sup>121</sup> Many corporations in this country, do, in these circumstances, seek appraisals from their investment banker. Because the valuation process involves a series of largely subjective judgments, it becomes important that the person making those estimates is independent. The investment banker might be reluctant to risk losing or hope to acquire the future business of the corporation and rather than displease the corporation, might consciously or unconsciously tend to resolve the many uncertainties in the corporation's favor. The ISA would possess the necessary independence and expertise to make a valuation in which the investor would have greater confidence.

The coming inclusion of forecasts in disclosure documents also intensifies the need for the ISA. In England, when a forecast is included in the disclosure document, the outside advisor, if one is required for the transaction, must also "report" on the forecast.<sup>122</sup> This makes eminent good sense. The value of a forecast depends, obviously, on the validity of the external and internal assumptions made by management. A small change in these assumptions could induce a large change in the bottom-line figure of the forecast. It is, therefore, critical that the validity of these assumptions be verified to the extent possible. Moreover, the ISA would have the expertise to determine whether the estimates made from the underlying assumptions were reasonable. This determination by the ISA that the internal assumptions were accurate and that the estimates therefrom were reasonable may also prove invaluable

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121. THE PANEL ON MERGERS, CITY WORKING PARTY, THE CITY CODE ON TAKE-OVERS AND MERGERS, RULE No. 4 (3d ed. rev. Feb. 1972). The *City Code* is a statement of business ethics and does not have the force of law.

122. *Id.* RULE No. 7.

to the corporation if the forecast is later challenged as not having been made in good faith.

The investor would also benefit from the increased quality as well as the increased quantity of the disclosure. Because the ISA would have to report that the information in the Prospectus or other disclosure document was not misleading and is set out as clearly as possible, the investor may be more able to understand the significance of the disclosures in the Prospectus. The ISA would be required to assure that specific problems are fully set out and explained. Such a problem might otherwise be concealed within a general "no assurance" clause which because of its generality and because it has become boilerplate, does not allow the investor to intelligently weigh the risks connected with the problem. For example, if the issuer had some indications that one of its new products would not be accepted in the market, the ISA would not favorably report on a Prospectus which merely stated that "there can be no assurance that the Company will be able to successfully market its products." The ISA, closer to the transaction, would be able to discover some of these inadequate disclosures which the Commission might otherwise have missed.

The concept of the ISA would prove to be more efficient as well as more useful to the investor. There is a certain inefficiency, if not illogic, in the requirement that several unconnected investigations be made. Certain officers, the directors and the underwriters each must make an investigation to earn their due diligence defense. The lawyer also, in certain cases, must make an investigation. These investigations do not necessarily compliment each other. An issuer who intends to defraud or mislead the investor is likely to choose the underwriter and lawyer whom it believes will perform only the most minimal investigation. If nobody makes an effective investigation the value of the investigation requirement is negative as the investor may rely on the investigation actually having been made; whereas if he or she knew that there was no investigation made, he or she might be more skeptical. If everybody makes an effective investigation, there is expensive and unnecessary duplication. The most likely situation is that everybody makes a superficial investigation. One thorough, in-depth investigation would afford greater protection to the investor. If each party does make a thorough investigation, the one thorough investigation would be more efficient.

One of the goals of the law is to provide the certainty necessary for people to regulate their primary conduct in accordance with the law and so that people know what they may legally expect from

others.<sup>123</sup> Similarly, certainty is crucial in complex transactions so that people may know what is to be done by them and what is to be done by others. As Professor Loss observed generally about the securities laws, "There simply is not enough predictability in this field."<sup>124</sup> The due diligence standard is too vague to allow people to know what is expected of them. By careful definition of the role of the ISA, the task of investigation would be centralized and performed in accordance with explicit standards. Each of the parties should be entitled to rely on the results of the investigation of the ISA as they are allowed to rely on the independent accountants, i.e., unless they have reason to know otherwise. This division of labor should benefit all concerned. The directors, officers, underwriters and lawyers would then be able to direct their efforts to those areas in which they are most efficient. The investor would be benefited by the increased effectiveness of the investigatory process and the higher quality of the disclosures. The Commission, as its confidence in the ISA grows, would be able to make greater use of cursory review procedures thereby reducing the burden upon their already overworked staff and substantially reducing the waiting period between filing and effectiveness.

The value of an independent investigation, especially of highly complex issues, has been recognized by a few underwriters who have hired independent consultants to do all or part of their due diligence. As a representative of such an underwriter testified before the Commission:

Our experience has shown that in addition to our own evaluation of companies, plants, products, and management and in addition to the due diligence exercised by leading attorneys and accountants, it is extremely desirable to supplement this work by the use of independent experts and specialists in the individual fields which constitute the business of the prospective issuer. We feel that no investment banking firm can expect to maintain on its staff the people who would be qualified to properly and in-depth evaluate the broad spectrum of companies which come before it for financing. We also feel that the objectivity of an independent evaluation provides a balance to an internal staff member's point of view.<sup>125</sup>

## B. THE COSTS

Most of this discussion has been in terms of the possibilities of

123. Friedman, *On Legal Development*, 24 RUTGERS L. REV. 11, 59 (1969).

"There must be some sort of security of transactions. . . ." *Id.*

124. *Proceedings of the Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 805 (1967), quoted in THE WHEAT REPORT, *supra* note 87, at 56.

125. SEC Securities Act Release No. 5275, 37 Fed. Reg. 16011, 16013 n.22 (1972).

violation of the securities laws. While the potential for violation is great, many issuers, underwriters, lawyers and accountants obey the law. Fraud does not run rampant in the area. It would be difficult to measure the actual level of compliance. Many of the misleading statements made in the Prospectus may go undiscovered if they do not cause the subsequent decline in the issuer's securities. The number of cases reported alleging fraud in the sale of securities would overstate the level of compliance because many of these cases may be settled before they are brought to trial. Moreover, when a major fraud does occur, investor losses may run into the tens of millions of dollars.<sup>126</sup>

The benefits of the ISA would still outweigh the costs even if the level of fraud is relatively low. The use of the ISA would raise the quality and quantity of disclosure above what is now the minimum level. The uniformity in the investigation and the report thereof would allow the investor to have a more realistic confidence in the information with which he or she is provided. The likelihood of the occurrence of a major fraud would be greatly reduced.

The benefits to the financial community would also be substantial. The issuer and the underwriter would both benefit from the increased confidence in the disclosure mechanisms of the stock market. In many offerings the diligence of the parties is above that required by section 11. In these cases the underwriter might make a full investigation itself or hire an independent consultant; the underwriter's counsel may perform an extensive legal audit; the issuer's counsel may do the same; some of the outside directors may hire their own counsel, probably at the issuer's expense, to conduct a separate investigation. In this situation, even though the lawyers should still examine the legal documents, the cost of a single thorough ISA investigation *may be less* than the cost of several investigations. The in-depth investigation of the ISA would also probably be of at least equal, if not greater value, to the investor.

The ISA concept would also benefit the issuer by making it easier to attract outside directors. Each director would be entitled to rely on the results of the ISA investigation unless he or she had reason to know otherwise. Under the present law, which is coming under increasing criticism, the outside director is largely

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126. Cf. SEC v. Equity Funding Corp., BNA SEC. REG. & L. REP. NO. 197 at A-6 (April 11, 1973) (D.C. Cal.). The court ordered the appointment of a "Special Investigator" to oversee the investigation and the accounting.

responsible for his or her own investigation. Because of this and the large amount of potential liability, many qualified people have refused positions as outside directors. Some of this reluctance might be overcome if the potential liability is limited to frauds of which the director has reason to know.

The Commission has been reluctant to allow "positive" disclosures in the Prospectus. Even with the coming inclusion of forecasts, it might be difficult for the investor to differentiate the different shades of doom of which the text foretells. Perhaps the primary reason for this is that positive disclosures are difficult for the Commission to verify. The ISA investigation would accomplish this verification and the verified positive disclosure should be allowed into the Prospectus. This would benefit both the underwriter and the issuer by making it easier to sell the stock. It would also benefit the investor who would be able to make a more useful comparison among issuers and by preventing issuers from hiding specific problems under the cloak of a general "no assurance" caveat. This would also benefit the economy as a whole because the increased comparability would aid in the allocation of capital to its most efficient uses.

The cost of the ISA investigation would also be offset by the ability of the issuer, underwriters and their counsel to make important decisions on the basis of increased factual input. The benefit of this information may extend beyond the context of the present securities offering. The ISA investigation might turn up problems of which the issuer itself was unaware or might discover the causes of problems with which the issuer is presently trying to cope.

The issuer and underwriter would also benefit from the decreased waiting period between filing and effectiveness. Generally this period runs between forty-five and sixty days or longer if more than one amendment is required. As the Commission's confidence in the ISA grows, it should be more willing to make use of the cursory review procedures in which case the registration statement could become effective upon expiration of the twenty-day statutory minimum or even sooner if the parties wish and the Commission is willing to accelerate the effectiveness.<sup>127</sup> If the offering were for \$10,000,000 the time value of that money at six per cent is approximately \$50,000 per month. The decrease in lag time may in itself justify the ISA fee to the issuer. Moreover, the investor is also able to put his or her money "to work" earlier.

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127. 1933 Act § 8(a), 15 U.S.C. § 77h(a) (1970); SEC Rule 460, 17 C.F.R. § 230.460 (1972).

This also benefits the underwriter and the issuer in that they will have to bear the risk of a disastrous downturn in the market for a shorter time period.<sup>128</sup> This is altogether proper as the market risk should be on the investor who has already made his or her decision to buy but is waiting for the registration statement to become effective. The benefits to all concerned would appear to greatly outweigh the costs. If we are serious in wanting verified information, the ISA is a bargain.

### C. THE ISA

Implementation of the ISA concept would require the existence of a readily available source of people competent to perform the investigation and, in non-arm's length transactions, the valuation. The ranks of business consultants, analysts and other business school graduates should provide such a source. For some time now, the business and financial community has availed itself of the services of consultants to identify and solve problems. Much of this work has involved investigation in the field. The diverse areas of expertise possessed by different business consultants, analysts, and other business school graduates should enable the selection of an ISA qualified to investigate almost any aspect of any business. What has essentially been a service to management would now be harnessed for the benefit of the investor.

An effective selective process would, of course, be essential. This selection process could be accomplished partially by the use of an examination similar to that proposed by the NASD for the QUP. Because the investigation of corporations in complex and high technology industries requires a knowledge of that industry, the examination should also test that knowledge on the part of applicants who wish to work in those areas. The examination should be vigorous as the investor would be largely dependent upon the competence of the ISA. The standards of moral character should also be very high. The job carries with it a tremendous amount of responsibility and only the most fit morally and the most competent should be entrusted with that responsibility.

The job of the ISA would utilize present skills in a new function. Because this function is new there is a tremendous amount of flexibility; obstacles such as tradition and the otherwise politi-

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128. Most underwriting contracts have "market out" clauses which allow the underwriter to escape from his commitment if there is a significant adverse change in market conditions. Underwriters are hesitant to make use of this provision, however, because of the effect on their reputation.

cally necessary grandfather clauses are absent. The Commission could utilize the ISA to do the necessary jobs which it cannot do. Thus, the rules under which the ISA would operate could be tailored expressly to the needs which it would fulfill. For instance, it could be required that the ISA submit his or her report to the Commission regardless of whether the offering was withdrawn. The ISA could also be put under a continuing duty of disclosure.

It is, of course, also essential that the ISA be completely disinterested and independent. The standards of independence should be at least as strict as those of the accountant. The ISA must have no financial interest whatsoever in the issuer, its affiliates, or the underwriter. The ISA also must have no affiliation with any officer, director or controlling person of the issuer, its affiliates or the underwriter.

The process of selection of the particular ISA for the underwriting might present an obstacle in the way of complete independence. If the ISA is to be chosen by the issuer or underwriter, the ISA might be under pressure to accede to their wishes or prematurely resolve doubts in their favor. The ISA might have an eye on being selected for the next underwriting by the underwriter or issuer. However, hopefully the underwriter will realize that it is to its advantage to choose an ISA who has the reputation for tough, in-depth investigation. Likewise, it is to the advantage of the ISA to establish such a reputation. The independence requirements coupled with the liability provisions<sup>129</sup> might be enough to overcome any pressure to do less than is required. In line with the Commission's policy of allowing the parties the maximum possible freedom, it would seem that private selection of the ISA would be worth the risk it involves, although the private selection should be subject to approval by the Commission.

If the Commission should determine, after some experience in the matter, that the effects of private selection are adverse to the investor, the selection could be made by the Commission itself.<sup>130</sup> If selection is made by the Commission, the ISA would be under

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129. See page *infra*.

130. It is probably preferable that the ISA also be independent of the Commission. The ISA should not be caught in funding problems, staff reallocation and other problems that administrative agencies face. The ISA should also have some latitude to use his or her independent judgment, especially in connection with fairness problems. Moreover, if the ISA were in the employ of the Commission it would be virtually impossible to counteract the erroneous impression of investors that the Commission had given its own stamp of approval to the issue.

pressure to please the Commission, which pleasure would involve more vigorous protection of the investor. This method of selection also has the advantage of giving the Commission more direct and immediate control in regulating the future of the ISA. Although this method of selection would involve a considerable grant of discretion to the Commission, there is no reason to believe that the Commission would abuse that discretion or would be less than impartial in choosing among equally qualified ISA's. A compromise between Commission selection and private selection might be usefully accomplished by means of the Commission putting forward the names of three ISA's, one of which would be selected by the parties.

It is inescapable that the parties to the transaction would pay the ISA fees either directly or indirectly through high filing fees. This should not compromise the independence of the ISA since he or she would be entitled to that fee whether the report was favorable or unfavorable. The Commission could arbitrate any dispute between the ISA and the parties. The fee received by the ISA would be included in the "Expenses of the Offering" section of the registration statement. The Commission should be suspicious of fees which appear unduly large and should ask for justification in those cases. It should also be obvious that the ISA should be allowed to accept no other form of payment or benefit from any of the parties. In this connection, the ISA should sign an agreement or it should be provided by rule that the ISA will not be allowed to accept employment from any party to the transaction or its affiliates in a capacity other than ISA for a reasonable period of time. A period of two years would seem sufficiently long to assure that the prospect of future employment did not influence the ISA's decisions.

#### D. THE STANDARD OF LIABILITY

One major problem in the implementation of the concept of the ISA is the standard of liability to which the ISA is to be held. The dilemma is at once apparent. If the standard of liability is too vigorous, people may be unwilling to take a job or take it only if paid a prohibitive fee. Conversely, if the standard is too lax, the incentive to thoroughly investigate may be reduced and the temptation to give into the pressure applied by the issuer and underwriter might have more of an effect. The protection offered to the public would be proportionately reduced.

The solution lies, as it usually does, between these two extremes. The standard set by section 11 for "experts" would seem, by analogy, to be appropriate. Section 11 provides the expert with



a defense to liability if after reasonable investigation he or she did not know and had no reason to know of the misstatement or omission. The reasonable investigation, in this case, would be an investigation which complied with the requirements for an ISA investigation. However, section 11 makes an expert jointly and severally liable for the entire amount of the investor loss. If the ISA is chosen by the Commission and the incentive to perform a thorough and competent investigation is greater, this standard is too extreme. The liability should be limited to a reasonable amount although an amount which would provide a healthy incentive for a thorough and competent investigation.

The ISA who is confident that he or she can perform a competent investigation should not be deterred by this standard. Malpractice insurance, however, should be made available on the same basis that it is made available to accountants and lawyers.

It would seem that the second most effective safeguard against an inadequate investigation would be to set out as clearly as possible the standards of the investigation and require that the report of the investigation forwarded to the Commission contain a step-by-step documentation of the work done and the conclusions drawn therefrom. The lines of investigation should parallel the primary disclosure and investigative requirements proposed by the NASD. The Commission should require by rule exactly how the investigation should proceed. The rules should be particularly explicit with regard to the use of questionnaires, actual physical verification, and use of certain additional exploratory procedures triggered by certain findings.

The most effective method of assuring a thorough investigation would be to give the ISA an incentive to uncover something. The lawyers have the "stick" behind them, but they have no incentive other than their professional pride—the value of which should not be minimized—to really come up with "something" about their own client. They have, on the other hand, the hope of being rehired by the issuer or underwriter or a continuing relationship and therefore have an incentive, though hopefully not one which often will overcome their professional judgment, to not find anything more than they have to find. The same is true of the accountants. If the Commission were to select the ISA it might choose on the basis of the thoroughness of past investigations. Although some might argue that this would cause the ISA to be too picky, this is clearly a case where too much is better than too little if one must choose between the two. If the ISA is selected privately, that incentive would not be present. Because of this and other factors, the Commission should not hesitate to bring the se-

lection process under its control if it appears that the quality of investigation is not a satisfactory implementation of the ISA concept.

#### E. IMPLEMENTATION UNDER THE Federal Securities Code

If it saw fit, the Commission would have the power, within the limits of the Administration Procedure Act, to promulgate immediately a rule requiring the ISA report as a necessary "expert" report to be included in the registration statement or to set up standards for the ISA. Obviously, however, such a change should be made only after careful and lengthy consideration. Much of the change is significant enough that it should be made at the legislative rather than the administrative level.

A major pre-legislation effort is presently well underway in the securities field. This effort is embodied in the new *Federal Securities Code*. The Code, which would integrate the "scatteration"<sup>131</sup> of the various securities laws, would require the registration of companies as opposed to the registration of a particular issue of the companies' securities. The company would be required to register when it first distributed its securities,<sup>132</sup> or when it attained one million dollars in gross assets and three hundred stockholders.<sup>133</sup> This registration process would be accomplished by the filing of a registration statement that probably would be similar to the present Form 10. Information in the registration statement would be updated periodically. Later sales of securities by the issuer would require the filing and circulation of an offering statement which would contain the Prospectus and would be the counterpart to the present registration statement<sup>134</sup> required under the 1933 Act. The information contained in the offering statement would supplement rather than duplicate the information contained in the Code's registration statement. A "sale" would include the exchange of securities in connection with a merger or sale of assets.<sup>135</sup>

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131. ALI FED. SEC. CODE (Tent. Draft No. 2 1973) (Introductory memo). See LOSS & BLACKSTONE, *Codification of the Federal Securities Laws* 28 BUS. LAW. 381 (1973).

132. ALI FED. SEC. CODE § 501 (Tent. Draft No. 1, 1972).

133. *Id.* § 401(a) (Tent. Draft No. 1, 1972). The issuer would also be permitted to register voluntarily. *Id.* § 401(b). The registration would continue under the registration reporting and other requirements until, basically, ninety days after the end of the fiscal year in which the number of shareholders fell to less than one hundred. *Id.* § 405.

134. *Id.* §§ 501(a), (c).

135. *Id.* § 296A.

If a person other than the issuer, a "secondary distributor," wishes to sell more than \$100,000 of the security,<sup>136</sup> and if the issuer is a "one year registrant",<sup>137</sup> that person may offer and sell the securities if the secondary distributor files a distribution statement.<sup>138</sup> Similarly, any person, including the issuer, who solicits a proxy, subject to certain exemptions, must file a proxy statement.<sup>139</sup> And, also subject to certain exemptions, a person who makes a "tender request"<sup>140</sup> must also file a statement.<sup>141</sup> These statements filed by persons other than the issuer would give the details of the transaction. Information about the issuer would be contained in the registration statement.

The concept of the ISA would fit in easily with the *Code*. The ISA investigation report could be required to be included in the registration statement. As the registration statement is to be the central, primary disclosure document and will serve as the "foundation" document for several other transactions, it is crucial that the information contained in the registration statement be as accurate and complete as possible. This is especially true in the case of a registration statement filed in connection with a first-time public offering. A thorough investigation would do much to assure that all material information has been disclosed to the investor and would also serve as a solid base for future disclosures to build upon.

Borrowing the similar provision of the English *City Code*, where the offering involves a merger, or what amounts to a merger, which is not completely at arm's length, an ISA report on the fairness of the transaction might also be required.<sup>142</sup>

Substantive merger requirements and fairness problems have traditionally been in the province of state rather than federal legislation. However, where the merger affects two or more corporations in different states with shareholders in many other states, it would seem that federal legislation is preferable. An exemption from the federal requirements might be allowed where the corporate parties to the transaction are subject to control by the

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136. *Id.* § 511(d).

137. *Id.* § 270.

138. *Id.* § 509.

139. *Id.* § 602.

140. *Id.* § 299.9.

141. *Id.* § 605.

142. The ISA fairness report would give a court deciding upon the fairness of the merger price a very useful independent evaluation. Because the report if it concludes that the price is not fair would include an estimate of what a fair price would be, it would eliminate some of the uncertainty faced by those dissenting shareholders contem-

same state and a great majority of the stockholders of those corporations are in the same state.

The Commission under Section 302 of the *Code* would have the power to exempt anything from any requirement. The Commission could use this power to further tailor the use of the ISA to provide verified information. The Commission could decide which, if any, of the periodic reports should include verified information. A less intensive investigation might be required for those companies with which the Commission has had longer favorable experience.

The ISA might prove useful in other ways. The *Code* would do away with the esoteric and unpredictable self-protection standards<sup>143</sup> which now control whether an offering comes within the non-public offering exemption from registration.<sup>144</sup> The *Code* would require only that there be thirty-five or less non-institutional purchasers (there may be an infinite number of offerees) and that there be no general advertising.<sup>145</sup> The *Code* would permit within this "limited offering" exemption sales to any number of institutional purchasers.<sup>146</sup> In these cases, under certain conditions, the state may wish to require filing of a modified form of the ISA report. The price of certainty here is that the initial disclosure may suffer and the investor will have to rely on the fraud provisions. This cost may be lessened somewhat by requiring a modified form of an ISA investigation when the proceeds of the offering are above a certain amount and the sales are made to persons "outside" the corporation other than institutions.

## V. CONCLUSION

The protection of the investor and the prevention of fraud presently rest largely upon the conscience of the issuer and the underwriter and the deterrent effects of the securities laws. While in many cases this will be enough, the value in any particular case will be uncertain. Providing verified information would provide extra protection in improving the quality and reliability of the disclosures and also act as a deterrent to the making of false or mis-

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plating suit for appraisal rights. Where the ISA finds that the terms are fair it would discourage suits and where the ISA finds the terms unfair it would be a signal which would encourage action. This should act as an incentive to management to propose fair terms, or if the original terms are unfair, to revise them.

143. See *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

144. 1933 Act § 4(2), 15 U.S.C. § 77d(2) (1970).

145. ALI FED. SEC. CODE § 227(b) (Tent. Draft No. 1, 1972).

146. *Id.*

leading statements in the first place. The accountant will verify only so much of the information provided in the registration statement or other disclosure document. As to the rest, neither the Commission nor the lawyers are in a position to effectively investigate.

The verification of information, however, is the key to the prevention of fraud. This requires an investigation. If the investigation is to be made at all, its value to the investor should be maximized while at the same time, if possible, minimizing its cost to the issuer and underwriter. A single, thorough investigation performed by a competent and independent person would maximize the value of the investigation to the investor. The efficient division of labor, the elimination of needless duplication, and the other benefits of the ISA concept would reduce the cost of this protection at least to acceptable levels if not below the present cost of full compliance.

## APPENDIX

PROPOSED ARTICLE III, SECTION 35 OF RULES OF FAIR PRACTICE  
CONCERNING UNDERWRITER INQUIRY AND INVESTIGATION  
STANDARDS RESPECTING DISTRIBUTIONS OF ISSUES  
OF SECURITIES TO THE PUBLIC

## Obligation to Establish and Maintain Written Procedures

(a) Every member engaged in investment banking activity as a managing underwriter shall establish and maintain written procedures which shall be followed by it in its inquiry and investigation of any issuer for whom it is acting in connection with the distribution of an issue of securities to the public. Such procedures shall include, but not necessarily be limited to, the following:

- (1) Review by underwriters' counsel of the issuer's corporate charter, by-laws, and corporate minutes;
- (2) Examination of the audited and unaudited financial statements of the issuer, including footnotes, for the preceding ten year period or for the entire period of the issuer's existence if less than ten years;
- (3) Review of all changes in auditors by the issuer within the preceding ten year period if applicable and the reasons therefor;
- (4) Review, with the issuer's auditors, of the financial statements which will appear in the prospectus or offering circular;
- (5) Review of the issuer's budgets, budgeting procedures, and order/backlog figures;
- (6) Review of internal projects of the issuer, including the intended use of the proceedings of the offering;
- (7) Review of all pertinent marketing, scientific and/or engineering studies or reports concerning the issuer or its products during the previous ten year period or for the term of the issuer's existence if less than ten years;
- (8) Consideration as to the necessity of third party review of appropriate portions of the inquiry if the issuer is a promotional organization or engaged in marketing high technology or previously unmarketed products;
- (9) Investigation of the issuer's current and past relationships with banks, creditors, suppliers, competitors and trade associations;
- (10) Communication with key company officials and appropriate marketing and operating personnel regarding the nature of the issuer's business and the role of each of the above individuals in the business operation;
- (11) Inspection of the issuer's property, plant and equipment;
- (12) Examination of business protection devices and related data such as trademarks, patents, copyrights and production obsolescence, among others;

- (13) Review of available information with respect to the issuer's position within its industry;
- (14) Review of pertinent management techniques, organization of management and the background of the management personnel of the issuer;
- (15) Preparation and maintenance of memoranda pertaining to all meetings and/or conversations regarding the issuer held during the member's performance by it of its obligation of adequate inquiry;
- (16) **Tax-Sheltered Program**—In addition to the above, when considered appropriate, written procedures relating to inquiry and investigation of tax-sheltered programs shall include but not necessarily be limited to, the following:
  - (i) Investigation to determine that the management of a tax-sheltered investment program has experience and a working knowledge of tax-sheltered investments sufficient for the proper handling of investment monies and the maintenance of the tax-sheltered program.
  - (ii) Physical inspection of all properties described in the prospectus as being acquired by the tax-sheltered program, a review of all documents pertaining to such acquisitions and an examination of the facilities of any servicing function performed by the tax-sheltered management, if any.
  - (iii) Examination of applicable partnership agreements.
  - (iv) Review of available information with respect to the issuer's position within its industry including:
    - (i) Examination for proper disclosure of all conflicts of interest of the sponsor of the tax-sheltered program; and
    - (ii) Examination of all records submitted by appraisers, engineers, financial consultants, and other independent consultants with emphasis respecting the procedures utilized in the formulation of their analysis of the tax-sheltered investment, and study of all tax aspects of the tax-sheltered program to insure that the described or anticipated tax benefits will, in fact, accrue to the investor.

**Obligation of Inquiry and Investigations in Issuer Distributed Offerings of Tax-Sheltered Programs**

(b) At least one member participating in the distribution to the public of an issue of securities for which there is no managing underwriter must assume the obligation of establishing, maintaining and following written procedures concerning inquiry and investigation of the issuer as delineated in paragraph (a) hereof and those obligation of certification and record keeping contained in paragraphs (c) and (d) hereof.

**Certification as to Adequate Inquiry**

(c) On or prior to the effective date of the distribution of an issue of securities to the public, the managing underwriter shall certify in the

agreement among underwriters that it had established adequate inquiry procedures in accordance with the provisions of subsection (a) hereof, and that in respect to the underwriting which is the subject of the agreement, it had followed procedures thus established. In the event there is no agreement among underwriters, the said certification shall be made to all selling group members. If there is no selling group, or if the required inquiry and investigation is performed by a member subject to the provisions of paragraph (b), the certification shall be made in the prospectus.

#### **Maintenance and Retention of Written Documentation**

(d) Every member subject to the provisions of paragraph (a) or (b) hereof shall keep and preserve appropriate written documentation demonstrating compliance with paragraphs (a) and (c) hereof. These records shall be preserved for a period of not less than five years, the first two years in an easily accessible place.

#### **Definitions**

(i) "Investment Banking Activity"—shall mean the business carried on by a member of underwriting or distributing issues of securities for which documents and other information are required to be filed with the Association pursuant to the provisions of the Interpretation of the Board of Governors Concerning the Review of Corporate Financing.

(ii) "Managing Underwriter"—for purposes of this Section 35 shall, where necessary in view of the context within which it is used, mean that member originating the distribution and/or the primary distributor of the issue in question, or the member who made the required filing with the Association pursuant to the provisions of the Interpretation of the Board of Governors Concerning the Review of Corporate Financing.

(iii) "Prospectus"—shall have the meaning given to that term by Section 2(10) of the Securities Act of 1933; provided, however, that such term as used herein shall also include an offering circular filed with the Securities and Exchange Commission pursuant to Rule 256 of the General Rules and Regulations under the Securities Act of 1933 and, in the case of an intrastate offering, any document, by whatever name known, filed and/or distributed as part of the registration or similar process by whatever name known for an issue of securities pursuant to the laws or regulations of any state.

(iv) "Tax Sheltered Program"—a program which provides for flow-through tax benefits regardless of the structure of the legal entity or vehicle for distribution including, but not limited to, oil and gas programs, real estate syndications (except real estate investment trusts), citrus grove developments, cattle programs and all other programs of a similar nature, regardless of the industry represented by the program, or any combination thereof.

#### **PROPOSED AMENDMENT TO SCHEDULE "C" OF ARTICLE I, SECTION 2 (d) OF THE ASSOCIATION'S BY-LAWS**

#### **(4) Registration of Qualified Underwriter Principal**

##### **(a) New Members**

(i) Effective \_\_\_\_\_, every applicant for membership who intends to engage in investment banking activity shall designate with the



corporation at least one person as a Qualified Underwriter Principal, the duties of whom shall include, but not necessarily be limited to, the organization and/or supervision of any participation in the origination or distribution of offerings of securities by a member whether as an underwriter or selling group member.

(ii) Before a member may engage in investment banking activity, the designated Qualified Underwriter Principal shall successfully complete Parts I and III of a three-part Qualification Examination for Principals. If a person is qualified to be registered as a principal pursuant to Part I hereof, such individual shall be required to pass only Part III of the Qualification Examination for Principals.

(iii) Only those persons who have three years of experience with a member actively engaged in the origination of the underwriting of offerings of securities and who can demonstrate that a significant part of their individual business experience with the member entailed involvement with investment banking activities may be designated and qualified as a Qualified Underwriter Principal. In an exceptional case, when the business background and experience of the designated individual justifies such, the experience requirement imposed herein may be waived by the President of the corporation upon written request of the designated Qualified Underwriter Principal. In all such cases the burden of justification for such waiver shall be upon the applicant.

#### **(b) Existing Members**

(i) Every member of the corporation engaged in investment banking activity shall as of \_\_\_\_\_ designate at least one person as a Qualified Underwriter Principal whose duties shall include, but not necessarily be limited to, the organization and/or supervision of any participation in the origination and distribution of offerings of securities by a member whether as an underwriter or selling group member. Except as otherwise provided in subparagraph (iv) herein, such person shall be required to take and successfully pass Parts I and III of the three-part Qualification Examination for Principals.

(ii) Every person becoming registered as a principal after \_\_\_\_\_, whose duties do or will involve the organization and/or supervision of any participation in the origination or distribution of offerings of securities by a member whether as an underwriter or selling group member shall be designated a Qualified Underwriter Principal. All persons so designated shall be required to pass Parts I and III of the three-part Qualification Examination for Principals.

(iii) Any registered principal whose duties with a member are changed after \_\_\_\_\_ to involve the organization and/or supervision of any participation in the origination or distribution of offerings of securities by a member whether as an underwriter or selling group member, shall be designated a Qualified Underwriter Principal and shall be required to pass Part III of a three-part Qualification Examination for Principals unless such individual is exempt from such requirement in accordance with the provision of subsection (iv) herein.

(iv) Any person designated as a Qualified Underwriter Principal who has been registered with a member or members as a principal for a period of at least three years prior to \_\_\_\_\_ and who was actively engaged in the origination of underwriting issues of securities shall not be

