Fifty Years of Securities Regulation in Search of a Purpose

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For slightly more than half a century the Securities and Exchange Commission (SEC) has been charged with the duty of regulating disclosure. This article examines the SEC's purposes in formulating disclosure requirements throughout the past fifty years, the SEC's disciplinary measures for violations, and the SEC's recently proposed legislation prohibiting insider trading on nonpublic information. The author believes that although the SEC exceeded its proper authority in the area of disciplinary measures in the 1970's, much of the overreaching has subsided. The author concludes that the proposed legislation is still too indefinite to meet the legitimate needs of the financial community.

The year 1983 marked the 50th anniversary of the Securities Act of 1933, which coincided closely with the time of my attendance at

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In this article:
The Securities and Exchange Commission is referred to as “SEC” or “the Commission.” Its Accounting Series Releases are cited as “ASR.” Its Codification of Financial Reporting Policies is cited as “CFRP.”
Rules promulgated by the SEC pursuant to the Securities Act of 1933 are found at 17 C.F.R. § 230.- Rules promulgated by the SEC pursuant to the Securities Exchange Act of 1934 are found at 17 C.F.R. § 240.-
The American Institute of Certified Public Accountants is referred to as “AICPA.” Its Accounting Research Bulletins are cited “ARB.” Its Opinions of the Accounting Principles Board are cited “APB Opinion.”

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the 50th reunion of my law class at the University of Michigan. This happened, of course, because the famous first hundred days of the Roosevelt Administration (during which the Securities Act was enacted) corresponded roughly with my last hundred days in law school.

By a fortuitous incident I became involved with the Securities Act very soon after my graduation and I have followed the securities legislation closely through most of these fifty years. During my period of service at the Securities and Exchange Commission (SEC), I became interested and involved in legal-accounting matters and in the meaning of accounting for legal, regulatory, and investment decision purposes.1 Subsequently, I came to believe that the Commission has not adequately modified its approach to accounting and financial disclosure to reflect the change from a deflationary to an inflationary economy and to reflect increased analytic and economic understanding of the working of the markets. While there have been improvements, they are not yet sufficient. My concern is reflected in Part I of this article.

I was a minor Roosevelt New Dealer during my period of service at the SEC, which was roughly during its fifth to tenth years. I remain sympathetic to the role of government in the economy and the society. However, I think that government tended to go too far in the 1970's and the SEC was an example of this tendency. This view is reflected in Part II.

I do not intend in this article to deal with securities regulatory problems at a technical level. Rather, I intend to use the SEC as an example of broader issues which have been presented in administrative law and the role of government over the last fifty years. The SEC is a fair example because it is generally conceded that the SEC has been among the best, if not the best, of the federal administrative agencies throughout its entire life. Its staff has retained a high level of competence, integrity, and assiduous performance of its duties.

Part of the reason for the SEC's excellent reputation is that it has done a very satisfactory job of limiting gross securities fraud, notwithstanding occasional egregious failures such as Equity Funding.2 Its excellent success in this respect leads some to believe that it is equally successful in its regulatory activities and in aiding investors in their investment activities. However, for at least fifteen years there has been a second school of thought to the effect that the SEC

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1. See Kripke, Accountants' Financial Statements and Fact-Finding in the Law of Corporate Regulation, 50 YALE L.J. 1180 (1941), and 72 J. Accr. 201 (1941); Kripke, A Case Study in the Relationship of Law and Accounting: Uniform Accounts 100.5 and 107, (pts. 1-2), 57 HARV. L. REV. 433 (1944), 57 HARV. L. REV. 693 (1944).
2. See infra text accompanying notes 102-106.
has not been wise or efficient in the latter respects, and that it has reached beyond its proper sphere of activities.\(^4\)

In this article, I will not attempt to appraise the SEC's regulatory activities. Professor Walter Werner, in two strong articles,\(^4\) contended that the SEC had deliberately disabled itself from maintaining the economic competence necessary for effective regulation, had failed to regulate effectively in two important fields, and had preferred to take a purely legal approach, assuming the role of the scourge of evil-doers, thus emphasizing its antifraud approach.\(^6\) Indeed, a former commissioner, Roberta S. Karmel, wrote a book, the title of which reflects her belief that the SEC's regulatory and even its disclosure activities have been skewed by its enforcement approach. The title of the book is *Regulation by Prosecution*.\(^6\)

Even spokespersons for the Commission concede that the Commission was unaware of the extent to which stock exchanges had diluted their net capital requirements for the brokerage industry in the late 1960's. The Commission relied on the stock exchanges in lieu of applying its own requirements. This reliance was responsible in part for the almost calamitous "back office" collapse of the early 1970's.\(^7\)

A recent book reviews the history of the SEC's efforts to force the stock exchanges to abandon fixed commissions, and concludes that the agency was culpable in delaying the accomplishment of that result.\(^8\) The book also reviews the agency's efforts to establish the national market mandated by Congress and again finds delay and lack.

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5. More recently the Commission has attempted a resurrection of its economic competence by creating an Economic Directorate. In my opinion, the studies emanating from that organization have been essentially statistical studies with little in the way of economic judgment that might be helpful in determining regulatory or disclosure policy. Of course, I have no way of knowing what role the Economic Directorate plays in the determination of Commission policy in camera.


8. See J. Seligman, *supra* note 7 at 382-416, 466-86.
of drive. Others have criticized the Commission’s requirements for disclosure from the point of view of usefulness.

A convenient way to examine whether the SEC has, in an overall view, served its purposes wisely and efficiently is to consider what its purposes were. Here we find considerable ambiguity and subtle shifts of position. Hence, the title of this article.

This article focuses on two areas: (1) the purposes of fifty years of disclosure requirements; and (2) the purposes behind the SEC’s overreaching in the 1970’s in the administration of the disclosure rules and the antifraud prohibitions.

PART I: ADMINISTRATION OF DISCLOSURE:
THE PURPOSES OF THE DISCLOSURE SYSTEM

PURPOSE ONE: Getting the markets working.

A good way to begin this discussion is with a pioneer article by Morton and Booker that is too little known: The Paradoxical Nature of Federal Securities Regulations. The authors’ thesis is that the real purpose of the Securities Act of 1933 was to restore public confidence in the securities markets to lift the country out of depression. Morton and Booker believe that the “peccadillos” or frauds in the securities markets in the period before the Great Crash of 1929 were no worse than those of prior periods; however, more persons and classes of society were hurt by the Great Crash than in prior periods because more people had been speculating. The authors believe that Congress’ real purpose in passing the Securities Act was getting the markets working to finance business, but the Act was sold to the public under the more attractive guise of protecting the individual investor by preventing fraud. Eventually, the SEC began to believe its own publicity and started to concentrate on the anti-fraud function, even at the expense of the flow of capital.
The SEC undoubtedly came to believe its own rhetoric. Professor Alison J. Anderson examined the question of its purposes in her 1974 article,\textsuperscript{14} and found that the legislative history and early SEC history are unclear as to the purpose of disclosure mandated by Congress in the securities legislation. She discussed two possible purposes:

**PURPOSE TWO:** Protecting investors against fraud and other abuses in the securities markets;

**PURPOSE THREE:** Providing useful information to assist investors in making buy, sell, and hold decisions in securities.

Professor Anderson at times refers to these as "the protective function" and "the informational function" respectively.\textsuperscript{15} For a long time I thought Professor Anderson's dichotomy was probably strained, and that the obvious answer was that the mandated disclosure had both the protective and the informational purposes to some extent. One simple explanation for the relatively slight effort in the early years to make disclosure more informative and useful could be that securities analysis was in its infancy at the beginning of securities regulation. Indeed, the first edition of the seminal book on fundamental security analysis, by Graham and Dodd, was not published until 1934.\textsuperscript{16}

After further thought, I now believe that Professor Anderson's thesis is correct. Much of the disturbing history of the SEC's role in the time of writing was the SEC's chief appellate litigator: "Since I believe Congress was attempting to improve the morality of the marketplace, I think that the economic effect is largely irrelevant . . . ." Ferber, *The Case Against Insider Trading: A Response to Professor Manne*, 23 *VAND. L. REV.* 621, 622 (1970).

\textsuperscript{14} Anderson, *supra* note 3, *passim*.

\textsuperscript{15} At one point, Professor Anderson describes the informational function somewhat differently: "[T]he promote efficient allocation of capital resources through well-informed securities markets . . . ." Anderson, *supra* note 3, at 323. Only at this point does she throw the emphasis on the public concern with efficient capital markets rather than on individual investors' concern with securities selection. At this single point she approaches Morton and Booker's **PURPOSE ONE**.

\textsuperscript{16} B. GRAHAM & D. DODD, SECURITY ANALYSIS (1934). The final edition was B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS (4th ed., 1962). A popularized version of this work, published in several editions, was B. GRAHAM, THE INTELLIGENT INVESTOR. The SEC's view of its informational function (**PURPOSE THREE**) during most of its history was congruent with the theories of fundamental analysis pioneered and exemplified by these books. It is interesting that Ben Graham's view in an interview shortly before his death was that the then current goal of "performance" had departed from his ideas of fundamental analysis and left the market more unpredictable. Moskowitz, *The 'Intelligent Investor' at 80*, N.Y. Times, May 5, 1974, § 3, at 7, col. 1.
mandated disclosure can be explained by its emphasis on disclosure as an aid to enforcement of the antifraud laws (PURPOSE TWO), rather than any intent to assist affirmatively in securities selection or to strengthen the capital markets (PURPOSES ONE and THREE).

**PURPOSE FOUR: Performing functions in a way that will avoid criticism.**

**PURPOSE FOUR** is not unique to the SEC; it is endemic to every bureaucratic organization, public or private. In the SEC, the feared criticism might come from investors who lost money because they relied on a disclosure document required by the SEC and from congressmen who might take some heat from such investors.

As one who has known many commissioners and staff members of the SEC I cannot doubt their sincerity, integrity, and good faith. Were it not for this, it would be hard to believe that before the early 1970's the SEC took PURPOSE THREE seriously, that is, the assertion that its purpose was to give effect to the philosophy underlying the act, that a disclosure law would provide the best protection for investors. In other words, if the investor had available to him all the material facts concerning a security, he would then be in a position to make an informed judgment whether or not to buy.17

Ray Garrett, Jr. had an explanation of the Commission's emphasis during its first four decades on historical accounting reports. In 1976, shortly after he had resigned as chairman of the Commission, he stated:

> There is an implicit fundamentalist's faith in the approach of the [Securities Act forms]. Investors make investment decisions primarily by extrapolation from a company's past experience accurately portrayed. I certainly do not know, and I am reasonably confident that the Commission collectively does not know, the extent to which this is statistically true.18

To support the Commission's approach as thus described one could quote J. M. Keynes:

> It would be foolish, in forming our expectations, to attach great weight to matters which are very uncertain. It is reasonable, therefore, to be guided to a considerable degree by the facts about which we may feel somewhat confident, even though they may be less decisively relevant to the issue than the other facts about which our knowledge is vague and scanty . . . our usual practice being to take the existing situation and to project it into the future, modified only to the extent that we have more or less definite reason for expecting a change . . . .

> The outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield have to be made . . . .19

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As Keynes indicates, recognition that the future may not be like the past still leaves one needing a working rule. The assumption that the future will be like the past may be useful, as a rule of thumb, unless we know otherwise. Such thinking, however, cannot justify the Commission's completely rigid opposition for nearly forty years to any estimation of the future. In shutting out any effort to project the future, the Commission was not making a judgment of relevance under PURPOSE THREE, for investors clearly considered projections to be relevant, and it was not the Commission's function to do the investors' thinking for them. Rather, it was operating under PURPOSE FOUR, to protect itself against the possibility that it could not adequately police discussions of the future and that such projections might prove to be inaccurate.20

Garrett's statement conceals another problem. He refers to "past experience accurately portrayed."21 The most useful information furnished by the SEC documents is financial information because it can be structured and made comparable. The most useful financial information which the SEC could supply consistent with its antifraud and self-protective purposes (PURPOSES Two and FOUR) has been accounting information. However, this begs the question of whether standard accounting information is "past experience accurately portrayed."

Accounting, while it was not new in the early 1930's, was still a jungle. No one had the authority to promulgate general practices or principles for issuers of securities and accountants to follow. A process of this nature began in 1932, the year before the adoption of the Securities Act, when the New York Stock Exchange and the American Institute of Accountants (now the AICPA) agreed on a program for adopting accounting principles. The AICPA adopted its first rules at a general meeting in 1934.22

Improvement of accounting is not an easy task. Accounting is not found in nature and is not derived from the laws of nature. It is a set of concepts existing by convention and agreement, yet it remains the heart of securities disclosure. The SEC at first sought to tame this

20. Former Commissioner Loomis, while he was General Counsel, made this point explicit in 1968: "We don't want [projections] going out under our auspices." PRACTISING LAW INSTITUTE, NEW TRENDS AND SPECIAL PROBLEMS UNDER THE SECURITIES LAWS 300 (Transcript, 1970). See also DISCLOSURE TO INVESTORS: A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 SECURITIES ACTS (The Wheat Report), 95-96 (1969).
22. These are now embodied in ARB No. 43, ch. 1, § A (1953).
jungle by obtaining the cooperation of the AICPA, but the AICPA refused to cooperate because it did not approve of government regulation of the accounting profession. After a few years the SEC capitulated and told the accountants, in effect, that if they would get on with the job of adopting accounting principles and striving toward uniformity, the SEC would allow them to do so. Thus, the SEC has delegated to the accountants, without any statutory authority for such delegation, the most important part of its disclosure job. This delegation is in contrast to the express statutory authority given for delegation to other self-regulatory bodies, such as the stock exchanges, the National Association of Securities Dealers, Inc., and the Municipal Securities Rulemaking Board.

As business and financing arrangements have become more complex over the years, the SEC has increasingly left accounting matters to the accountants. It has frequently argued that it does not have the personpower to make the studies and to exercise the supervision necessary to regulate accounting effectively. It also contends that it has


The latest SEC justification for this position is by then-Commissioner Bevis Longstreth in The Sec's Role in Financial Disclosure, 7 J. ACCT., AUDITING, & FIN. 110, 116, 118 (1984):

Some are critical of the Commission's failure to assert a more formal role in the accounting standards-setting process. Professor Homer Kripke, for example, describes the accounting area as the Commission's biggest failure. Professor Joel Seligman voiced similar concerns in his recent book. Professor Kripke argues that 'accounting principles have to be set jointly by the private profession and the Commission.' He describes the current process as 'an uneasy cooperation caused by the Commission's unwise exclusion of itself from an avowed role in the process and the guerrilla warfare it therefore has to wage to influence the process.'

I disagree with Professor Kripke. Under the Commission's current procedures, accounting principles are, in fact, set jointly by the profession and the SEC. The process is not exactly as Professor Kripke would fashion it. There is a productive tension between the Commission and the FASB, resulting from the Commission's oversight efforts. What is "guerilla warfare" to Professor Kripke was the 'prodding, guidance, and review necessary to ensure the profession meets its challenges' to former SEC Chairman Harold Williams. The Wheat study group on establishment of accounting principles called it a 'continuing dynamic relationship.'

Through a constant exchange of views with the FASB, the Chief Accountant, and through him, the Commission, is kept current on all significant accounting developments.

This informal process of oversight creates numerous opportunities for the Commission to affect not only the approach to be taken by the FASB with respect to various issues but the agenda of issues to be considered.

But what is the significance of the FASB's vaunted due process or the Commission's compliance with its own administrative rule-making due process requirements when the Commission is able to "affect" the FASB by the "informal" back door?
not given up its control, but operates in a supervisory capacity.

The question of using historical cost or current market value of assets shown in financial statements is the basic issue in accounting. Initially the Commission’s emphasis on cost may have been justified because during the Depression, when securities regulation was born, issuers wrote down their assets below cost. This was done on a real or purported value basis, to reduce depreciation and other exhaustion charges, and thus to boost the issuer’s income. But the SEC persisted in its position long after the Depression was over, even though adherence to historical costs bolstered income by keeping exhaustion charges below what they would have been if those charges had reflected the current replacement costs or another basis of recognizing values. Admittedly, the SEC did not encounter any resistance from the accounting profession on this point. The accountants, partly on principle and partly because of risks of liability, have shown a preference for the objective historical cost system over any other kind of value system. This position of the accountants still persists under FAS 33 (1979), which retains the historical cost system and treats disclosure of current costs as supplementary information, outside the principal financial statements and thus outside the auditor’s opinion.


26. Frequently the result is that when the property is sold and a new larger cost recognized by the new owner, the increased depreciation charge reduces the new owner’s income to the point that he loses the advantage of the acquisition. This applies in “purchase accounting,” even when the new larger cost is determined by the market value of the stock issued in exchange. Alternatively, under the concept of “pooling,” in the case of an acquisition for stock consideration, this result is avoided by retaining the former owner’s costs and balancing the transaction by using lower dollar figures for the acquirer’s stock issuance. The accounting authorities have sought to justify “pooling” by drawing metaphysical distinctions between it and “purchase accounting.” See ARB No. 48 (1957); APB Opinion No. 16 (1970); cf. FASB Discussion Memorandum, An Analysis of Issues Related to Accounting for Business Combinations and Purchased Intangibles (Aug. 19, 1976). I have contended that the real purpose of pooling is to avoid a disruption of the basis for depreciation caused by a transfer which requires recognition of a new cost, a disruption which would be avoided if the basis for depreciation was periodically adjusted on a value basis. See G.R. Catlett & N.O. Olson, Accounting for Goodwill 122 (1968) (comments of Homer Kripke) (AICPA Research Study No. 10); Kripke, Accounting for Corporate Acquisitions and the Treatment of Goodwill: An Alert Signal to All Business Lawyers, 24 Bus. Law 89 (1968); T.J. Fiflis & H. Kripke, Accounting for Business Lawyers 605-22 (2d ed. 1977).
Disclosure of Forward-Looking Information and Estimates

Similarly, the SEC long forbade, even outside the financial statements, any estimates of value or forecasts of earnings from which estimates of value might have been deduced. The SEC feared that opening the door to estimates of value or earnings could unleash the potential for fraud (PURPOSE Two) because such estimates could not be policed by the SEC, thus leaving it vulnerable to criticism (PURPOSE Four). It denied forecast and estimate information even to sophisticated professionals for fear that someone might be unwary and be deceived. The SEC also forbade disclosure of any other "soft information" which it could not objectively verify.

Cash flow information was also not permitted to be supplied to readers of financial statements for fear that this information might be confused with accrual accounting disclosures and thus open the door to fraud. Cash flow had long been the basis on which investments in real estate securities were considered and it was important in many other respects. Management accounting, as distinguished from financial accounting, rests more on a cash flow basis than an accrual accounting basis. Yet the SEC specifically denied permission for cash flow disclosure, even as a supplement to accrual accounting, until accountants themselves began emphasizing the importance of cash flow. Since then, having learned from the accountants, the SEC has begun emphasizing in Regulation S-K, Item 303(a), Instruction 2, the importance of estimating cash flow, its risks, and

28. Schneider, supra note 3, passim.
30. To some extent this rigid exclusion became less damaging when the accountants added a fourth principal financial statement to the usual three, namely, a Statement of Changes in Financial Condition. See APB Opinion No. 19 (1971). Even that, however, did not clearly focus on cash flow for many years, but focused on working capital, an imprecise concept which could obscure cash flow. See L. Heath, Financial Reporting and the Evaluation of Insolvency (1978) (AICPA Accounting Research Monograph No. 3). It has been only in the last two years, propelled by the FASB's proposal to change the emphasis toward a Statement of Cash Flows, that accountants have begun to redirect the Statement of Changes in Financial Condition from analyzing changes in working capital to analyzing changes in cash. See FASB Exposure Draft on Reporting Income, Cash Flows and Financial Position of Business Enterprises, ¶ 36 (Nov. 16, 1981); FASB Exposure Draft on Recognition and Measurement in Financial Statements of Business Enterprises, ¶¶ 28-30 (Dec. 30, 1983).

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the timing thereof. While both the SEC and the accounting profession assert that accrual accounting is more useful than cash-oriented statements in estimating future cash flow, they have not demonstrated the point.

It is hard to believe the Commission thought that financial disclosure limited principally to historical cost accounting, with its rigid rules for recognition of revenues, modeled the real world or supplied the information on which investment decisions could be based. The best that can be said is that (1) having delegated its control over accounting to accountants, the Commission did not think deeply about the meaning of accounting, the nature of investors' needs for financial information, and the proper role of the SEC's mandated disclosure to meet that need; and (2) accounting information with its built-in conservatism was useful for the Commission's antifraud and self-protective purposes (PURPOSES TWO and FOUR).

One commentator, writing shortly after he left a top position in the SEC's Division of Corporate Finance, suggested that the proper function of mandated disclosure was to provide "facts," that is, objectively determinable information about the past to slow down the decisional process through a mandatory waiting period, leaving the decisional process in the hands of the investor and his broker.34

While the commentator's express assumption to justify his theory was that the investor and broker would examine the "facts" in the registration statement, he understood that they would consider the

[A] cash flow statement provides an incomplete basis for assessing prospects for future cash flows because it cannot show interperiod relationships. Many current cash receipts, especially from operations, stem from activities of earlier periods, and many current cash payments are intended or expected to result in future, not current, cash receipts. Statements of earnings and comprehensive income, especially if used in conjunction with statements of financial position, usually provide a better basis for assessing future cash flow prospects of an entity than do cash flow statements alone.


To prior statements of this the writer has answered: "In this the FASB is at least partially right." H. Kripke, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 222 (1979). But, the writer argued that accrual accounting ignores (and depreciation accounting in particular ignores) the disparate time values of immediate and delayed cash flows. Id. at 224-27.

33. See supra text accompanying notes 23-24. See also H. Kripke, supra note 25, pt. III.

very kind of material whose exclusion from the registration state-
ment he defended. In fact, he argued that this was their role.\textsuperscript{35}

It would be tempting to designate this program of causing delay as
another purpose of the program. However, this theory certainly did
not conform to the Commission’s pronouncements about its role, or
its sense of its own value and importance. But I believe that when
this comment was written in 1961, and for the next dozen years, it
correctly expressed what was actually happening in the new and
more vigorous post-Eisenhower era.

I therefore conclude that the dominant purposes of the Commis-
sion in disclosure during its first forty years, until the 1970’s, were
PURPOSE TWO — prevention of fraud (aided by rigid conservatism
and refusal to permit optimistic statements), and PURPOSE FOUR —
self-protection.

\textit{The SEC Recognizes the Real World in the 1970’s}

I have described the situation as it existed until the end of the
1960’s. Several changes for the better occurred early in the 1970’s.
First and foremost was the arrival of John C. Burton as Chief Ac-
countant. He was principally responsible for bringing SEC disclosure
into the real world. He provided the principal impetus for requiring
the recognition of current values and of inflation accounting through
ASR 190.\textsuperscript{36} The FASB took over the problem (with the SEC’s con-
currence) by issuing its FAS 33 and subsequent ancillary state-
ments.\textsuperscript{37} Under Burton, the SEC developed what is now the Man-
agement Discussion and Analysis of Financial Condition and Results

\textsuperscript{35} Heller, \textit{supra} note 34, at 307-11.
\textsuperscript{36} ASR 190 (1976).
\textsuperscript{37} FAS 33 (1979). A very recent study prepared for the FASB asserts: “State-
ment 33 earnings variables provide no incremental information over and above that al-
ready provided by historical cost earnings.” W.H. BEAVER \& W.R. LANDSMAN, INCRE-
MENTAL INFORMATION CONTENT OF STATEMENT 33 DISCLOSURES (1983) (FASB
research report) reprinted in part in Deloitte, Haskins \& Sells, \textit{The Week in Review}
(Dec. 9, 1983) at 1-2. This conclusion was reached because none of six variables in
Statement 33 explained changes in stock prices of the reporting companies better than
historical cost earnings. But the authors continue:

Other studies have found little or no interest by the analyst community in the
use of Statement 33 data . . . . Why do analysts show so little interest in State-
ment 33 data? The reason may be that the data are too complex and unfamiliar
to use. However, another reason is that the data provide little or no additional
information relative to that already used by analysts.

. . . .

There are 2 conditions that could lead to different results than those reported
here: (1) The level of unanticipated inflation (and unanticipated changes in spe-
cific prices) could become sufficiently high to overcome the effect of measure-
ment errors. If unanticipated inflation is high enough, the potential information
content may dominate measurement errors. (2) The measurement errors in
Statement 33 data could be reduced.

\textit{Id.}

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of Operations, required by Regulation S-K, Item 303. Accordingly to this regulation, the firm’s management must analyze the corporate financial statements in terms of the liquidity of the company (including cash flow), the available capital resources, and the extent to which past financial statements are not likely to be indicative of the future. Thus, the Management Discussion and Analysis necessarily involves a management projection of what the future is going to be like, at least in comparison to the past. Burton was a strong supporter of disclosure of projections in Commission documents; it was not by accident that the Commission in the 1970’s abandoned its long-maintained negative attitudes toward disclosure of projections.

The Commission’s authorization and, indeed, asserted encouragement of the use of projections in Commission documents in the 1970’s admittedly has not been widely used; and could not have been expected to be widely used, considering the staff’s traditional hostility to projections and its adherence to old patterns. These were shown first by an unworkable first draft of the proposed authorization for projections, and later in a battle by the Enforcement Division of the SEC to place the burden of proving good faith on the issuer who seeks to invoke the safe harbor provisions for use of forward-looking information. These efforts, even though overruled, were not likely to encourage anyone to volunteer projections. Nevertheless, the struggle for the use of projections was the focal point in the successful effort in the 1970’s to loosen up the Commission’s rigidly stereotyped required disclosures and to let the issuer tell its story in a meaningful way.

Despite these improvements, there is still a major question whether the FASB’s accounting principles, enforced by the SEC,
model the real world. The FASB principles are still a long way from showing the time value of money, and neither the Commission nor the FASB has moved very far in that direction. In fact, the FASB moved substantially backward in FAS 15 on Accounting by Debtors and Creditors for Troubled Debt Restructurings, in which it held that no gain or loss is suffered when a restructuring postpones the payment of the principal amount of a debt either with no interest or with very low interest for a long period. This ruling severely undercut the principal advance made by the accounting authorities in APB Opinion No. 21 toward recognition of the time value of money. Present disclosures do not go very far to disclose to the investor values which many investors consider important, such as the ability to borrow, the ability to make acquisitions by the use of "paper" (i.e., the corporation's newly issued stock), and the ability to leverage one's assets.44 Perhaps this kind of value recognition and appraisal should be left outside of SEC disclosure and relegated to the analyst.

Another individual who played an important part in bringing the Commission into the real world was Commissioner A. A. Sommer, Jr. He was among the first to suggest the informal annual report to stockholders as potentially the most useful disclosure document.45 He was also chairman of the SEC Advisory Committee on Corporate Disclosure, which existed from 1976 to 1977. As a member of that committee, I criticized its failure to go far enough in thinking through the implications of the modern economics of the securities markets.46 There is no doubt, however, that that committee made a great advance in causing the Commission to realize the key position of the professional in securities decisions. The committee also advanced the push to unify and modernize the forms which led to the recent integrated securities disclosure system.47 The committee took the lead in pointing out that the mandated disclosure system furnished only part of the information needed by and available to the investor, and does not necessarily furnish this information first. There is a wide-spread informal disclosure system operating through informal corporate reports, meetings with financial analysts, press releases, information from suppliers, customers, competitors, and trade journals. These sources frequently provide information long before it

44. See M.J. Whitman & M. Shubik, THE AGGRESSIVE CONSERVATIVE INVESTOR (1979); Whitman & Shubik, Corporate Reality and Accounting for Investors, 39 FIN. EXEC. 52 (May 1971).
46. Kripke, infra note 63.
appears in the mandated disclosure system. This raises a question, of course, as to the need for and the purpose of the mandated disclosure system, which in turn leads us to PURPOSE FIVE.

**PURPOSE FIVE:** Requiring that information which may already be circulating in the market be restated formally in documents filed with the Commission under threat of statutory penalties.

This filing requirement provides a sanction for the truth of the informal disclosure system, for discrepancies would be rapidly disclosed. PURPOSE FIVE also presents substantial issues of cost and benefit because a mandated disclosure system could provide the sanction mentioned simply by the necessity that the bottom lines of required financial statements jibe with the informal information, without the present elaboration of the mandatory system.

Without denigrating Burton's and Sommer's contributions, it is fair to say that the SEC was pushed into modernized and flexible disclosure in part by commentators and in part by general criticism of its adamant stand. The Commission was far too late in switching its emphasis from use of disclosure for protective purposes (PURPOSE TWO) to use of disclosure for informational purposes (PURPOSE THREE). This switch coincided with the increased growth of the financial analyst profession and the growth of financial intermediaries like pension funds and mutual funds which also applied

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49. Advisory Committee Report, supra note 48, at XI, XVII-XXVI, 310-15. (The Roman numerals refer to the Introduction to the Report written by the committee's Chairman, A.A. Sommer, Jr., who had been a commissioner of the SEC at the beginning of the committee's functioning).

50. This is particularly the case because much of the information is mandated not by the SEC, but by a private organization, the FASB, functioning under the protective enforcement arm of the SEC. The effect is a privately levied tax on issuers in the form of reporting expense without their consent, for the benefit of the analyst community and the investment public. While the Financial Analysts Federation and the Securities Industry Association are sponsors of the FASB, there seems to be no sponsor who could be deemed the spokesman for issuers. Two possible exceptions are the Financial Executives Federation and the National Association of Accountants. In each case their members are primarily accountants in the employ of issuers and potential issuers, who may potentially have an accountant's bias.

51. See authorities cited supra note 3.
analytic techniques, and a general realization that protective disclosure focusing on fraud prevention excluded materially important information, including estimates and forecasts needed by investors for future-based decisions. Investors are not interested in learning from the past years' earnings figures required by the SEC that they should have purchased a security five years earlier. Otherwise stated, some persons buy for the long term; some persons buy for the short term; but no one buys for the past term.

Disclosure to prevent fraud (PURPOSE TWO) could never have been justified on a cost-efficient basis. Emphasis on conservative accounting principles and hard information may have served initially to prevent recurrence of the fraud believed to have been characteristic of pre-SEC days, but after a few years attempts to register blatantly fraudulent issues for public sale ceased. The more blatant forms of fraud took place outside the SEC disclosure system, with rare exceptions like Equity Funding. The antifraud laws and the sanctions for failure to register, not the registration process itself, are the prime tools used to block outright fraud. Considering the number of speculative issues that are sold despite the SEC's conservative bias and the most complete disclosure of "risk factors," it is doubtful that the registration system efficiently protects the public against speculations.

The Challenges of Economics to the SEC's System of Disclosure

Even as the SEC began using its disclosure system with a more appropriate orientation toward the informational needs of investors (PURPOSE THREE), economic analysis and other factors cast new doubts on the efficiency of the system. First, it became apparent that the SEC's disclosure system contained little or no "information," in the sense of factual knowledge not already available. Second, the SEC eventually recognized a necessary correction in its concept of its informational function (PURPOSE THREE). Several writers insisted that disclosure concerning a complicated corporation could be understood only by a professional. But SEC officials were gearing their appeals for brevity and simplicity to the needs of the lay investor,

52. See supra text accompanying notes 27-28, 34-43.
53. For an assertion that the public did not attempt to make securities decisions from prospectus disclosure as administered by the SEC to 1970, see Kripke, supra note 27, at 1164-75. For an account of the sale of securities for the Tucker automobile despite the most complete disclosure of unsoundness and risk, see Morton & Booker, supra note 3, at 494.
54. For a discussion of PURPOSE FIVE see supra text accompanying notes 48-50.
and were insisting that the prospectus be written for the layperson.\(^5^6\) Toward the end of the 1970's, the SEC recognized that the layperson's benefit from securities disclosure comes after a process of filtration of information through professionals, directly in the form of investment advice or management and indirectly through their effect on the market.\(^5^7\) It came to be accepted that the best estimate of the value of a broadly-traded security is the market price determined by the interplay of buyers and sellers in an active market.\(^5^8\) The SEC very properly referred to this in the explanation of its streamlined procedures in Form S-3. Form S-3 relies heavily on incorporation by reference of filed information and reduction of the material that must physically be furnished to the investor in the filed and distributed prospectus.\(^5^9\)

The third challenge to the SEC system came from economists' findings that active securities markets are "efficient," that is, all publicly available information is rapidly "impounded" in the prices of securities, so that trading or investment on the basis of public information is unlikely to produce abnormal profits. The economists concluded that for most investors the best program is to assume that market prices reflect all available information, the market is fair, and market prices are the best evidence of value. Therefore, attempts to gain more than normal profit are likely to be useless or counter-productive, and the proper procedure is to hold a portfolio of securities diversified by industries, rather than trading in the hope of beating the market.\(^6^0\)

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56. Levenson, *Appropriate Disclosure*, Rev. Sec. Reg. 961 (March 4, 1971). Mr. Levenson was then Director of the SEC's Division of Corporation Finance.

57. Advisory Committee Report, supra note 48, at 312-14.


Equally important were the economic findings that the risks of particular securities can be reduced by adequate diversification. Modern portfolio theory bases investment on appropriate diversification of the portfolio, not on intensive study of the individual security. Many institutional investors now invest, at least in part, on an index fund basis. They are trying to parallel in their holdings a broad representation of the market, rather than picking individual securities and trading actively. The vast College Retirement Equities Fund (CREF) recently announced that 80% of its $11.5 billion portfolio is managed on an index fund basis to “generally track the results of the entire U.S. stock market. Most of this 80% is invested in Standard & Poor’s (S&P) 500 stocks, held in proportion to their weights in this well-known indicator, with the balance invested in a representative sampling of non-S&P stocks.”

On their face, these theories leave little room for the present disclosure system. Admittedly, not all theorists or participants in the investment world accept them, but certain conclusions seem inescapable. Diversification leaves the small investor with so little investment in any particular company that it is scarcely worth his while to wade through the enormously complicated disclosures, financial and otherwise, in the annual report and prospectus disclosure system, or in the proxy system. The average stockholder thinks of himself or herself as an investor, not an owner of the corporation, and has little interest in proxy disclosures relating to the character, experience, stockholdings, remuneration, and perquisites of management. Instead of trying to exercise control as an owner of the business, such an average stockholder thinks of himself as an investor who, if he is dissatisfied, tends to sell out and look for a different company.

As a member of the SEC Advisory Committee on Corporate Disclosure in 1976 and 1977, I was unable to get the committee to study adequately the impact of the new economics on the disclosure system. To this I dissented. The Commission itself, however, in the last five years has paid more attention to the new economics. The SEC has recited the theory of the efficient market as justification for reducing the disclosures required in the prospectuses of large,


61. See references supra note 60.


63. Advisory Committee Report, supra note 48 at D-49 (Dissenting Statement of Homer Kripke). I enlarged this dissent in Kripke, Where Are We on Securities Disclosure After the Advisory Committee Report?, 6 Sec. Reg. L.J. 99 (1968), and in 2 J. Acct., Auditing & Fin. 4 (1968). See also H. Kripke, supra note 25, pt. II.
widely-traded companies\textsuperscript{64} and for permitting incorporation by reference. For less widely traded securities, it has permitted physical attachment of filings from the continuous reporting system instead of requiring repetition of information in the prospectus. Finally, the Commission has approved "shelf registration."\textsuperscript{65} Shelf registration essentially eliminates the waiting period which was originally designed to give investors time to study the securities before they are subject to buying pressure from underwriters and dealers.\textsuperscript{66}

All of these devices are commendable and I have commended them.\textsuperscript{67} I have also commended a rationalization of the Commission's exemptions from registration under the Securities Act for non-public issues and small issues,\textsuperscript{68} although I have pointed out some dead wood in the system which has not yet been pruned.\textsuperscript{69} There is still a need for an even more drastic pruning of dead wood in the Securities Act registration system.

For the large and widely-traded companies using Form S-3, the system has become merely pro forma, with perfunctory disclosure through incorporation by reference. Any investor sophisticated enough to obtain the information incorporated by reference knows of its availability without the formal incorporation by reference. The typical investor will never have or use the full disclosure. Instead, as the Commission expected, investors will make decisions by relying upon professionals or the market price. These two sources constitute an investor's principal protection. Therefore, apart from achieving formal compliance with present statutory requirements, 1933 Act disclosure for the largest companies now serves little or no purpose.\textsuperscript{70}

\begin{itemize}
  \item \textsuperscript{65} Reversing a long-standing prior position, the Commission by Rule 415 now permits companies to register securities under the 1933 Act "for the shelf," so that when they are ready to sell them they can determine price and underwriting terms and be in a position to sell very rapidly without the traditional twenty-day (or longer) waiting period under § 8(a) of the 1933 Act. This enables issuers to hit a "window," a brief favorable situation in the market.
  \item \textsuperscript{66} Rule 415, \textit{reprinted in} 2 \textit{Fed. Sec. L. Rep. (CCH)} \textnumero 5,813. \textit{Compare} Heller, \textit{supra} note 34 and accompanying text. The Commission has recently extended Rule 415, but has limited its use to Form S-3 companies. Wall St. J., Nov. 11, 1983, at 2, col. 2.
  \item \textsuperscript{67} Kripke, \textit{Has the SEC Taken All of the Dead Wood Out of Its Disclosure System?}, 38 \textit{Bus. L.} 833 (1983).
  \item \textsuperscript{69} \textit{See} Kripke, \textit{supra} note 67.
  \item \textsuperscript{70} Friedman, \textit{Address to New York Chapter of Financial Executives Institute},
\end{itemize}
This is a major problem because liability risks (at least theoretical ones) are imposed on underwriters who are being pushed by issuers into deciding very quickly whether to take securities off the shelf under Rule 415. This certainly makes it difficult, if not impossible, for underwriters to comply with the statutory expectation that they police the issuers' disclosure in their own interest under the threat of liability. Statutory liability could be preserved and the Commission could mandate delivery of a description of the issue, without filing, if we had the courage to break a fifty-year-old habit.

In summary, the Commission's disclosure system cannot be given high marks either for performance or on a cost/benefit basis during its first forty years. The system was founded not on disclosure of "all material facts," but on disclosure of events in the past which the Commission could objectively verify. This historical perspective was assumed for the inefficient purpose of preventing blatant securities fraud (PURPOSE TWO) and for the less apparent purpose of protecting the Commission from criticism for issues that turn sour (PURPOSE FOUR). In recent years, while the Commission has shown commendable willingness to try to modernize the system, developments and economic theory have outrun adaptation of the system. A large apparatus of disclosure which serves little purpose still remains. The disclosure mandated for large companies by the Securities Act does not reach the public in any more useful fashion than the same information already reaches the public through the companies' reports to stockholders and the Securities Exchange Act disclosure system. The purpose of mandated disclosure, when so many investment decisions turn on subjective factors dependent on each investor's time frame and portfolio position, has not been completely thought through. The Commission has been content to pass increasing responsibility to accountants not only for accounting but also for all financial disclosure.

summarized in Deloitte Haskins & Sells, The Week in Review (April 3, 1981). Mr. Friedman was then a commissioner of the SEC.


72. An SEC Advisory Committee on Tender Offers has recommended that a tender offer by exchange of stock instead of for cash could take effect without a registration statement for the stock having become effective. An SEC staff member commented: "I don't think it is way out at all." Wall St. J., Aug. 2, 1983, at 31, col. 3. Yet if there is ever a case for the full Securities Act registration process with a waiting period, effective registration statement, and full prospectus, it is in the case of an exchange offer. In that case, the offeree needs up-to-date information on both companies and prospective changes in them; for example, the offeror's plans and pro forma financials.

73. If the statutory disclosure system has any real purpose, the SEC, not one of the participating professions, has to take responsibility for its responsiveness to need. A recent article asserts that the supplementary disclosures mandated by the FASB's FAS 33 show that earnings of corporations generally and of most individual corporations are less satisfactory than the primary statements based on historical cost seem to indicate. Evans

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fundamental rethinking as we embark on a new fifty years; however, signs that this rethinking is in process are not visible.

PART II: THE PURPOSES BEHIND THE SEC'S OVERREACHING IN THE 1970'S

The 1970's spawned overregulation in many fields, such as the airlines, motor transport, the Occupational Safety and Health Administration, and the Environmental Protection Administration. The older agencies such as the Securities and Exchange Commission and the Federal Trade Commission also reflected the prevailing tendency in government.  

In its enforcement operations the SEC was undoubtedly disturbed by low corporate standards, which first showed themselves in illegal political contributions and later in "questionable payments" (fre-
quently a euphemism for direct or indirect bribery of public officials). Abusive perquisites were taken by corporate management and other insiders, and "sweetheart loans" were made by banks to affiliates of insiders or other favored customers. The SEC also believed that boards of directors and stockholders were letting managements operate without effective control and that corporate counsel were lax in permitting their clients to approach or exceed the boundaries of legality. The SEC thought that state corporation laws and state courts gave stockholders insufficient protection against overreaching by corporate insiders in violation of fiduciary obligations to investors.

Accordingly, the SEC in the 1970's purported to find two additional purposes of securities legislation:

**PURPOSE SIX:** Increasing corporate responsibility by improving the system of corporate governance;

**PURPOSE SEVEN:** Improving corporate morality in respect to statutes administered by the SEC and in respect to business conduct generally.

Instead of seeking additional express statutory powers, the SEC sought to fulfill these purposes by pushing the limits of its existing powers. Seemingly, the SEC felt like Horatius alone at the bridge, the one defender of high standards in the public interest. It thought itself charged with broad duties as *pater patriae*—father of the people—with power to discharge these duties based on enormously flexible and broad interpretation of its specific powers, and perhaps from a general emanation of authority going beyond its specifically granted powers.

The SEC's express powers in the field of corporate governance are limited. They are principally reflected in the proxy rules. Undoubtedly the proxy rules are an express power in the field, but the statutory authorization for the rules was intended to assist the stockholders in exercising control by giving them information with which to exercise their voting franchise, not to authorize the SEC to control the methods and purposes of corporate governance. Unfortunately, the statutory effort of Congress and the vast rule-making and enforcement activity of the SEC have been ineffective for two fundamental reasons. First, diversification of portfolios leaves individual stockholders with so little investment in the individual company that they are uninterested in trying as owners to control the company's conduct. They see themselves only as investors who can and do move out of a company with which they are dissatisfied. Second, no feasible method exists for small stockholders to concert activity before an

75. See E.S. Shuckburgh, *A History of Rome* 64-65 (1917).
annual or special meeting and agree on positions. Nor is there any feasible method of direct nomination of directors by independent stockholders so that the stockholders can reach an agreement as to which nominees they will support. Effective stockholder participation in corporate governance remains nonexistent; the directors are in fact nominated by management. The stockholders’ power to introduce proposals for action at the meeting under Securities Exchange Act Rule 14a(8) has long been a subject of controversy and has recently been amended to reduce the occasions on which stockholders can resort to it.  

A proposal was made to use the proxy rules to extend the SEC’s powers vastly. The proposal was to require the existence of an audit committee to be disclosed in the proxy statement, which would force the company either to create an audit committee, or be guilty of having made a false assertion in its proxy statement. Even though this was seriously proposed by a general counsel of the SEC as a source of power, it was wisely ignored by the SEC. The very occurrence of the proposal shows the mood of the SEC staff in the 1970’s.

The outcome of these efforts to make the proxy rules effective for corporate governance in the 1970’s was to proliferate meaningless detailed disclosure regarding officers’ and directors’ salaries, fringe benefits, perquisites, stock ownership, and experience of nominees. None of this information has ever served to lessen management’s control of the director election process through the proxy rules. The principal result was to increase the wealth of legal printers. Much of this proliferation of useless disclosure has recently been undone by the SEC.

The SEC also tried to affect corporate management by reforming the board of directors of the public corporation. Former SEC Chairman Williams urged in several speeches that the board be composed of independent directors, who would pay more attention to the interests of larger constituencies such as employees, suppliers, customers, and the general community, as well as the interests of stockholders.

alone. The SEC has no authority in that direction, however, and attempts to find authority failed.\textsuperscript{79}

\textit{The SEC's Questionable Methods of Intrusion into Corporate Governance}

The staff then resorted to devices presenting serious questions of policy. Agreements for the appointment of independent directors were obtained during negotiations for consent decrees to settle injunction actions, or negotiations to accept agreed disclosures regarding questioned transactions in lieu of formal charges of violations. The SEC thus used indirect pressures to achieve what it could not achieve directly using its granted powers.\textsuperscript{80} The SEC also used pressure to induce the New York Stock Exchange to require listed companies to have audit committees.

A questionable assertion of a disputed power was used to push the SEC into the field of corporate governance by disciplining lawyers under Rule 2(e).\textsuperscript{81} The Commission sought to force lawyers to become what one author called “The SEC's Reluctant Police Force”\textsuperscript{82} by trying to force lawyers to support the SEC in the enforcement of the statutes. Commissioners argued expressly that because they had a small staff and Congress would not give them the budget to hire

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\textsuperscript{79} SEC STAFF, 96TH CONG., 2D SESS., REPORT ON CORPORATE ACCOUNTABILITY, (Comm. Print of the Senate Comm. on Banking, Housing, and Urban Affairs 1980).

SEC Chairman Williams resigned following the 1980 election, but before that he played a significant role in getting the American Law Institute to take on a project of reforming corporate governance. The Institute has been working on this project with reporters whom I respect. They have produced some debatable drafts congruent with Williams' views. ALI, PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE (Tent. Draft No. 1 1982). The first public draft was resoundingly rejected by the American Bar Association's Litigation Section and by the Business Roundtable in separate reports. See Statement of the Business Roundtable on the American Law Institute's Proposed Principles of Corporate Governance and Structure: Restatement and Recommendations (1983). The criticisms are discussed in Arieff, ALI Governance Recommendations Criticized, Legal Times, Feb. 28, 1983, at 1, and in a lecture by Roswell B. Perkins, President of the ALI, to the Association of the Bar of the City of New York (March 14, 1983). Where this initiative which stems in part from the SEC will be going is anyone's guess.

\textsuperscript{80} These points are covered in more detail in Kripke, The SEC, Corporate Governance and the Real Issues, 36 BUS. LAW. 173 (1981). The validity and propriety of this form of ancillary relief in consent decrees are reviewed in Dent, Ancillary Relief in Federal Securities Law: A Study in Federal Remedies, 67 MINN. L. REV. 865 (1983).

\textsuperscript{81} See Siedel, Rule 2(e) and Corporate Officers, 39 BUS. LAW. 455 (1984). In Touche Ross & Co. v. SEC, 609 F.2d 570 (2d Cir. 1979) the Court sustained the validity of Rule 2(e) as to accountants, and in a remarkable dictum suggested that the same conclusion applied to lawyers. The Touche Ross case was settled after the Second Circuit decision. In footnote 126 of the article, Siedel cites another lawyers assertion that "many consider the Touche Ross settlement a sweetheart deal for the defendant. The theory is that, because the SEC did not want to provide the U.S. Supreme Court with an opportunity to review the Court of Appeals decision, an offer was made that the defendant could not refuse."

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more staff, they had the right to force lawyers to assist in enforcing the laws (perhaps like a sheriff who calls on the public to serve as members of a posse to enforce the law). The commissioners not only made speeches to that effect but in the case of In re Carter and Johnson,83 the SEC began a proceeding which, in my opinion, was begun primarily because the staff saw an opportunity to teach a lesson in corporate governance. The lesson was that when a client fails to follow his lawyer's advice in respect to compliance with the securities laws, the lawyer must do something or he may be found to be lacking in the ethical character that entitles one to practice before the SEC. The Commission ultimately reached a questionable result, namely, that it would not punish the attorneys because the doctrine had not been pronounced before; however, it would use the occasion to make law by questionable dictum and to issue a warning that on the next occasion it would take action. Having terminated the case by dismissal, the SEC submitted its dictum to the Bar for comment, saying that it did not want any discussion as to the SEC's power to punish lawyers, but merely wanted views on the formula proposed.84 The American Bar Association refused to comment on the formula and simply took the position that the SEC had no power to punish lawyers for conduct outside the hearing room (except, of course, for violation of law).85 We have not heard of the SEC's dictum since.

An SEC power more firmly rooted than the use of consent decrees and Rule 2(e) is its general power to prevent and punish securities fraud. The statutes contain direct prohibitions against fraud in sales or other transactions in securities. The SEC added to its arsenal by using its general rule-making powers to adopt Rule 14a(9) as an antifraud rule which applies to the solicitation of proxies under section 14(a) of the Exchange Act.86 The Commission also adopted the famous Rule 10b-5,87 incorporating section 17 of the Securities Act and making it applicable to buyers as well as sellers. The SEC found the power to do so in catch-all statutory section 10(b) of the Securities Exchange Act, which authorizes rules forbidding manipulative

87. Id. at § 240.10b-5.
or deceptive devices.\textsuperscript{88} Rule 10b-5 was not adopted until 1942, eight years after the 1934 Act was passed, and it attracted little attention at the time. It became more important a few years later when in \textit{Kardon v. National Gypsum Co.}\textsuperscript{89} the court held that private civil causes of action could be implied for violation of the rule.

Generally speaking, the SEC did little with the antifraud rules until World War II except to pursue obvious securities fraud. That war slowed down the SEC as it did all peacetime agencies. During the Truman and Eisenhower eras, the SEC remained nonaggressive and nonexpansive. The return of aggressiveness came during the 1960’s under Chairmen Cary and Cohen, and was accelerated in the 1970’s. In that atmosphere, the SEC purported to find dynamic, expansive power in the antifraud provisions of the statutes. This expansion of power was achieved by decoupling the statutory concept of fraud from the common law precedents. The SEC seemed to believe that “fraud” could mean anything that the SEC did not want to happen.\textsuperscript{90} With this weapon, the SEC apparently thought it was free to roam at will in the corporate field.

An early sign of this came in \textit{In re Cady, Roberts & Co.,}\textsuperscript{91} which held that it was fraudulent for an insider to trade in a corporation’s securities using inside information stemming from the corporation, unless the information was first made available to the public. The reasoning in Chairman Cary’s opinion is important to our discussion below. He reasoned that inside information about the corporation is corporate property, and that no one has the right to take it for his or her own benefit by trading on it. This position appears to have received general acceptance. It seems fair that insiders and their “tippees” should not be trading on inside information.\textsuperscript{92} The first court approval of this position came in the famous \textit{Texas Gulf Sulphur} case.\textsuperscript{93}

The SEC then tried to go further. Lawyers within the agency suggested that the doctrine should not be limited to inside information

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\footnote{89. 69 F. Supp. 512 (E.D. Pa., 1946).}
\footnote{90. I do not mean to suggest common law fraud or deceit was a static concept, incapable of development to adapt to changing practices and new situations. The question is one of degree, and particularly what content can reasonably be put into broad words without precise meaning, in our federal system and under our administrative system of delegated powers.}
\footnote{91. \textit{In re Cady, Roberts & Co.}, 40 S.E.C. 907 (1961).}
\footnote{92. It is important, however, to note, as Professor Wang has demonstrated, that it is impossible to determine who is victimized by insider trading. \textit{Wang, Trading on Material Nonpublic Information on Impersonal Stock Markets: Who Is Harmed, and Who Can Sue Whom Under S.E.C. Rule 10b-5}, 54 S. CAL. L. REV. 1217 (1981). The majority of the Supreme Court recognized this in \textit{Dirks v. SEC}, discussed \textit{infra} text accompanying notes 119-126.}
\end{footnotes}
stemming from the corporation. They believed that it should apply to information concerning transactions overhanging the market or events that might affect demand and supply for the company's securities in the market ("market information"), and indeed to any nonpublic information.94 The SEC brought such a case against Oppenheimer & Company, a broker-dealer. As one might expect, the Commission said that it was not going to punish the brokers for passing on nonpublic information to their clients because the law had not been determined at the time of the events. However, the SEC did issue a warning that it believed that it had power to punish use of nonpublic market information in the future.95

The SEC's market information initiative was repelled by the Supreme Court in Chiarella v. United States.96 The Court held that there could not be a duty not to trade unless a prior fiduciary relationship existed between the issuer and the trader. In Chiarella the trader was an employee of the legal printing company that was printing a tender offer.

Subsequent lower court decisions circumvented Chiarella by finding criminal liability for trading on the basis of market information used in violation of obligations to a tender offeror, although there were no obligations to the issuer.97

The SEC sought to bypass Chiarella, which had interpreted section 10 and Rule 10b-5, by adopting a rule under section 14(e) of the 1934 Act. Rule 14e-3 characterizes such trading as a fraudulent, deceptive, or manipulative act or practice within the meaning of section 14(e).98 The SEC has also proposed legislation in the present Congress which might codify this principle, although the bill's draftsmanship is open to question.99 It remains to be seen whether

99. See infra text accompanying notes 126-136.
The ultimate extension of this movement was toward an ideological view entertained in some quarters that everyone must have equal opportunity for access to all relevant information in the market.101 This view was reflected in the Commission's Order for Public Proceedings in *In re Boston Co. Institutional Investors,*102 more commonly known as the *Dirks* case because it arose out of Mr. Dirks' disclosure of fraud in Equity Funding Corporation. In the order, the Commission simply alleged that the respondents traded while in possession of nonpublic information. It did not allege that they had received information from insiders or that they had stolen the information or that they acquired it in any other disreputable fashion. The allegation was simply that they had traded while they had information that the public did not have. In an article103 and an appendix to my book104 I asserted that the Commission could never establish the law as broadly as that. In fact, the SEC staff did not attempt this at the early stages of the case. This was fortunate for the staff, in light of the Supreme Court's express rejection of the concept in *Chiarella* and *Dirks.*105 Instead the staff tried the case as an inside information case.

The special feature of the *Dirks* case was that the company denied the truth of the so-called inside information because the information asserted that the company's financial statements were fraudulent. Moreover, the so-called insiders from whom the information first came were discharged employees who were merely trying to bring the fraud to public attention without a personal profit, by inducing selling, because public authorities seemed nonresponsive. Dirks was investigating and spreading the reports of fraud at least in part to further this purpose, although there was also inconclusive evidence that he had a purpose of obtaining brokerage orders for the firm of which he was an employee. Thus, factually the case represented an expansion in the concept of improper trading on inside information. The result of the *Dirks* case will be discussed below after additional context has been set forth.106

In the late 1970's the SEC began using its new doctrine of con-

100. See Fogelson & Stein, supra note 97.
104. H. Kripke, supra note 32, app. B.
105. See infra text accompanying notes 119-126.
106. See infra text accompanying notes 119-126.
structive fraud to assume the role of defender of securities investors on all fronts, going far beyond express statutory delegations of authority. Some of the SEC staff have defended this point of view by arguing that there is no attorney’s privilege against the SEC. In Garner v. Wolfinbarger the court held that there is no attorney’s privilege against stockholders in favor of attorneys who act for the corporation and its officers and directors, because the stockholders are the corporation and therefore are the client. One cannot have an attorney’s privilege against his client. The SEC staff asserted that since it is the shield and defender of the stockholders or clients, this rule should apply to it. That proposition has never been seriously tested.

In the 1970’s, the SEC supported private litigants who contended that mergers or similar corporate transactions were fraudulent because management was treating minority stockholders unfairly. The Supreme Court blocked this development in Santa Fe Industries Inc. v. Green, by holding that breach of a fiduciary obligation (in the absence of nondisclosure) was a matter of state law and is not securities fraud. This issue has been complicated, as lower federal courts have circumvented the Supreme Court decision. A technical discussion of the distinction which those cases draw from Santa Fe is beyond my present purpose.

Another reason for this expanded concept of statutory fraud was the SEC’s concern that managements were treating minority stockholders unfairly with the “going private” tactic. Some managements, having taken their companies public when stock prices were


Another aspect of going private was the “leveraged buyout,” in which the SEC was concerned that although all stockholders might be offered the same price, management might have an unfair advantage through employment contracts, special opportunity for tax benefits, etc. The SEC used its power to publish information concerning violations under § 21(a) of the 1934 Act to publicize the facts and to hold up such deals pending review of the fairness question by an independent person. See, e.g., In re Spartek, Inc., SEC Securities Exchange Act Release No. 15,367 (Feb. 14, 1979), reprinted in [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,961. Commissioner Karmel dissented to use of this power in that fashion without actually charging anyone with a violation of law.
good, decided that the burden of filing periodic reports with the SEC and proxy statements with the stockholders was too great once the market turned down, and stock prices and market conditions were no longer suitable for acquisitions. Management then offered to buy back stock held by the public or force the public out through cash mergers or other techniques. These offers looked bad, because even though the offer price was above the then current market price, it was often below the original public sale price. The SEC decided that this was a serious fraud problem and took the position that any company which had gone public had thereby represented that it would maintain the status of being a public company. As originally proposed, Rule 13e-3 would have provided substantive regulation of these transactions. The Bar protested, however, because Santa Fe clearly indicated that the SEC has no power over fiduciary obligations. The SEC retreated from its proposed substantive regulation of going private transactions, and adopted a different Rule 13e-3 based on disclosure. This rule is now law, and practitioners tell me that it is even more onerous than the originally proposed regulation.

Finally, using the open-end concept of statutory fraud, the SEC has in many instances undertaken to police, through disclosure, all corporate morality of management, including actions which, although disreputable, have nothing to do with securities or securities legislation. This is said to bear on the "integrity of management" or to be "qualitative materiality," as distinguished from quantitative materiality which relates to whether any particular matter may have a bearing on the value of the stockholders' investment.

The first examples of qualitative materiality involved cases of illegal corporate political contributions, which obviously had nothing to do with securities legislation. The issue was then broadened to include so-called "questionable payments" to foreign officials in the effort to get contracts. Note the term "questionable payments." In many cases the payments were clearly not unlawful under the law of the foreign country where they were made, although they may have been questionable by American standards. The SEC began forcing disclosure of these in proxy statements, on the ground that they related to the integrity of management who were candidates for reelection as directors. In many cases, the management had not been guilty of paying bribes for any personal benefit to themselves; rather, they had submitted reluctantly to the practices which prevail in many countries in Asia, Africa, and South America, where, in order to move government or to get an equal hearing from government, one has to pay off the right people. Many American corporate man-

112. See Kripke, supra note 80, at 188.
agreements made these payments reluctantly, and without personal gain, because they believed it was necessary and in the best interests of the corporation. The SEC did not distinguish between cases of personal grafting and this kind of conduct on behalf of the corporation. Instead, the SEC gave them equal publicity. It used the resulting public disturbance to put through the Foreign Corrupt Practices Act which gave the SEC new powers over corporate books and corporate internal control. Without describing other SEC crusades of the time, I will refer to former Commissioner Karmel's book, *Regulation by Prosecution.*

To summarize Part II up to this point: In 1973, there was a securities institute in Washington under the auspices of the American Bar Association. Ray Garrett, Jr., then the new chairman of the SEC, in his keynote address at the institute, noted that during the preceding ten-year period of great vigor, with the country moving again (to use President Kennedy's words), we had the biggest and most blatant securities frauds in history. I suggested that the explanation of Garrett's phenomenon might be that the SEC was guilty of the sin of *hubris*, the Greek word which is usually translated "pride" or "arrogance." In this case, I said, the arrogance was in "thinking that what you were doing was the most important thing in the world and that some more of the same would be still better."

The SEC was arrogating to itself power and jurisdiction which were not within the fair intendment of the statutes, and as to which it did not have any consensus supporting its new purposes. As Patrick Moynihan said long before he was a senator: "Somehow liberals have been unable to acquire from life what conservatives seem to be endowed with at birth, namely, a healthy skepticism of the powers of government agencies to do good." This remark sounds a proper cautionary note, which the SEC failed to heed in its expansive push of the 1970's.

The last ten or fifteen years have been marked by government overregulation. There has been too little recognition of the government's limited power to change things by fiat or by enforcement and

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115. *Supra* note 6 and accompanying text.
of the undesirability of a heavy governmental hand. The SEC overstepped its boundaries in the 1970's, but recently new faces in the SEC have properly retracted the boundaries. They have withdrawn some of the expansive positions I have just described.\textsuperscript{118}

In 1983, however, as the first fifty years of federal securities regulation were drawing to a close, \textit{Dirks} \textsuperscript{119} came before the Supreme Court for decision. The SEC pursued the case even though it had its determination affirmed in the court of appeals by only a 2 to 1 vote without a majority opinion, and with only a single judge expressing his reasons for his vote.\textsuperscript{120} The SEC could not support and did not defend this opinion or its reasoning before the Supreme Court. It sought to defend this slim victory before the Supreme Court despite the fact that the Solicitor General filed a brief on behalf of the United States in opposition. This strange situation, when considered with the SEC's proposed legislation on the subject of insider trading as described below, is so remarkable that it warrants further discussion.

In the mid-1970's, while the SEC was pursuing expansionist policies, its long record of success in the Supreme Court of the United States came to a halt. The SEC lost a series of cases, many of them concerned with the meaning of Rule 10b-5 and related rules.\textsuperscript{121} At an American Law Institute-American Bar Association (ALI-ABA) program on the Supreme Court and the Federal Securities Laws, held in Washington on March 10 and 11, 1977, I was the first speaker, at the request of Harvey Pitt, then General Counsel of the SEC. My outline in the coursebook\textsuperscript{122} ends with the following:

\begin{enumerate}
\item \textsuperscript{118} See, e.g., Fedders, \textit{Illegal Conduct — Materiality — An Enforcement Overview}, 14 Sec. Reg. & L. Rep. (BNA) 2057 (July-Dec. 1982) (Mr. Fedders is Director of the Division of Enforcement of the SEC); Longstreth, \textit{SEC Disclosure Policy Regarding Management Integrity}, 38 Bus. Law 1413 (1983) (the author was an SEC commissioner). The principal thrust is a more cautious attitude on integrity disclosure in the absence of economic materiality or personal gain. \textit{See also} Address by Edward F. Greene, then General Counsel of the SEC, foreshadowing a more circumspect use of Rule 2(e) against lawyers, \textit{Lawyer Disciplinary Proceedings Before the Securities and Exchange Commission}, 14 Sec. Reg. & L. Rep. 168 (Jan. 13, 1982). Similarly, Lee J. Spencer, Jr., when Director of the Division of Corporation Finance, in effect announced the abandonment of the unsound and undefended "presumptive underwriter doctrine," used during the 1970's to muddle the question of duty to register securities in secondary distribution situations and other situations. \textit{See} H. KRIPKE, supra note 25, at 250-53. See also the discussion of Rule 415 and the relaxation of proxy rules as to management compensation, supra notes 65-66, 70-72, 78 and accompanying text.
\item \textsuperscript{119} \textit{Supra} text accompanying notes 101-06.
\item \textsuperscript{120} \textit{Dirks} v. SEC, 220 U.S. App. D.C. 309, 681 F.2d 824 (D.C. Cir. 1982).
\item \textsuperscript{121} \textit{See} Pitt, \textit{The Supreme Court's Securities Law Decisions: What's Wrong with the Picture?}, lecture at the ALI-ABA Program described \textit{infra} note 122 and accompanying text. Mr. Pitt was then General Counsel of the SEC. Later, as a practicing lawyer he reviewed these cases again. \textit{See} Pitt, \textit{Dirks' Deals Blow to SEC Insider Program}, Legal Times, July 11, 1983, at 10.
\item \textsuperscript{122} ALI-ABA Course of Study Materials - The Supreme Court and the Federal Securities Laws 5 (March 10-11, 1977).
\end{enumerate}
"'Quos deus volt perdere prius dementat.' Did these earlier victories . . . lead the Commission into unlawyerlike and vulnerable litigating positions?" I then suggested that the Commission has been unawyerlike and lacking in statemanship, in seeking unlimited expansion of the word "fraud" in Rule 10b-5 and related provisions through litigation, instead of seeking a meaningful consensus by legislation or a rule-making process. The Dirks case, which came to a climax more than six years later and after a continuing series of SEC defeats, regrettably clearly illustrates my appellation "unlawyerlike." The legislation on insider trading which the SEC proposed while Dirks was pending, discussed below, illustrates my appellation "lacking in statemanship."

To establish that Dirks' conduct constituted "fraud" or "manipulation," the SEC had to deduce from those words the following conclusions: First, knowledge that management is guilty of recording fraudulent transactions is "inside information," even if the company is denying the accusation. The requirement of Cady Roberts that the information be for the exclusive use of the company may be disregarded in the prohibitions on trading on inside information. Second, the fact that public authorities, including the SEC, had ignored attempts to bring the information to the public did not justify the possessor in bringing it forcibly to public attention, without profit to himself, by inducing selling, even though he was not violating a duty to the company in doing so. Third, the tippee, Dirks, who cooperated in the effort without direct profit to himself or his firm by inducing trading "inherits" the same prohibitions as the original possessor, whether or not he uses the information for his own benefit. He is at fault in not taking the information to the SEC even though he reasonably believes that the SEC will again disregard the information unless the occurrence of sales forces the agency's attention. Fourth, the public's evaluation of the tippee as the hero of the situation does not entitle him to the benefit of the doubt as to whether he was motivated by hope of personal gain, or to an exercise of enforcement discretion in not pressing the case.

The Supreme Court sustained the SEC on only the first of these points. As to the others, the Court administered a severe defeat to the SEC, perhaps partly because it had flouted the view of the Solicitor General, the Government's official advocate in the Supreme

123. Those who God wishes to destroy he first makes mad.
124. See supra text accompanying note 91.
Court. The Court reiterated its view in *Chiarella* that trading on nonpublic information was not wrong unless the trader owed a pre-existing fiduciary duty to the opposite party. Applying this view to a tippee, the court held that a tippee does not inherit the insider's inhibition on trading unless the insider had motives of personal profit. The SEC thereby suffered a huge setback to its program for restricting trading by tippees on inside information.

Detailed consideration of the *Dirks* case and the substantive law of insider trading is not my principal purpose in this discussion. The case certainly illustrates my view about unlawyerlike conduct, for the SEC risked its gains over several years on a patently weak case against a public hero, based on tenuous and novel theories. The Commission left itself open to the interpretation that it was miffed because it had not been handed the information to break the case.

My contention that the SEC was unstatesmanlike in sponsoring the legislation it tendered against trading on nonpublic information while *Dirks* was pending is supported as follows: The SEC's and the United States' contentions in *Chiarella* and *Dirks* showed that the extent of the prohibition on insider trading, especially as applied to tippees, was uncertain. *Chiarella* and subsequent cases left uncertainty as to whether the prohibition extended to market information, when the trader allegedly breached a fiduciary duty to a tender offeror. The validity of the SEC's Rule 14e-3 is doubtful in light of *Chiarella* and the close similarity of sections 10(b) and 14(e) of the Securities Exchange Act. Yet, pleading the need for haste as a reason for not seeking to clarify any of these matters in the statutes, the SEC proposed a civil penalty equal to treble the trader's profit for violation of the 1934 Act, "while in possession of material nonpublic information."

The bill as drafted did not contain an exclusion of liability when a "Chinese Wall" through which inside information does not penetrate is maintained between departments of a multidepartment investment banker and broker, even though that point had been covered in the SEC's Rule 14e-3. It does nothing to clarify the question whether the prohibitions are violated by trading when information is

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126. *Dirks* is discussed in Fogelson & Stein, *supra* note 97, and in Goelzer, infra note 140.
129. *Supra* note 127.
possessed but not used.

Nor did the bills as originally submitted clarify an obvious question suggested by prior cases and discussions\(^{131}\) and by a recent SEC contention\(^{132}\)—whether the trader's "profit" which may be tripled under the bill's penalty is to be all of his profit on his transaction or is to be limited to that portion of his profit which was possible because of the effect of the nondisclosure. For instance, the trader buys a share of common stock for $1, and the price goes to $10 because of the Arab oil embargo. The price would have fallen to $8 if the true condition of the company's reserves had been reported, and did fall to $8 after disclosure, but the trader, an insider, sold at $10 without disclosing his knowledge of the necessary revision of the reserves. Is his profit to be measured at $2 or at $9 for the purpose of tripling it?\(^{133}\) The above problem is cured by the bill as amended in the House of Representatives before passage. The revision provides:

\[
\text{(c) for purposes of this paragraph 'profit gained' or 'loss avoided' is the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information.}\]

But a similar problem in reverse is not cured by the revision. For example, the insider sells at $10, without disclosing a necessary revision of the reserves that would have reduced the price to $8, but disclosure of the condition is not made for some time. General market conditions cause the price to fall to $3 and then the announcement about the reserves causes the price to fall to $1. Under the test


\(^{132}\) In SEC v. MacDonald, 699 F.2d 47 (1st Cir. 1983) (en banc), the SEC argued that the defendant should be required to disgorge all of his profit when he had bought on undisclosed inside information, even that profit made possible by appreciation of the security after the information was publicly disclosed. The First Circuit en banc rejected this theory.

\(^{133}\) This example is based on one in D. RATNER, SECURITIES REGULATION 532 (2d ed. 1980), which in turn is based on a dissenting opinion of Judge Sneed in Green v. Occidental Petroleum Corp., 541 F.2d 1335 (9th Cir. 1976).

of H.R. 559 his liability (which could be tripled) would be $9, but
under the test of § 11(e) of the Securities Act and the other authori-
ties cited in note 131 and in common sense, it should be $2.

Of course, the Bar and the financial community protested the bill,
and Chairman Shad admitted that the language was too broad.135
The bill was stalled until July 27, 1983, when a House subcommittee
approved it in modified form. The new form excludes brokers from
liability for executing a transaction for a person who has committed
a violation of law by trading on nonpublic information, and it con-
tains the imperfect limitation of damages discussed above. The
House passed the bill in its 1983 session. The amended bill does not
protect a broker or banker in the Chinese Wall situation.136

How could it have happened in the 1980's that the SEC would
introduce and continue to push a bill which did not meet the legiti-
mate needs of those affected?137 I have the greatest respect for the
present commissioners of the SEC. Why did they pursue Dirks and
sponsor such legislation?138 The answer may be what I have called
the “bureaucratic momentum” of the staff. Commissioners and divi-
sion directors may change, but the momentum of the staff which
drafted the Order for Hearing in Dirks139 still persists, probably still
dreaming of complete equality of information in the marketplace,
and draconian penalties for those who trade while having an infor-
national advantage.

Daniel L. Goelzer, Esq., the present General Counsel of the SEC,
has recently defended the Commission’s failure to offer a definition
of the prohibited conduct on the ground that “the courts need to
retain the flexibility to respond to new types of fraud.”140 This has

135. Hudson, SEC’s Shad Backs Brokerage Industry’s Drive to Cut Scope of In-
136. H.R. 559, 98th Cong., 1st Sess. § 2 (1983) (as amended on Union Calendar
No. 221, Report No. 98-355, Sept. 15, 1983). The first session of the 98th Congress
adjourned without the Senate having taken any action on its own bill or on the bill as
passed by the House.
137. See notes 129-35.
138. I personally would have seen no objection to a properly limited bill; that is,
one authorizing a treble damage penalty in cases that were clearly prohibited under the
decided cases — trading by corporate insiders while in the possession of and using mate-
rial inside corporate information. I would not have objected to codifying the lower courts’
extension of penalties to trading tippees who understood the source of the information
and knew it was not public. While I believe that Chiarella was rightly decided under the
then-existing state of the law, I would have had no objection to legislation codifying Rule
14e-3 and thus prohibiting trading by a person using non-public information about a
tender offer. This was the proposal of Milton V. Freeman, Esq., an experienced SEC
lawyer, as a substitute for the SEC bill. See his testimony in Hearing on H.R. 559 before
the Subcomm. on Telecommunications, Consumer Protection, and Finance of the House
139. See supra text accompanying note 102.
140. Goelzer, SEC General Counsel’s Speech on Insider Trading, Legal Times,
always been the SEC's standard answer to protests about the SEC making law through litigation (as criticized in former Commissioner Karmel's book, *Regulation by Prosecution*141), instead of resorting to rule-making or legislation. In my view, whatever may be the merit of the SEC's position in connection with issues subject to standard penalties, the threat of invoking the triple penalty gives the SEC and its staff too great a power to exert pressure to force defendants into consent decrees through which new far-out law would be made by acquiescence. I have elsewhere discussed the SEC's practice in this respect.142 I am surprised that the current leaders of the SEC, in whom I have confidence, have proposed it.143 It would have been much more statesmanlike to accept a ninety to ninety-five percent improvement of the deterrent situation (i.e., not to reach for triple damages on applications of the inside trading doctrine that have not been clarified by statutory definition or by adjudication). The triple penalty authorization should be limited to the presently certain scope of the doctrine plus whatever extensions Congress may be willing to

141. See note 6 and accompanying text.
143. An answer might be that persons in whom I have confidence would not abuse the power. My reply would be that the SEC cannot always control the zealots on its staff, as perhaps illustrated in the remainder of this note.

A current case is alleged to be a recurrence of the SEC's goal of the 1970's, which was to police corporate morality generally, without the appropriate limits of relevance to the securities legislation. Paradyne Corp. moved to dismiss a SEC injunction suit based on allegedly fraudulent methods used by Paradyne to obtain a very large contract for computers from the Social Security Administration. Paradyne charged that "the SEC's action represents an unprecedented attempt to expand the jurisdiction of . . . the SEC to matters that are the proper concern of other statutes, other agencies." Wall St. J., April 15, 1983, at 10, col. 1. Market reaction to the SEC's charges indicates that the Social Security Administration's reaction to established fraud might quantitatively be material to the company's financial position and thus well within the SEC's concerns. But Paradyne alleges that the Social Security Administration is satisfied with Paradyne's performance of the contract, and that the SEC is trying to induce dissatisfaction. Wall St. J., April 27, 1983, at 4, col. 2. See also Wall St. J., June 24, 1983, at 10, col. 1. Recently one Social Security official gave lukewarm credence to the SEC's charges, Wall St. J., July 28, 1983, at 8, col. 2, but later said that an SEC official had dictated his statement. Wall St. J., Sept. 2, 1983, at 4, col. 2. More recently it was rumored that an SEC Washington official had expressed doubt whether the regional office should have brought the suit, and that the SEC would amend its complaint and submit a "fairly bland" version preparatory to a settlement. Wall St. J., Sept. 13, 1983, at 5, col. 1. But no settlement has been announced.

Thus far Paradyne has won the publicity war in the *Wall Street Journal* and elsewhere, but the SEC charges have materially injured Paradyne in its reputation and business, and in the out-of-pocket costs of litigation. From the point of view of comfort with securities regulation, one hopes that at the trial the SEC will justify itself by proving that the damage to Paradyne was inherent in the situation but undisclosed in the company's SEC filings.
enact, such as trading on nonpublic information about tender offers.

It is interesting to note that while Mr. Goelzer asserted that his staff was unable, despite several drafts, to define insider trading for purposes of the triple damages bill, the SEC accepted a very specific and quite narrow definition for purposes of cooperation with the Swiss on insider trading emanating from Switzerland into United States markets.\textsuperscript{144} This narrow definition does not reach fact situations like \textit{Chiarella} or \textit{Newman}, relating to nonpublic information on tender offers. No doubt the SEC has accepted this because its bargaining power with the Swiss was not as great as it believes its bargaining power to be with a compliant Congress. But John Fedders, Director of the SEC's Division of Enforcement, referred to this as a "landmark achievement."\textsuperscript{145}

So, while I think the excesses of the 1970's are largely gone, some excesses — exemplified by \textit{Dirks} and the proposed legislation — may still continue. There should be no more of them. After fifty years of efforts to expand the Commission's present authority through "\textit{Regulation by Prosecution},"\textsuperscript{146} instead of a fair legislative or rule-making process, the excesses should cease. New challenges relating to the presently ongoing legislative and nonlegislative restructuring of the financial community will take all of the energies of that community, the Bar, the courts, and the Commission.

\begin{footnotesize}
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\item \textsuperscript{144} The definition of an insider contained in Convention XVI is as follows: (a) a member of the board, an officer, an auditor or a mandated person of the Company or an assistant of any of them; or b) a member of a public authority or a public officer who in the execution of his public duty received information about an Acquisition or a Business Combination or c) a person who on the basis of information about an Acquisition or a Business Combination received from a person described in . . . a) or b) above has been able to act for the latter or to benefit himself from inside information.'


\item \textsuperscript{145} Fedders, \textit{supra} note 144, at 16.

\item \textsuperscript{146} \textit{Supra} text accompanying note 6.
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