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The Securities and Exchange Commission's Administrative, Enforcement, and Legislative Programs and Policies — Their Influence on Corporate Internal Affairs

Marc I. Steinberg*

Less than two years ago, some authorities criticized the Securities and Exchange Commission ("SEC" or "Commission") for overstepping its statutory authority. These critics argued that the SEC's myriad activities advanced a carefully wrought and exquisitely detailed master plan to raise the level of corporate accountability. According to these critics, the Commission's administrative, enforcement, and legislative programs and policies were aimed at regulating corporate internal affairs.¹

This assertion was an overstatement. Life is much more prosaic at the Commission. SEC regulation during the Chairmanship of Harold M. Williams,² although undoubtedly affecting corporate processes, was principally directed to addressing particular conditions, wrongdoings, and deficiencies. Nonetheless, there is much truth to the statement that the Commission desired to raise the level of corporate consciousness. Indeed, while former Chairman Williams' speeches reflected generalized views on corporate governance and accountability,³ the Commission's disclosure, enforcement, and legislative policies represented significant regulatory actions to in-

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This Article is an extensive revision and expansion of a paper presented by Paul Gonson, Solicitor, Securities and Exchange Commission, and the author for the program "Standards for Regulating Corporate Internal Affairs." See Gonson & Steinberg, The S.E.C.'s Administrative and Legislative Programs Aimed at Regulating Corporate Internal Affairs, in STANDARDS FOR REGULATING CORPORATE INTERNAL AFFAIRS 317 (D. Fischel ed. 1981). The views expressed herein are those solely of the author.

Copyright Marc I. Steinberg. All rights reserved. This Article serves as the basis for a chapter in a forthcoming book by the author: M. STEINBERG, CORPORATE INTERNAL AFFAIRS—A CORPORATE AND SECURITIES LAW PERSPECTIVE (Greenwood Press: Quorum Books 1983).


² Harold M. Williams served as Chairman of the SEC from 1977 to 1981.

³ See notes 30-41 infra and accompanying text.
duce corporations to be more accountable to their shareholders and the public.

In the last two years, some SEC policies have unquestionably changed. As evidenced in both rhetoric and action, there has been a shift in Commission philosophy. For example, Commission policies now appear to be more concerned with aiding the capital formation process. The theme of corporate accountability has all but vanished under the present chairmanship of John S.R. Shad. Nonetheless, the nature of the Commission's activities necessarily affects internal corporate processes. By pursuing its various and sometimes changing policies, the Commission exerts a very significant influence on corporate internal affairs.

This Article will examine the methods by which the Commission affects internal corporate processes. Following a discussion of the general methods of administration and enforcement, the Article will examine the Commission's exhortatory approach. Next, the Article will discuss the SEC's disclosure processes, focusing on their impact on corporate internal affairs. Later sections examine SEC substantive "non-enforcement" regulation, law enforcement and related proceedings, the Commission's legislative program, and the Commission's amicus curiae program. Finally, the Article describes how the various Commission initiatives addressed to lawyers and accountants may affect their clients' internal affairs.

I. General Methods of Administration and Enforcement

In undertaking its administrative and enforcement responsibilities, the Commission has generally employed adjudication, rulemaking, and occasionally, legislation. For example, in *In re Cady, Roberts & Co.*, the Commission in an administrative proceeding extended liability under section 10(b) of the Securities Exchange Act of 1934.

4 See notes 154-78 infra and accompanying text.
6 15 U.S.C. § 78j(b) (1976). Section 10(b) of the Securities Exchange Act of 1934 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.
and rule 10b-5 prescribed thereunder by holding that a broker-dealer who received material nonpublic information from a corporate director had an affirmative duty to disclose that information to purchasers to whom he sold the corporation's stock. Cady, Roberts represented, as the Supreme Court recently perceived, "an important step in the development of § 10(b)."

Subsequent Commission actions and judicial decisions have re-

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7 17 C.F.R. § 240.10b-5 (1982). Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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8 40 S.E.C. 907, 911 (1961). The Commission based its extension of liability on the Securities Exchange Act's broad remedial purpose of reaching deceptive and manipulative practices, whether or not the practices would have been actionable at common law. Id. at 913-14. See notes 9-13 infra.

9 Chiarella v. United States, 445 U.S. 222, 226 (1980). The Chiarella Court held that silence will not give rise to § 10(b) liability without a duty to disclose. However, the Court appears to have reinforced the principle that a duty to disclose or abstain from trading does arise when insiders and their tippees possess material nonpublic information. The Court reasoned:

The SEC took an important step in the development of § 10(b) when it held that a broker-dealer and his firm violated that section by selling securities on the basis of undisclosed information obtained from a director of the issuer corporation who was also a registered representative of the brokerage firm. In Cady, Roberts & Co., the Commission decided that a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him. The obligation to disclose or abstain derives from "[a]n affirmative duty to disclose material information [which] has been traditionally imposed on corporate 'insiders,' particularly officers, directors, or controlling stockholders. We, and the courts have consistently held that insiders must disclose material facts which are known to them by virtue of their position but which are not known to persons with whom they deal and which, if known, would affect their investment judgment."

Id. at 226-27 (emphasis added) (citation omitted) (quoting In re Cady, Roberts & Co., 40 S.E.C. at 911). See also 445 U.S. at 230 n.12. In Marrerro v. Banco di Roma (Chicago), 487 F. Supp. 568 (E.D. La. 1980), the district court stated that, in view of Chiarella,

[f]actors to be considered in ascertaining whether such a relationship [of trust and confidence] exists include the parties' relative access to the information, the benefit to be derived by the defendant from the sale, defendant's awareness of plaintiff's reliance on him in reaching his investment decision, and defendant's role in initiating the purchase or sale.

Id. at 574. See also note 10 infra.
fined and textured the obligation to disclose or refrain from trading under section 10(b) and rule 10b-5. Indeed, it was partially due to one such subsequent decision that the Commission responded through the rulemaking process. In *Chiarella v. United States*, the Supreme Court held that a financial printer, who purchased stock after deciphering from confidential documents entrusted to his employer that certain companies were to be the subjects of mergers or tender offers, did not breach a duty to the investing public under section 10(b) and rule 10b-5. In the aftermath of *Chiarella*, the SEC

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12 *Id.* Thus, the Court held that silence, absent a duty to disclose, will not give rise to § 10(b) liability. The Court stated:

Thus, administrative and judicial interpretations have established that silence in connection with the purchase or sale of securities may operate as a fraud actionable
promulgated rule 14e-3, which establishes a "disclose or abstain from trading" rule under section 14(e) of the Williams Act.\textsuperscript{13}

The Commission occasionally has employed both adjudication and rulemaking in a single proceeding. For example, in \textit{In re Carter},\textsuperscript{14} the Commission in a rule 2(e) proceeding\textsuperscript{15} set forth a standard for

under § 10(b) despite the absence of statutory language or legislative history specifically addressing the legality of nondisclosure. But such liability is premised upon a duty to disclose arising from a relationship of trust and confidence between parties to a transaction. Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder's welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information.

\textit{Id.} at 230 (emphasis added) (citation omitted).

\textsuperscript{13} See 17 C.F.R. § 240.14e-3 (1982); SEC Sec. Act Release No. 6,239, Exch. Act Release No. 17,120, Inv. Co. Act No. 11,336, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶82,646. As adopted, with certain exceptions, rule 14e-3 applies this disclose-or-abstain provision to the possession of material information relating to a tender offer where the person knows or has reason to know that the information is non-public and was received directly or indirectly from the offeror, the subject corporation, any of their affiliated persons, or any person acting on behalf of either company. Moreover, the rule contains a broad anti-tipping provision and provides exceptions for sales to the offeror and for certain activities by multiservice financial institutions.

As stated by this commentator:

In regard to SEC authority to adopt rule 14e-3 [17 C.F.R. § 240.14e-3 (1981)], the following rationales may be used as support: (1) Section 14(e) of the Exchange Act grants the SEC authority "by rules and regulations . . . [to] prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." 15 U.S.C. § 78n(e) (1976). (2) Congressional testimony in 1968 Williams Act hearings highlighted the market disruptions and abusive practices associated with leaks by the bidder relating to a tender offer. (3) During the hearings on the amendment to the Williams Act in 1970, the issue of trading on material nonpublic information relating to a tender offer was brought to Congress' attention in the discussion of the manner in which the SEC would implement its rulemaking authority under § 14(e) of the Exchange Act. (4) As observed by the Supreme Court, the Williams Act was designed to avert a stampede effect. \textit{Rondeau v. Mosinee Paper Corp.}, 422 U.S. 49, 58 n.8 (1975). Trading on material information and tipping such information tends, in the tender offer context, to promote this effect. (5) As an additional basis, other than the broad rulemaking language of § 14(e) and the pertinent legislative history, the SEC has general rulemaking authority under § 23(a) of the Exchange Act to adopt rules and regulations that are reasonably related to its specific statutory functions. 15 U.S.C. § 78w(a) (1976).


\textsuperscript{15} 17 C.F.R. § 201.2(e) (1982). For a description of rule 2(e), see note 253 infra.
ethical conduct that had prospective application. In that decision, the Commission also stated that it intended to solicit public comment regarding the standard adopted.

By exercising its discretion to choose between adjudication and rulemaking, the Commission has been able to efficiently pursue its statutory mandates. This practice has generally received judicial approbation. As the Supreme Court stated in SEC v. Chenery Corp., "[T]he choice made between proceeding by general rule or by individual, ad hoc litigation is one that lies primarily in the informed discretion of the administrative agency." The fact that the adjudication will have far-reaching impact is not normally dispositive of whether the agency abused its discretion in selecting adjudication over rulemaking. This principle, however, may have been eroded somewhat by the Ninth Circuit's recent decision in Ford v.

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18 See Amicus Curiae Brief of Federal Administrative Agencies in Support of Petition for Rehearing and Suggestion for Rehearing En Banc, Ford Motor Co. v. FTC, 673 F.2d 1008 (9th Cir. 1982).

19 See notes 20-22 infra.


21 Id. at 203 (emphasis in original). See also NLRB v. Bell Aerospace Co., 416 U.S. 267, 294 (1974) (the NLRB "is not precluded from announcing new principles in an adjudicative proceeding and . . . the choice between rulemaking and adjudication lies in the first instance within the Board's discretion."); NLRB v. Wyman-Gordon Co., 394 U.S. 759, 765 (1969) ("Adjudicated cases may and do, of course, serve as vehicles for the formulation of agency policies, which are applied and announced therein.").

22 As stated by one source:

When an agency is deciding between rulemaking and adjudication, the three Supreme Court cases [Chenery, Wyman-Gordon, and Bell Aerospace] indicate that the agency decision will not be overruled unless there has been an abuse of discretion. In such cases, however, the burden of proof lies with the party challenging the agency choice of proceeding. This burden of proof is most often satisfied where a party demonstrates that due to the agency action he has suffered serious adverse consequences. In rendering its decision the court must balance the interests of the affected party against those of the agency, and although the court may indicate its preference for rulemaking, the court may order rulemaking only on a definite showing of abuse of discretion.

SEC POLICIES

The court in Ford, in holding that the Federal Trade Commission exceeded its authority by creating new law through adjudication rather than rulemaking, premised its decision on the consequence that the FTC's order would have widespread application.

As the foregoing discussion indicates, the SEC generally has relatively broad discretion to select the forum which it believes will most effectively enable it to carry out its legitimate functions and policies in a particular proceeding. The result is that the Commission's diverse programs and their concomitant impact on corporate internal affairs are usually effectuated by either adjudication or rulemaking. The Commission also may seek or promote legislation to resolve widespread and egregious misconduct.

II. Exhortation

The exhortatory approach, perhaps more appropriately viewed as jawboning, was frequently employed during the Williams Chairmanship to help remedy certain perceived problems in the corporate machinery. Undoubtedly, this approach was directed at corporate management and self-regulatory organizations. Regardless of the particular problem addressed, the SEC's exhortatory approach generally seeks to ameliorate or address particular weaknesses in the cor-

23 673 F.2d 1008 (9th Cir. 1982).
24 Id. at 1009-10. See Patel v. Immigration & Naturalization Serv., 638 F.2d 1199 (9th Cir. 1980). But see Brief, supra note 18, where nine federal administrative agencies jointly filed an amicus curiae brief in support of the FTC's petition for rehearing and suggestion for rehearing en banc. Referring to the Ninth Circuit's opinion, the agencies argued that "[t]o state, as the present opinion does, that articulation of 'new law' in an adjudication with potentially widespread applicability constitutes an abuse of discretion is to effect a major alteration in the way in which administrative agencies operate, and to cast substantial doubt upon the validity of ongoing and future adjudication." Id. at 4. The petition was denied. See 673 F.2d at 1010-12.
26 The SEC has also affected corporate conduct by issuing reports and holding conferences, several of which have been conducted with the assistance of leading members of the securities bar. See notes 48-76 infra and accompanying text.
porate accountability mechanism without imposing government regulation.

A. Jawboning

In a variety of contexts, SEC Commissioners have addressed corporate mechanisms and procedures that, in their views, needed increased accountability. For example, former Commissioner Phillip A. Loomis, Jr., urged that corporations should adopt their own codes of conduct to provide officers and employees with sufficient guidance for determining acceptable behavior in business dealings.\(^27\) According to Commissioner John Evans, disclosure should extend beyond financial matters to social issues, thereby enhancing accountability to shareholders and the public.\(^28\) On the other hand, former Commissioner Roberta Karmel, an outspoken critic of SEC policy during the Williams era, cautioned that SEC policies to promote corporate accountability should "go forward in an atmosphere of respectful, creative tension."\(^29\)

The most active Commissioner in addressing perceived problems of corporate accountability was former Chairman Williams. Chairman Williams preferred a corporate structure that held those who wield corporate powers accountable for the consequences of their stewardship. To help effectuate this objective, Chairman Williams' ideal board of directors would consist entirely of independent directors except for the Chief Executive Officer, who would not serve as Chairman of the Board. In defining directors who would be independent of management, Chairman Williams excluded the corporation's outside counsel, investment bankers and major suppliers.\(^30\)


\(^28\) See Fed. SEC. L. REP. (CCH) No. 886, Part I, at 4 (Nov. 19, 1980). But see Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2d Sess., Securities and Exchange Commission Staff Report on Corporate Accountability 277 (Comm. Print 1980) [hereinafter cited as SEC STAFF CORPORATE ACCOUNTABILITY REPORT] ("Proposals that the Commission move away from primarily an economic test of materiality [to require disclosure of socially significant information] are troubling to the staff because there is no readily available alternative basis for determining the materiality of information.").

\(^29\) Karmel, "The Quest for Accountability," Address before the Middle Atlantic Regional Group of the American Society of Corporate Secretaries 12 (Jan. 9, 1980).

\(^30\) See Williams, "Corporate Accountability," Address before the Fifth Annual Securities Regulation Institute, San Diego, Cal., at 26 (Jan. 18, 1978); Williams, "Corporate Accountability and Corporate Power," presented at the Fairless Lecture Series, Carnegie-Mellon University, Pittsburgh, Pa. (Oct. 24, 1979). In this regard, the American Bar Association's
Moreover, he stressed that audit, nominating, and compensation committees should play an integral part in the accountability process.\textsuperscript{31}

Chairman Williams also addressed the roles of the lawyer and the accountant in the accountability process. He stated that corporate counsel has the opportunity to bring considerations of both ethics and law to bear on a corporation's behavior.\textsuperscript{32} Noting that the responsibility and prestige of inside counsel have increased dramatically in recent years, Chairman Williams stressed that such persons should play an active role in shaping corporate events as they occur, in assessing and determining corporate policies, and in establishing the tone and standard for what may be called "the conduct of corporations."\textsuperscript{33} In discussing the accountant's role, Chairman Williams,

Section of Corporation, Banking and Business Law recommended that corporate boards be comprised of a majority of non-management directors and that each important committee, except for the executive committee, have only nonmanagement members. \textit{Corporate Director's Guidebook} (rev. ed. 1978), reprinted in \textit{33 Bus. Law.} 1591 (1978). \textit{But see} Kripke, supra note 1, at 175-79.

\textsuperscript{31} \textit{See} Williams, Speech before the Institute of Advanced Legal Studies, \textit{reported in FED. SEC. L. REP.} (CCH) No. 885, Part I, at 6 (Nov. 12, 1980). \textit{See also} Brudney, \textit{The Independent Director—Heavenly City or Potemkin Village?}, 95 \textit{Harv. L. Rev.} 597 (1982). At Chairman Williams request, the New York Stock Exchange (NYSE) required as a listing requirement that domestic firms maintain audit committees comprised solely of outside directors. Some commentators contend that the Commission compelled the NYSE to adopt this measure. \textit{See} Coffee, \textit{Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response}, 63 \textit{Va. L. Rev.} 1099, 1274 (1977) ("[T]he SEC virtually thrust the audit committee rule upon the New York Stock Exchange . . . . \textsuperscript{2}"); Kripke, supra note 1, at 190 ("to characterize the New York Stock Exchange's action as that of a self-regulatory agency providing voluntary leadership . . . is unreal"). More recently, the American Stock Exchange and the Board of Governors of the National Association of Securities Dealers have taken action in regard to the establishment of audit committees. \textit{See SEC Staff Corporate Accountability Report,} supra note 28, at 637-39.

It is possible that this "exhortatory" approach, along with other factors, has partially achieved its objective. For example, in the fall of 1978, the NYSE conducted a corporate governance survey. Questionnaires were mailed by the American Association of Corporate Secretaries to their 1,700 members, of which 993 responded (58%). 655 NYSE companies responded. The survey indicated that approximately 80% of the companies responding had a board of directors composed of a majority of nonmanagerial directors; the number of companies that had established audit, compensation, and nominating committees had significantly increased since 1975; the committees composed of nonmanagerial directors had increased significantly since 1975; and 92% of the companies responding (both NYSE and non-NYSE companies) maintained an audit committee composed of nonmanagerial directors. Both 1980 and 1981 studies indicate that, from a corporate accountability perspective, these figures have improved. \textit{See} notes 58, 70 & 274-75 \textit{infra} and accompanying text.

\textsuperscript{32} Williams, \textit{Corporate Accountability and the Lawyer's Role}, 34 \textit{Bus. Law.}, 7, 13 (1978).

\textsuperscript{33} Williams, \textit{The Role of Inside Counsel in Corporate Accountability}, [1979-1980 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) \textsuperscript{2}82,318, at 82,369 (Oct. 4, 1979). For further discussion on this issue, see Ferrara & Steinberg, \textit{The Role of Inside Counsel in the Corporate Accountability Process}, 4 \textit{Corp. L. Rev.} 3 (1981).
among other suggestions, encouraged the American Institute of Certified Public Accountants to adopt a professional standard mandating independent audit committees.\textsuperscript{34}

It bears emphasis that while Chairman Williams and other Commissioners exhorted those involved in the corporate machinery to remedy certain perceived deficiencies, they, for the most part, called for voluntary initiatives rather than governmental intervention. Although some commentators have suggested that such statements of voluntary action represented an \textit{in terrorem} approach,\textsuperscript{35} the fact of the matter is that the Commission has frequently opposed undue federal incursion into the corporate accountability area. Chairman Williams stated that he "ha[d] little confidence in Government's ability to dictate corporate governance structure without becoming oppressively destructive."\textsuperscript{36} Thus, for example, in testimony before the Senate Subcommittee on Securities regarding the proposed Protection of Shareholders' Rights Act of 1980, which attempted to establish federal minimum standards relating to the composition of corporate boards, rights of shareholders, and duties of corporate directors and board committees,\textsuperscript{37} Chairman Williams expressed his opposition to such government intervention.\textsuperscript{38} While sensing the

\textsuperscript{34} Williams, "The Role of the Director in Corporate Accountability," Address before the Economic Club of Detroit 24 (May 1, 1978).

\textsuperscript{35} See Kripke, \textit{supra} note 1, at 191 ("The constant repetition of the refrain—that experts and institutions of the financial world, \textit{i.e.}, the accounting standard setters, the auditors, the lawyers, must voluntarily improve the arrangements for internal control and corporate governance or government will step in—is too insistent to be passed off as mere exhortation to voluntary action.").

\textsuperscript{36} \textit{Financier (Correspondence)}, Aug. 1980, at 15-16.

\textsuperscript{37} S. 2567, 96th Cong., 2d Sess. (1980). See Corporation Democracy Act of 1980, H.R. 7010, 96th Cong., 2d Sess. (1980). Pertinent provisions of the bills would have required that a majority of a corporation's board be composed of independent directors, that the audit and nominating committees be composed solely of independent directors, that each director has a "duty of loyalty" and a "duty of care" to the corporation and its shareholders, that cumulative voting be required, that shareholders be entitled to vote on major corporate transactions, and that extensive disclosure be required in regard to such matters as employment discrimination, compliance with environmental controls, tax rates, cost of legal and accounting fees, and planned plant closings. See generally Metzenbaum, \textit{Legislative Approaches to Corporate Governance}, 56 \textit{Notre Dame Law} 926 (1981) ("There is widespread agreement within and without the business community that reforms are necessary in the governance of the nation's major corporations."); Millspaugh, \textit{The Corporate Democracy Act—A Renaissance or Death Knell for the Corporate World?}, 4 \textit{Corp. L. Rev.} 291 (1981).

\textsuperscript{38} Protection of Shareholders' Rights Act of 1980. Hearings on S. 2561 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 2d Sess. 33-67 (1980) (statement of SEC Chairman Williams). In his testimony, Chairman Williams stated that "the views which I express today are my own and not necessarily those of my fellow Commissioners—although I believe that at least a majority would agree with my conclusion at this time." \textit{Id.} at 39.
need for enhancing corporate accountability by increasing the role and responsibility of independent directors, he expressed "severe reservations about the wisdom of legislation designed to regulate the corporate boardroom," and concluded that enactment of the bill might well "retard" the goals that it intended to achieve. Other examples of deference to voluntary action include the Commission's long-held view of looking to the private sector to promulgate accounting standards, notwithstanding its statutory authority in this area, and urging Congress that the accounting profession be given the opportunity for self-reform. By contrast, the Commission strongly advocated legislation to deal with improper payments and off-books slush funds when it perceived that only legislation would correct the widespread abuses that then existed.

Rhetoric urging improved standards of corporate accountability and governance has largely disappeared during the Shad Chairmanship. Indeed, jawboning currently focuses on the capital formation process, and stresses that the abuse of inside information is a matter of major enforcement priority. In this regard, Chairman Shad has called upon investment banking, brokerage, and law firms, as well as publicly-held corporations, to help ferret out such abuses.

An argument can be made that the Commission's apparent abandonment of the corporate accountability rhetoric is well founded. During a recessionary period, capital formation, rather than the number of independent directors on corporate boards, will help stimulate the economy. Moreover, insider trading constitutes one of the greatest threats to maintaining the integrity of the market-

39 Id. at 60.
40 See Securities and Exchange Commission Report to Congress on the Accounting Profession and the Commission's Oversight Role, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶82,120, at 81,594 (June 28, 1979). In the concluding remarks to its second report to Congress, the Commission stated that it was not recommending legislation to supersede or control the regulation of accountants. Id. at 81,973. For more discussion on this point, see Gruenbaum & Steinberg, Accountants' Liability and Responsibility: Securities, Criminal and Common Law, 13 LOY. L.A. L. REV. 247, 292-94 (1980).


place and investor protection. Nonetheless, it may be argued that the Commission's focus is too narrow. The Commission's current rhetoric may imply that the SEC is concerned only with so-called traditional frauds, thereby greatly diminishing the advances made in the Stanley Sporkin era to seek enforcement solutions for a wide range of corporate activities that implicate the federal securities laws. Hence, it may be argued that while capital formation is laudable, the SEC is not a chamber of commerce. In short, the Commission was created primarily to protect the investing public, not to serve the interests of business.

B. Reports and Conferences

During the past decade, the Commission and its staff, with substantial input from the private sector, have sponsored or participated in at least three major reports or conferences: the SEC Major Issues Conference, the Advisory Committee Report on Corporate Disclosure, and the SEC Staff Corporate Accountability Report. Each of these undertakings concerned, at least in part, the impact of SEC regulation and exhortation upon certain developments in corporate internal affairs. For example, the Final Report of the SEC Major Issues Conference discussed the desirability that reporting companies maintain audit committees composed of independent directors. Along similar lines, the Advisory Committee Report on Corporate

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44 See generally notes 9-13 supra.
45 Stanley Sporkin was Director of the SEC's Division of Enforcement from 1974 to 1981.
46 As stated in a recent article: "Under Mr. Sporkin, the SEC brought about 60 cases alleging corporate bribery overseas, uncovered several instances of secret self-dealing by top corporate officers and tackled some of the most prestigious accounting firms, underwriters and law firms." Hudson, supra note 42, at 18.
50 SEC Staff Corporate Accountability Report, supra note 28.
51 SEC Major Issues Conference, supra note 48, at 8. The conferees also "urged that the establishment of such committees should be expanded beyond companies listed on the New York Stock Exchange. . . ." Id.
Disclosure recommended that the Commission should promulgate requirements that enhance "the ability of directors—as the representative shareholders—to serve as the independent, effective monitors of management."\(^{52}\)

The most intensive study of corporate internal affairs was undoubtedly the 1980 Staff Report on Corporate Accountability. This study, the result of a three year effort, drew upon public hearings and comments received from several different groups, including corporations, self-regulatory organizations, law firms, financial institutions, public interest groups, academicians, and government officials.\(^{53}\) Its genesis lay not in a generalized academic concept of ideal corporate structure, but in the wake of "the collapse of several major companies, the hundreds of corporations involved in questionable payments, and corporate non-compliance with environmental and other laws [which] astonished the public, shareholders, and, in many cases, even the affected companies' directors."\(^{54}\) The Report noted that successive investigations and reports suggested that the corporate accountability framework needed to be strengthened.\(^{55}\) The Report carefully and narrowly focused on the corporation's accountability to shareholders and investors, leaving "others" to consider the "larger corporate accountability issues [which] transcend the jurisdiction and expertise of this Commission"—the obligations of corporations to noninvestor constituencies such as "employees, consumers, communities, federal, state and local governments and the public generally."\(^{56}\)

Although the Report makes several specific recommendations, it does not propose major substantive or procedural innovations. The Report generally sets out staff discussion on a broad range of signifi-

\(^{52}\) Report of the Advisory Comm., supra note 49, at D-22. Other Advisory Committee recommendations included a requirement that shareholders be given information regarding "the identification of the nominating committee members and a requirement that if a director resigns and submits a letter stating a reason, that letter should be filed with a Form 8-K if the director so requests." \(Id.\) at 413. Also, the Committee recommended that "particularly in those areas of possible conflicts of interest, such as anti-takeover proposals and compensation plans, the Commission should attempt to get better, more uniform disclosure in proxy statements of the disadvantages as well as the advantages of management's proposals." \(Id.\) at 416.

\(^{53}\) SEC Staff Corporate Accountability Report, supra note 28, at 29-30.

\(^{54}\) \(Id.\) at 29.

\(^{55}\) \(Id.\).

\(^{56}\) \(Id.\) at 33 ("Inevitably, the effectiveness of a corporation's board of directors and the degree of concern and participation by its shareholders will affect the corporation's relationships with other constituencies, but the Report is, first and foremost, about accountability of the corporation to shareholders and investors.").
cant and controversial issues, including shareholder participation in the corporate electoral process, the shareholder proposal rule, disclosure of socially significant information, the role of the board of directors in the corporate accountability process, and the role of institutional investors in this process. The following discussion highlights some of the major issues discussed.57

One issue considered by the staff was whether the Commission should adopt a rule requiring all of the country’s more than 10,000 publicly-held corporations to have audit committees composed of independent directors. A staff survey of 1,200 companies found that 85% of the companies surveyed already had audit committees and that the majority of these committees were composed of independent directors. In light of this finding, the staff recommended that the Commission not proceed to consider a rule to require such audit committees.58

Another issue considered by the staff was the extent to which corporations used nominating committees to foster accountability in selecting, evaluating, and reviewing nominee and incumbent directors. The staff found that only 29% of publicly-held companies, principally the larger ones, had created such committees. Despite this percentage, the staff recommended that the Commission delay the development of a nominating committee rule until it could assess whether more corporations would independently initiate such committees. The staff indicated, however, that if the number of companies having independent nominating committees did not substantially increase, it would urge the Commission to require companies to adopt procedures for considering shareholder nominations.59

58 SEC STAFF CORPORATE ACCOUNTABILITY REPORT, supra note 28, at 28-29, 583. The Report also stated:

The audit committee today has become so well established that any company which has chosen not to establish such a committee, composed solely of directors independent of management, should weigh carefully the costs of such a decision in terms of liability and loss of control against the reasons, if any, for not establishing an audit committee.

Id. at 583.
59 Id. at 57-58, 583-84. The Report continued:

It is essential to recognize . . . that under corporate statutes the power to elect the board is vested in the shareholders, and to the extent that boards of directors are not more forthcoming in their efforts to facilitate shareholder participation in the electoral process, a shareholder nomination rule may be necessary.

The staff also considered the adequacy of the Commission's approach to the disclosure of socially significant corporate information. During the 1970's, the Commission increasingly was called upon to address questions relating to the disclosure of socially significant information.\textsuperscript{60} Although the information in question may not be economically material and although many shareholders desire solely to maximize their investments, many shareholders are concerned that the companies in which they have an equity interest adhere to certain minimal ethical and legal standards.\textsuperscript{61} With these competing policies in focus, the Report examined the extent to which proxy statements should disclose socially significant information, and concluded that "unless issuers know that there is a reasonable probability that shareholders would consider information about a particular social topic important when voting, the economic materiality standard, in conjunction with the Commission's proxy rules, are

\textsuperscript{60} See, e.g., Natural Resources Defense Council, Inc. v. SEC, 606 F.2d 1031 (D.C. Cir. 1979); Medical Comm. for Human Rights v. SEC, 432 F.2d 659 (D.C. Cir. 1970), \textit{vacated as moot}, 404 U.S. 403 (1972).

\textsuperscript{61} See, e.g., Natural Resources Defense Council, Inc. v. SEC, 389 F. Supp. 689 (D.D.C. 1974), in which the court alluded to the qualitative nature of information relating to a corporation's environmental policy. Desiring broader SEC disclosure rules, the plaintiffs requested the Commission to modify its corporate disclosure regulations to require each reporting company to "provide to the SEC for public disclosure information concerning the effect of its corporate activities on the environment and statistics about its equal employment practices." \textit{Id.} at 689. With respect to the claim's environmental portion, the court discussed the relevance of the concept of materiality to the relationship between the ethical investor and management:

There are so many so-called "ethical investors" in this country who want to invest their assets in firms which are concerned about acting on environmental problems of the nation. This attitude may be based purely upon a concern for the environment; but it may also proceed from the recognition that awareness of and sensitivity to environmental problems \textit{is the mark of intelligent management}. Whatever their motive, this court is not prepared to say that they are not rational investors and that the information they seek is not material information within the meaning of the securities laws. 

sufficient guides to issuers in determining what socially significant information should be disclosed in the proxy statement.62 While the staff's recommendation probably did not satisfy some advocates,63 the Report significantly recognizes the crucial distinction between an investment decision and a voting decision. For example, although a corporation's antisocial conduct may not be considered material in an investment context due to the remote possibility that economic consequences would ensue, such conduct may be important to shareholders voting to elect directors because it reflects upon the directors' integrity to assume a corporate position of trust.64

Another interesting area addressed in the Staff Corporate Accountability Report was the impact of the Supreme Court's 1978 decision in First National Bank of Boston v. Bellotti.65 That decision found unconstitutional a state statute that prohibited a corporation from expending corporate funds to publicize its views on a political referendum unless the subject matter was materially related to the corporation's business. In so holding, the Supreme Court reasoned that shareholders could be informed of such corporate expenditures through the process of corporate democracy.66 In light of that holding, the Staff Report urged the Commission to request comments on possible ways to inform shareholders of such expenditures, including the need for a general disclosure requirement regarding corporate political activities and expenditures.67

62 SEC STAFF CORPORATE ACCOUNTABILITY REPORT, supra note 28, at 234. See id. at 44-45; supra note 28.
63 See note 61 supra.
66 435 U.S. at 794 ("Ultimately shareholders may decide, through the procedures of corporate democracy, whether their corporations should engage in debate on public issues.").

Another concern expressed by the staff was the role of institutional shareholders. The staff concluded that institutions, in discharging their fiduciary duties, should exercise the voting authority that accompanies their management of securities in a manner that promotes corporate accountability. Specifically, the staff recommended that such institutions: (1) establish formalized procedures for reaching proxy voting decisions; (2) establish voting criteria designed to produce objective voting decisions, including criteria for reaching decisions on matters having no investment impact; and (3) discontinue treating an uncontested election of directors as a matter warranting an automatic vote for the slate of nominees. The staff also
As previously stated, the Staff Corporate Accountability Report contained no major or startling recommendations. Yet, the moderate nature of the Report says something significant about the Commission's role in the corporate governance process. Less than a decade ago, few would have predicted that, by the end of the 1970's, most publicly-held corporations in this country would have boards containing a majority of outside directors and audit committees comprised solely of independent directors. In the last decade, the corporate accountability framework has undergone an evolutionary process in which the Commission's exhortatory approach played a crucial role.

Although much of the Corporate Accountability Report remains viable, recent Commission actions (or inaction) signal an apparent retreat from some of the corporate accountability themes stressed in that Report. For example, less than two years after the Report was issued, the staff declined to recommend that the Commission promulgate a rule requiring independent nominating committees, even though the number of corporations having such committees had only slightly increased. Similarly, despite the Report's recommendation, the SEC has yet to request comments on how to provide a means of informing shareholders of corporate political activities and expenditures. Moreover, the Commission's decision not to take action against Citicorp for failing to disclose alleged foreign exchange trading impropriety urged institutions to make their voting procedures and practices readily available to customers and the public. The staff sought Commission authorization to study the public availability of this information and, if necessary, to develop a legislative proposal designed to increase disclosure in this area. See SEC Sec. Exch. Act Release No. 15,385, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,766 (Dec. 6, 1978); SEC Sec. Exch. Act Release No. 14,970, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,645 (July 18, 1978). These releases involve the Commission's proposal, and ultimate withdrawal, of a rule requiring certain institutions subject to the SEC's proxy provisions to disclose their voting policies and procedures in the annual reports to stockholders. The major drawback to the proposed rule was that many large institutions, such as pension funds and banks, other than bank holding companies, are not subject to the proxy provisions. In withdrawing the proposed rule, however, the Commission reaffirmed its belief that "there is shareholder interest in institutional voting policies and procedures."

See notes 31 & 58 supra and accompanying text.

See Vandegrift, supra note 57, at 24.

SEC Sec. Exch. Act Release No. 18,532 (March 8, 1982), 24 SEC Docket 1224, 1225 (March 16, 1982) (according to the 1981 results, 30.4% of companies, compared to 19.4% in 1979, had nominating committees). But see SEC STAFF CORPORATE ACCOUNTABILITY REPORT, supra note 28, at 525 ("The staff's own statistics indicate that 28.9 percent of the category of all companies have nominating committees . . . ").
and currency exchange controls\(^{71}\) has been viewed as a significant step backward from prior SEC positions regarding management integrity.\(^{72}\) Most recently, the Commission proposed "sweeping" changes in its shareholder proposal rule,\(^{73}\) some of which would enable corporations to exclude such proposals on a much easier basis than current practice.\(^{74}\) These SEC proposals stand in marked contrast to the statement contained in the Corporate Accountability Report that the rule "was operating well."\(^{75}\) Perhaps sensing this potential reversal of policy, Commissioner Evans has defended the current system, asserting that the shareholder proposal process "is one of the trappings of corporate democracy, and we have to be careful not to snuff out that little light [of democracy]."\(^{76}\)

III. SEC Disclosure

Undoubtedly, the central focus of the federal securities laws applied to publicly-held corporations is disclosure. Although crucial, disclosure requirements are "flanked" by two other Commission sources that affect publicly-held corporations. The first, discussed in the preceding section, is the Commission's exhortatory approach. The second, to be examined in the following sections, is substantive regulation through rules and enforcement measures.\(^{77}\) The present discussion addresses the Commission's influence on corporate internal affairs from the perspective of disclosure. As will be seen, the Commission's current approach toward disclosure appears in certain respects to take a narrower perspective than prior practice.

Although the rationale underlying disclosure is not based primarily on influencing corporate internal affairs, but rather on providing shareholders and the marketplace with sufficient information to make intelligent decisions and to be apprised of significant developments, there is little question that disclosure has a substantial impact on the normative conduct of corporations.\(^{78}\) In this regard, the

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71 See SEC Statement on Citicorp (March 5, 1982).
72 See Hudson, supra note 42; Vilkin, supra note 47. For further discussion, see notes 112-21 infra and accompanying text.
76 Hudson, supra note 74.
78 See, e.g., L. Brandeis, Other People's Money 92 (1914) ("Sunlight is said to be the
Commission’s disclosure policies, in Brandeisian manner, have not only deterred unlawful or questionable conduct, but have also helped to establish improved standards of conduct.

Certain disclosure obligations directly affect the integrity and competency of corporate management. For example, the Commission’s disclosure mandates relating to remuneration and conflicts of interest require corporations to disclose management self-dealing.

Generally, Commission forms require disclosure of adjudicated illegal activities by officers and directors where such violations are mate-

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79 See Brandeis, supra note 78.
80 See Cohen, supra note 77, at 296 ("on the positive side, if specific facts as to the independence and diligence of directors, or as to the use of special board committees or particular types of internal controls, are required to be openly discussed, many a corporation will prefer to report progress in these areas rather than backwardness and progress will indeed occur."). See also 14 SEC. REG. & L. REP. (BNA) 1575-76 (Sept. 17, 1982) ("Wharton Economics Professor Says SEC Disclosure Rules Benefit Economy").
81 See Item 402, Regulation S-K, 17 C.F.R. § 229.402 (1982); Item 404, Regulation S-K, as adopted, SEC Sec. Exch. Act Release No. 19,290 (Dec. 2, 1982), 14 SEC. REG. & L. REP. (BNA) 2166 (Dec. 10, 1982). In part, Item 402 requires registrants to disclose the compensation of the five most highly paid executive officers receiving remuneration over $50,000, plus remuneration data for all officers and directors as a group, including all remuneration proposed to be made to the officers pursuant to any existing plans. Item 404 in part requires disclosure of transactions with the corporation by directors, director-nominees, executive officers, five percent shareholders, and members of the immediate family of the primary reporting persons involving more than $60,000 made within the past year in which such persons have a direct or indirect material interest. In addition, Item 402 provides, with certain limitations, for a specified tabular remuneration format which requires disclosure concerning remuneration paid to certain specified persons and groups "for services in all capacities to the registrant and its subsidiaries during the registrant’s last fiscal year or, in specified instances, certain prior fiscal years." 17 C.F.R. § 229.402(a) (1982). The term "remuneration" includes, inter alia, salaries, fees, commissions, bonuses, securities, property, insurance benefits, and personal benefits not directly related to job performance, other than those provided to broad categories of employees and which do not discriminate in favor of officers and directors. See also SEC Sec. Exch. Act Release No. 19,431 (Jan. 17, 1983) (proposing rule and schedule amendments to the disclosure of management remuneration, including proposed amendments to Item 402).
rial to an evaluation of the officer's or director's ability or integrity. Also, certain "events" transpiring during the previous five years that are material to an evaluation of the competency or integrity of any director, director-nominee, or executive officer must also be disclosed. Although the extent to which these disclosure requirements affect corporate internal affairs is uncertain, it may be safely said that they have such an impact.

Turning to rulemaking proceedings which have centered on disclosure obligations, the Commission has addressed such subjects as the structure and role of corporate boards of directors, financial reporting and accounting developments, extraordinary events (such as going private transactions and tender offers), and developments in the corporation finance area. With respect to corporate boards, the

83 Id. Such "events" include:

(1) A petition under the Bankruptcy Act or any State insolvency law was filed by or against, or a receiver, fiscal agent or similar officer was appointed by a court for the business or property of such person, or any partnership in which he was a general partner at or within 2 years before the time of such filing, or any corporation or business association of which he was an executive officer at or within two years before the time of such filing;

(2) Such person was convicted in a criminal proceeding or is a named subject of a pending criminal proceeding (excluding traffic violations and other minor offenses);

(3) Such person was the subject of any order, judgment, or decree, not subsequently reversed, suspended or vacated, of any court of competent jurisdiction permanently or temporarily enjoining him from, or otherwise limiting the following activities:

(i) Acting as an investment adviser; underwriter, broker, or dealer in securities, or as an affiliated person, director or employee of any investment company, bank, savings and loan association, or insurance company, or engaging in or continuing any conduct or practice in connection with such activity;

(ii) Engaging in any type of business practice; or

(iii) Engaging in any activity in connection with any violation of federal or State securities laws.

(4) Such person was the subject of any order, judgment, or decree, not subsequently reversed, suspended or vacated, of any Federal or State authority barring, suspending or otherwise limiting for more than 60 days the right of such person to engage in any activity described in paragraph (f)(3), of this section or to be associated with persons engaged in any such activity.

(5) Such person was found by a court of competent jurisdiction in a civil action or by the Commission to have violated any Federal or State securities law, and the judgment in such civil action or finding by the Commission has not been subsequently reversed, suspended, or vacated.

84 See generally Ferrara, Starr & Steinberg, supra note 61. Another example of a disclosure item, Item 401(e) of Regulation S-K, 17 C.F.R. § 229.401 (1982), requires a brief account of the business experience of management and nominees during the prior five years.
Commission has adopted rules that mandate disclosure of whether a board has auditing, nominating, or compensation committees, and that require a brief description of committee functions, the total number of board and committee meetings held, and the identity of directors who do not attend 75% of the total number of board or committee meetings.\(^8\) The Commission declined to adopt the staff suggestion of labeling directors as either management, affiliated non-management, or unaffiliated non-management.\(^8\) A corporation must disclose, however, any substantial business and personal relations between directors and issuers.\(^8\)

These disclosure developments, while important, should be viewed in conjunction with Commission exhortation and enforcement actions that obtained, as ancillary or other equitable relief, the restructuring of corporate boards comprised of a majority of non-management directors as well as the establishment of independent audit committees.\(^8\) When viewed in their entirety, these Commission activities had the beneficial effect of inducing corporate boards to include more outside directors and to establish audit committees.

Regarding accounting and financial reporting developments, the most important recent development has been the enactment of the Foreign Corrupt Practices Act.\(^9\) One possible consequence of the Act is that disclosure of the making of questionable payments may be required, not necessarily because such payments affect corporate earnings, but because they bear on management integrity.\(^9\)

\(^{85}\) SEC Sec. Exch. Act Release No. 15,384, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,766 (Dec. 6, 1978). The rule amendments also provided, \textit{inter alia}, (1) that a resigning director can submit a description of the reasons for resignation, which the issuer must disclose, but the issuer can give its own views of the disagreement; and (2) that the issuer must disclose the settlement terms of an election contest.

\(^{86}\) \textit{Id.}

\(^{87}\) \textit{Id.} Disclosure of substantial personal and business relations requires the issuer to disclose that the nominee or director is a relative of an executive officer, that the nominee or director is a former officer or director of the issuer, that the nominee or director is an officer or director of a customer or supplier of the issuer, and that the law firm of the nominee or director has been retained by the issuer for the prior two years. On this last point, the Commission stated that “[i]n view of inherent conflicts faced by lawyers who serve both as directors and as counsel to corporations, the Commission is reluctant to limit disclosure of such relationships solely on the basis of the economic test.” \textit{Id.} at 81,092. \textit{See also} SEC Sec. Exch. Act Release No. 19,290 (Dec. 2, 1982)(placing certain limitations on the foregoing disclosure requirements).

\(^{88}\) For discussion of such enforcement actions and the ancillary or other equitable relief obtained, see notes 181-89 \textit{infra} and accompanying text.


Thus, the required disclosure of questionable payments may well have the effect of deterring the making of such payments.

An important development in the Commission’s administration of the Foreign Corrupt Practices Act was its proposed rules which, had they been adopted, would have mandated that corporate annual reports contain a statement by management regarding the adequacy of internal accounting controls. The rules would have required such statement to be examined and reported on by an independent accountant.¹¹ Not surprisingly, the proposed rule generated heavy criticism and was characterized as a compliance certificate having exorbitant costs.¹² Subsequently, the Commission declined to adopt the proposal in order “to allow existing voluntary and private-sector initiatives . . . to continue to develop.”¹³ In its release, however, the Commission provided guidance to further encourage voluntary initiatives regarding internal accounting controls. This guidance may play an influential role in improving internal accounting control practices and systems.¹⁴

SEC disclosure policy has affected tender offers and going private transactions. In October 1978, the Division of Corporation Finance issued a statement regarding disclosure in proxy and

¹² See Cohen, supra note 77, at 311. See also Gruenbaum & Steinberg, supra note 40, at 292 (the proposed rules concerning management’s statement on internal accounting controls, had they been adopted, would have generated claims of liability against accountants if management’s statement was found deficient).
¹⁴ See Cohen, supra note 77, where the author stated: “Some guidance” amounted to many pages of elaborate exposition, including endorsement of the original objectives and coverage of some matters going beyond what would have been included in the compulsory statements originally proposed. The end result is that there is no SEC rule requiring any specific conduct or any specific disclosure concerning conduct in respect of internal accounting controls, but — an unusual case where jawboning may be said to be a triumphant end rather than a modest beginning of the process — there is an elaborate guidebook promulgated by the SEC, not having the force of law, but perhaps affecting corporate conduct more broadly and pervasively than a formal rule would have done.

Id. at 312. Most recently, the Commission announced that it will take no further action in this regard. Significantly, the Commission stated: “In reaching this conclusion the Commission has considered the significant private-sector initiatives in this area, including the increased number of management reports to security holders of large companies.” Accounting Series Release No. 305, 24 SEC Docket 888 (Feb. 9, 1982), [Accounting Series Transfer Binder] FED. SEC. L. REP. (CCH) ¶72,327, at 62,989 (Jan. 28, 1982).
information statements of antitakeover or similar proposals. Noting that the increased use of hostile tender offers to obtain corporate control has prompted many companies to consider defensive techniques, the staff expressed concern over the adequacy of disclosure made to investors when the corporation seeks shareholder approval to amend its charter or by-laws to incorporate antitakeover or similar proposals. Disclosure recommended by the staff included: (1) the reasons for the antitakeover proposals and the basis for such reasons, (2) the overall effects of the proposal, including the impact upon management tenure, (3) the advantages and disadvantages of the proposal, (4) a description of how the proposal will operate, (5) a statement of whether the proposal was the subject of a vote of the issuer's board of directors and, if so, the result of such vote, and (6) the limitations or restrictions, if any, on the adoption of such proposals.


96 Id. at 80,985. See Steinberg, supra note 10, at 223-24. As noted by one commentator, although anti-takeover provisions have been challenged in a number of cases, few of these challenges have been successful. See Labaton v. Universal Leaf Tobacco Co., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶96,943 (S.D.N.Y. 1979) (defendant's motion for summary judgment granted in damage suit involving company that had a supermajority provision); Seibert v. Gulton Indus., Inc., No. 5641 (Del. Ch. June 21, 1979) (supermajority provision held not invalid under Delaware Law); Valhi, Inc. v. PSA Inc., No. 5730 (Del. Ch. Nov. 15, 1978) (arising in context of takeover, court denied plaintiff's motion for temporary restraining order regarding effectuation of supermajority charter amendments); Seibert v. Milton Bradley Co., No. 77-464 (Mass. Super. Ct. Jan. 31, 1979), aff'd, 405 N.E.2d 131 (1980) (supermajority provision adopted by shareholders, with shifting vote requirement based on board's judgment, not invalid). But see Televest, Inc. v. Olsen, No. 5768 (Del. Ch. March 8, 1979) (enjoined a dividend to common shareholders of blank check preferred stock that had supermajority voting rights); Moran, Anti-Takeover Charter Changes Upheld by Courts, Legal Times (Washington), Mar. 24, 1980, at 32, col. 1. See also In re American Inv. Co., SEC Sec. Exch. Act Release No. 17,004, [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶82,633, at 83,406 (§ 21(a) Report) ("The Staff's position is that disclosure of the adoption of the By-law Amendments was required by the tender offer provisions of the Exchange Act and rules promulgated thereunder at the time the Board first communicated its recommendation to the public.").

97 In particular, the staff suggested that the issuer's proxy material or information statements should disclose in a prominent place that the overall effect of the proposal is to render more difficult the accomplishment of mergers or the assumption of control by a principal shareholder, and thus to make difficult the removal of management. [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶81,748, at 80,985. See generally Friedenberg, jaws III: The Impropriety of Shark-Repellant Amendments as a Takeover Defense, 7 DEL. J. CORP. L. 32 (1982).

As noted in the release, specific disclosures should be required with respect to: supermajority voting provisions (disclosure of the acquisition by management or principal shareholders of the power to veto any merger); classification of directors to serve staggered terms (disclosure of the number of elections required to change the majority of the board of directors); and authorization of certain classes of equity securities (disclosure as to whether
The Commission's tender offer rules establish several disclosure obligations. For example, the tender offeror must promptly reveal material changes in the information published, sent, or delivered to shareholders. In addition, rule 14d-9 calls for the subject company to file with the SEC a Schedule 14D-9, which requires the disclosure of certain information, including a description of any material contract, agreement, arrangement, or understanding and any actual or potential conflict of interest between, among others, the offeror, the subject company, and their affiliates, and disclosure of certain negotiations and transactions by the subject company. Perhaps the most pertinent provision is rule 14e-2, which requires the subject company to publish or send to security holders a statement disclosing its position with respect to the tender offer within ten business days of the commencement of the tender offer by a person other than the issuer. The statement of position can take one of three forms: (1) recommendation or rejection of the tender offer, (2) a statement that the subject company is unable to take a position with respect to the tender offer, or (3) issuance of no opinion, in which case the subject company will remain neutral toward the tender offer. The company is required to include the reasons for its position with respect to the tender offer, including the inability to take a position. Conclusory
or "boilerplate" statements are not considered sufficient disclosure.\textsuperscript{103}

Rule 14e-2 may have a significant effect on how target management responds to a hostile tender offer. Prior to the rule, a number of court decisions permitted management to remain silent during the course of a tender offer.\textsuperscript{104} Of course, target management rarely, if ever, would remain silent during a hostile battle for control.\textsuperscript{105} What the rule does seemingly accomplish, however, is that it compels target

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state its position and the reasons for that position. SEC Schedule 14D-9, item 4(b), 17 C.F.R. § 240.14d-101 (1982). Also, if the subject company changes its position or other material changes occur, the subject company is required to promptly publish, send, or give to security holders a statement disclosing the material change. See Sommer & Feller, \textit{Takeover Rules: A Cohesive Comprehensive Code}, Legal Times (Washington), Dec. 17, 1979, at 18, col. 1.
\end{quote}


\textsuperscript{104} See, e.g., Berman v. Gerber Products Co., 454 F. Supp. 1310, 1325 (W.D. Mich. 1978) ("It is true that in general the Williams Act does not appear to impose upon the management of a target company an affirmative duty to respond to a tender offer at all."). In regard to the propriety of rule 14e-2, one source has commented:

The Supreme Court's interpretation [in \textit{Chris-Craft}] is consistent with the duty that Rule 14e-2 imposes upon target directors to disclose affirmatively any informative material to the tender offer. The failure to support the imposition of such a duty is inconsistent with the Act's goal of informing the investing public. Furthermore, a target management disclosure duty furthers the efficient market purposes of the Act. Information defines the fair market value of a security. When an investor chooses between the alternatives of tendering or holding, he needs to have all material information in order effectively and efficiently to assess his alternatives. With incomplete knowledge, the investor's decision will be inefficient.

\begin{quote}
Gelfond & Sebastian, \textit{Reevaluating the Duties of Target Management in a Hostile Tender Offer}, 60 B.U.L. REV. 403, 410 (1980) (footnotes omitted) (referring to Piper v. Chris-Craft Indus., Inc., 430 U.S. 1 (1977), which held that a defeated tender offeror has no implied right of action for damages for violations of § 14(e)).
\end{quote}

\textsuperscript{105} See Electronic Specialty Co. v. International Controls Corp., 409 F.2d 937 (2d Cir. 1969), where Judge Friendly stated:

\begin{quote}
The likeness of tender offers to proxy contests is not limited to the issue of standing. They are alike in the fundamental feature that they generally are contests. This means that the participants on both sides act, not "in the peace of a quiet chamber," . . . but under the stresses of the marketplace. They act quickly, sometimes impulsively, often in angry response to what they consider, whether rightly or wrongly, to be low blows by the other side. Probably there will no more be a perfect tender offer than a perfect trial. Congress intended to assure basic honesty and fair dealing, not to impose an unrealistic requirement of laboratory conditions that might make the new statute a potent tool for incompetent management to protect its own interests against the desires and welfare of the stockholders. These considerations bear on the kind of judgment to be applied in testing conduct—on both sides—and also on the issue of materiality.
\end{quote}

\textit{Id.} at 948. Courts have frequently reaffirmed Judge Friendly's recognition of the practical realities of battles in the tender offer and proxy setting. See, e.g., Seaboard World Airlines, Inc. v. Tiger Int'l, Inc., [1979 Transfer Binder] FED. SEC. L. REP. (CCH) §96,877, at 95,590 (2d Cir. 1979); Kennecott Copper Corp. v. Curtiss-Wright Corp., 584 F.2d 1195, 1200 (2d Cir. 1978); Ash v. LFE Corp., 525 F.2d 215, 221 (3d Cir. 1975); Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1300 n.19 (2d Cir. 1973); General Time Corp. v. Talley Indus., Inc., 403
management to articulate its position in a conscientious manner, thereby enabling shareholders to make their investment decisions after hearing all sides.\textsuperscript{106} Failure by management to abide by this disclosure obligation under rule 14e-2 may result in antifraud liability under the federal securities laws, even if a valid business purpose defense exists under state law.\textsuperscript{107}

In regard to going private transactions, the most relevant Commission action has been the promulgation of rule 13e-3.\textsuperscript{108} In the proposal stage, the rule required any going private transaction to be both substantively and procedurally fair to minority shareholders.\textsuperscript{109}

\begin{footnotes}
\footnotetext[106]{The legislative history of the Williams Act indicates that it was designed to protect the legitimate interests of the target corporation, its management and its shareholders, and simultaneously to allow both the target and the bidder to present fairly their views to the shareholders. As the Act's sponsor Senator Harrison Williams stated: "We have taken extreme care to avoid tipping the scales either in favor of management or in favor of the person making the takeover bid." 113 CONG. REC. 24,664 (1967) (remarks of Sen. Williams). See Lynch & Steinberg, supra note 105, at 903-04. Apparently, however, the Supreme Court took a more restrictive view of the Act's objective in Piper v. Chris-Craft Industries, Inc., where the Court stated that "[t]he sole purpose of the Williams Act was the protection of investors who are confronted with a tender offer." 430 U.S. at 35.}

\footnotetext[107]{See Mobil Corp. v. Marathon Oil Corp., 669 F.2d 366, 372 (6th Cir. 1981) ("[M]anipulation under the Williams Act cannot be justified by the good faith performance of fiduciary duties."). For recent cases dealing with the business judgment rule under state law, see Panter v. Marshall Field & Co., 646 F.2d 271 (7th Cir.), cert. denied, 102 S. Ct. 658 (1981); Tréadway Cos., Inc. v. Care Corp., 638 F.2d 357 (2d Cir. 1980); Crouse-Hinds Co. v. Inter-North, Inc., 634 F.2d 690 (2d Cir. 1980); Johnson v. Trueblood, 629 F.2d 287 (3d Cir. 1980); Berman v. Gerber Products Co., 454 F. Supp. 1310 (W.D. Mich. 1978). For a discussion of these cases, see Steinberg, supra note 10, at 245-60.}

\footnotetext[108]{SEC Sec. Exch. Act Release No. 16,075 (Aug. 8, 1979), 44 Fed. Reg. 46,736 (1979) In short, a going private transaction is one in which the controlling persons of a corporation eliminate public shareholders while retaining their ownership of the business. In general, the SEC's rules prohibit fraudulent, deceptive, or manipulative acts or practices in connection with going private transactions and prescribe filing, disclosure, and dissemination requirements as a means reasonably designed to prevent such acts or practices. See also SEC Sec. Exch. Act Release No. 16,112 (Aug. 19, 1979), 44 Fed. Reg. 40,406 (1979), in which the Commission adopted rule 13e-4, which governs an issuer's tender offer for its own securities. In general, rule 13e-4 requires that a schedule 13E-4 be filed with the SEC, and establishes, \textit{inter alia}, disclosure, dissemination, and compliance requirements. In addition, rule 13e-4 proscribes manipulative, deceptive and fraudulent conduct in connection with issuer tender offers. Note also that an issuer tender offer regulated by rule 13e-4 is also a going private transaction subject to rule 13e-3; therefore it must comply with both rules. Importantly, an issuer tender offer under state law "must be premised upon a valid business purpose consistent with the interests of the issuer's security holders and not with the primary objective of preserving management in office." Manges, \textit{SEC Regulation of Issuer and Third-Party Tender Offers}, 8 SEC. REG. L.J. 275, 278 (1981).}

\end{footnotes}
Relying on *Santa Fe Industries, Inc. v. Green*, several commentators asserted that the proposal was an attempt to usurp state law. Although adhering to the soundness of the proposal, the Commission declined to adopt a "fairness" requirement. Rather, as adopted, rule 13e-3 requires the issuer to disclose material facts about the transaction, including whether it reasonably believes that the going private transaction is fair or unfair to unaffiliated security holders and the factors upon which the belief is based. In prescribing this requirement, the Commission has arguably focused on its disclosure function, rather than engaging in substantive regulation. Nonetheless, by requiring such disclosure, private transactions today are quite possibly fairer to minority shareholders than before the adoption of the rule.

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110 430 U.S. 462 (1977). In *Santa Fe*, the Supreme Court held that in order to state a cause of action under § 10(b) and rule 10b-5 of the Securities Exchange Act, deception or manipulation must be alleged. In other words, under § 10(b) and rule 10b-5, "mere" breaches of fiduciary duty that do not involve any misrepresentation or nondisclosure are not actionable. For an analysis of *Santa Fe* and its progeny, see Ferrara & Steinberg, *A Reappraisal of Santa Fe: Rule 10b-5 and the New Federalism*, 129 U. PA. L. REV. 263 (1980).

111 See *Cohen*, supra note 77, at 309; *Connolly, New Going-Private Rule*, 13 REV. SEC. REG. 975, 977 (1980); see also notes 108-09 supra.


113 See *Cohen*, supra note 77, at 309-10. A number of commentators, however, contend that the Commission has engaged in substantive regulation. See Comment, *supra* note 113, at 883-84 ("Although Rule 13e-3 does not impose an explicit substantive fairness standard on going private transactions, the rule prescribes such rigid disclosure requirements regarding the effects, purposes, and fairness of the transaction that a fairness objective is clearly implicit in its objectives."). See also note 115 supra.

114 See *supra* note 77, at 309-10. A number of commentators, however, contend that the Commission has engaged in substantive regulation. See Comment, *supra* note 113, at 883-84 ("Although Rule 13e-3 does not impose an explicit substantive fairness standard on going private transactions, the rule prescribes such rigid disclosure requirements regarding the effects, purposes, and fairness of the transaction that a fairness objective is clearly implicit in its objectives."). See also note 115 supra.

Responding to a number of proxy statements involving novel, multi-sale-of-assets transactions, in February, 1979, the Division of Corporation Finance issued a statement of its views and practices in administering the proxy rules' existing disclosure requirements pertaining to those transactions. SEC Sec. Exch. Act Release No. 15,572 (Feb. 15, 1979), 44 Fed. Reg. 11,537 (1979). The Division expressed its concern that disclosure has not in the past "adequately highlighted the actual and potential conflicts of interest presented to management or its affiliates in transactions such as these, which are structured in part to accommodate their tax or estate needs and in which the purchaser also retains the management under long term employment arrangements." Id. at 11,538-39. Accordingly, the Division recommended that,
Although rules 14e-2 and 13e-3 were adopted during the Williams era, the present Commission generally supports these disclosure provisions. In contrast, the present Commission appears to be diverging from its predecessor regarding disclosure of qualitatively material information in the context of unadjudicated illegalities and similar improprieties. Participating as amicus curiae in a case before the Second Circuit which involved alleged nondisclosures of the directors' intent to thwart or violate the federal labor laws, the Williams Commission stated that "it is clear that future plans of a corporation must be disclosed where they are material and legal, and there is no basis for concluding that disclosure obligations may be avoided by making future illegal plans." Most recently, however, the present Commission refused to bring an action against Citicorp, reasoning in part that "[t]he law concerning disclosure of

in appropriate cases, a Special Factors Section be included in the forepart of the proxy statement, which should discuss the following items: that the principal shareholders or management may have actual or potential conflicts of interest, with a description of the conflicts; the sale price per share compared to the net tangible book value per share; a statement, if applicable, that the public seller may remain secondarily liable with respect to liabilities assumed; that certain officers and directors have entered into long term employment contracts with the purchaser and, if applicable, that they will receive increased salaries or other benefits; any such factors in the transaction that management believes require particular attention by shareholders in making their voting decision; and the reasons for and the effect of the proposed transaction. Id. at 11,539. In this regard, the staff noted that "it is important that material aspects of the transaction be adequately disclosed so that shareholders may fully appreciate the nature of the transaction for which their approval is sought." Id. The staff also focused on employment arrangements, terms of financing, the fairness of the price offered, and the rights of shareholders under state law. Id. at 11,539-40. See also SEC Sec. Exch. Act Release No. 16,883 (May 23, 1980), 45 Fed. Reg. 36,374 (1980) (reflecting the views of the Division of Corporation Finance on disclosure in proxy contests where a principal issue is the liquidation of all or a part of the equity of an issuer).


117 Brief of the Securities and Exchange Commission as Amicus Curiae at 17 (emphasis in original), Amalgamated Clothing & Textile Workers Union v. J.P. Stevens, 638 F.2d 7 (2d Cir. 1980). Continuing, the Commission asserted:

The very concept of disclosure may be contrary to human nature, in that management might prefer to conceal all unfavorable information about a company, including such matters as financial losses. Nevertheless, the essence of the federal securities laws, as stated in the preamble to the Securities Act of 1933, is "to provide full and fair disclosure."

Id. at 17-18.

118 See SEC Statement in Citicorp (March 5, 1982).
unadjudicated allegations is unclear." If this analysis reflects the Commission's current thinking on the subject, the possibility of SEC action in future such cases is virtually nil. Moreover, the SEC refused to take action against Citicorp on a much broader rationale, stating that "even if [the improprieties were] established, the alleged amounts for the years in question were not material to Citicorp." Although this language is not necessarily determinative, such language arguably rejects a corporation's duty to disclose qualitatively material information, particularly where explicit Commission rules, self-dealing, or kickbacks are not involved. Application of such a standard could well signal the death knell to the bringing of such enforcement actions where the subject directors and management did not directly benefit from the illegals. It would also constitute a marked deviation from previously established Commission policy.

119 Id. The Commission stated that "[t]here would have been a serious possibility of court reversal of the Commission's action, which would have been a bad precedent." The Commission stated that the allegations were not adequately established, that the Comptroller of the Currency had concluded that no action was justified under the federal banking laws, that the case was basically a banking or tax matter, not a securities case, and that the case was old, as the alleged practices occurred between 1973 and 1978. Id. See 14 SEC. REG. & L. REP. (BNA) 419 (March 10, 1982).

120 SEC Statement, supra note 71.

121 Compare Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981), cert. denied, 102 S.Ct. 1006 (1982), with Weisberg v. Coastal States Gas Corp., 609 F.2d 650 (2d Cir. 1979), cert. denied, 445 U.S. 951 (1980). The Commission did, however, file a memorandum as amicus curiae in support of the Petition for Rehearing and Rehearing En Banc in Gaines. The position taken in the brief, filed in 1981, indicated that the Commission supported the application of the qualitative materiality rationale in the proxy context, even when no kickbacks or self-dealing were involved. See also SEC v. Vornado, Inc., [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶98,377 (D.D.C. 1981) (pursuant to consent decree, Commission alleged, inter alia, that corporate officers violated the proxy provisions by not disclosing that management countenanced off-the-books slush funds, falsification of records, and bribery).

122 According to Congressman Dingell, Chairman of the House Subcommittee on Oversight and Investigations (of the House Energy and Commerce Committee): "In rejecting a recommendation to bring an enforcement action against Citicorp, the Commission overturned long-established precedents and introduced new criteria for disclosure." 14 SEC. REG. & L. REP. (BNA) 1565 (Sept. 17, 1982). Congressman Dingell also opined that there has been "a fundamental shift in the attitude of the Commission towards its responsibilities." Id. Former SEC Enforcement Director Stanley Sporkin testified before the House Subcommittee that "an action against Citicorp was warranted . . . ." Id. at 1564. See also SEC v. Joseph Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978); Memorandum of Amicus Curiae, SEC, in Support of Petition for Rehearing and Rehearing En Banc, Gaines v. Haughton, 645 F.2d 761 (9th Cir. 1981). In Schlitz, the SEC alleged that the defendant had failed to disclose a nationwide scheme of bribing retailers of beer and malt beverages to purchase Schlitz's products and also had failed to disclose its alleged violation of Spanish law in falsifying its books and records regarding payments and transactions with certain Spanish corporations described as affiliates. Denying Schlitz's motion to dismiss, the court concluded that "the
While shareholders undeniably are primarily interested in obtaining the maximum economic return on their investments, many are also concerned that the corporations in which they invest and the nominees for whom they vote adhere to certain minimal ethical, social, and legal standards. Allegations that defendant directors authorized, employed, or affirmatively concealed corrupt business practices, if true, would be material to reasonable shareholders, especially if they are being asked to reelect these same directors. Disclosure of management misconduct is necessary to allow shareholders to evaluate directors’ fitness to serve as fiduciaries of the corporate trust.

IV. Substantive Non-Enforcement Regulation

SEC substantive regulation is most often based on a fraud or enforcement rationale. What is sometimes lost sight of, however, is that in pursuing its statutory mandates, the Commission frequently premises its substantive regulation on other grounds. In this context, the following discussion will address SEC substantive “non-enforcement” regulation that affects or influences corporate internal affairs. As will be discussed, although the present Commission apparently supports many of the actions previously taken, the recent promulgation of Regulation D serves as an example as to the extent to which the Commission’s focus has changed.

Besides addressing and developing proxy disclosure policy, the question of the integrity of management gives materiality to the matters the Commission claims should have been disclosed.” 452 F. Supp. at 830.


A substantial number of reasonable shareholders would often consider management’s authorization of foreign bribery or unadjudicated illegal conduct to be material to their investment and, particularly, voting decisions. See Concern for Issues Fills Some Investors, Chicago Tribune, Sept. 15, 1981, § 3, at 3-4 (“a recent study by Georgeson & Co., an investor relations consultant, found that 20 per cent of a random sample of stock investors in seven companies rated corporate social responsibility as an important factor in their investment”; such investors range “from unions and pension funds to individuals.”).

Adequate and fair disclosure is the fundamental precept underlying the federal securities laws. Disclosure of management misconduct, particularly in an election contest, lies at the very heart of the proxy provisions. See Ferrara, Starr & Steinberg, supra note 61.


To permit nondisclosure on the broad ground that management is not disposed to reveal such practices ignores the fact that, under well settled disclosure standards, management must disclose much that is contrary to its interests. See Brief of the SEC, supra note 117 and accompanying text. See also note 61 supra.

125 See notes 85-87 supra and accompanying text.
the Commission has also engaged in substantive regulation of proxy disclosure. Perhaps most notably, the Commission in November 1979 promulgated rules which require that shareholders be provided with a form of proxy that (1) contains the names of persons nominated to the board of directors, (2) permits shareholders to withhold authority to vote for each nominee for election as a director (or to vote against each nominee in those jurisdictions so permitting), (3) permits shareholders to specify, by boxes, a choice to approve, disapprove, or abstain with respect to each matter to be acted upon, and (4) indicates whether the proxy is solicited on behalf of the issuer’s board of directors or on behalf of persons opposing the issuer’s solicitation. In addition, the proxy may allow a shareholder to grant authority to vote for nominees set forth as a group, provided that there is a similar means to withhold such authority (or to vote against such nominees in those jurisdictions so permitting). These rules, based on the Commission’s broad rulemaking authority under section 14(a), enable shareholders to participate more actively in the corporate decisionmaking process. By providing shareholders with the right to abstain or vote against matters in both election and other contests, these rules also may have the indirect effect of promoting revitalized shareholder interest. The ultimate result may be that otherwise recalcitrant management will be more circumspect in selecting questionable director-nominees or putting forth contemplated proposals of dubious benefit to the corporation, due to apprehension that a significant percentage of shareholders will disapprove or abstain or that a lawsuit based on the contemplated nomination or transaction will ensue.

126 SEC Sec. Exch. Act Release No. 16,356 (Nov. 23, 1979), [July-Dec.] SEC. REG. & L. REP. (BNA) No. 530, at F-1 (Nov. 28, 1979). Also of interest in this regard is rule 14a-8, 17 C.F.R. § 240.14a-8 (1982), the stockholder proposal rule. Although the Commission’s justification for the rule is principally based on fraud, see Hearings Before the House Comm. on Interstate and Foreign Commerce on H.R. 1493, H.R. 1021, and H.R. 2019, 78th Cong., 1st Sess. 169-71 (1943), “it is clear that, over the years, the rule has come to carry a substantial amount of corporate governance baggage as well.” Cohen, supra note 77, at 313. For commentary on rule 14a-8, see Black & Sparks, SEC Rule 14a-8: Some Changes in the Way the SEC Staff Interprets the Rule, 11 U. Tol. L. Rev. 957 (1980); Curzan & Pelesh, Revitalizing Corporate Democracy: Control of Investment Manager’s Voting on Social Responsibility Proxy Issues, 93 Harv. L. Rev. 670, 672-75 (1980); Eisenberg, Current Applications of the Shareholder Proposal Rule, 15 Rev. Sec. Reg. 903 (1982); Business Judgment Rule and Corporate Governance are Focus of PLI Institute on Securities Regulation, [July-Dec.] SEC. REG. & L. REP. (BNA) No. 578, at A-7 (Nov. 12, 1980). Regarding the proposed SEC changes to the shareholder proposal rule, see notes 73-76 supra and accompanying text.

127 Such lawsuits may be based on breach of fiduciary duty under state law or a failure adequately to disclose under federal law. For a discussion of relevant case law, see Ferrara & Steinberg, supra note 110.
The SEC has also engaged in substantive "nonenforcement" regulation in the tender offer setting. In November 1979, the Commission adopted new tender offer rules,\(^{128}\) including rule 14d-2(b).\(^{129}\) Rule 14d-2(b) generally provides that an announcement of an intent to make a tender offer, disclosing the amount of shares sought to be purchased and the price to be offered, triggers the commencement of a tender offer.\(^{130}\) The rule's effect is to preempt many of the state takeover statutes that provide for a significant precommencement waiting period and require a hearing to be held before a tender offer can commence.\(^{131}\)

130 More specifically, the material terms that trigger rule 14d-2(b) include the identity of the bidder and target corporation, disclosure of the class and amount of securities that are sought, and a statement of the price or range of prices being offered. 17 C.F.R. § 240.14d-2(c)(1982). The rule, however, provides a grace period of five days for the bidder to file the requisite information with the SEC and disseminate such information to shareholders. As aptly explained by one source:

If... a bidder makes a public announcement through a press release, newspaper advertisement or public statement setting forth only the bidder's and subject company's identity, the amount and class of securities being sought, and the consideration being offered therefore, and then Rule 14d-2(b) provides that the tender offer shall not be deemed to commence on that date if within five business days the bidder either publicly announces that the tender offer has been discontinued or files a Schedule 14D-1 and disseminated the requisite information to security holders. In the latter case, the date of commencement is the date on which the requisite information is first disseminated. A public announcement by a bidder disclosing only his and the subject company's identity and a statement that he intends to make a tender offer in the future, without specifying the amount of securities involved or the consideration therefore, does not constitute the commencement of a tender offer.


131 The adoption of rule 14d-2(b) has added to "[t]he confrontation between state requirements and federal law..." Bloomenthal, supra note 98, at 58. At the time it adopted the rule, the SEC recognized the conflict with state laws:

Thus, the conflict between Rule 14d-2(b) and such state statutes is so direct and substantial as to make it impossible to comply with both sets of requirements as they presently exist. While recognizing its long and beneficial partnership with the states in the regulation of securities transactions, the Commission nevertheless believes that the state takeover statutes presently in effect frustrate the operation and purposes of the Williams Act and that... Rule 14d-2(b) is necessary for the protection of investors and to achieve the purposes of the Williams Act.

In promulgating rule 14d-2(b), the SEC relied on its broad rulemaking authority under section 14(d) as well as other provisions. The Commission reasoned that the rule was necessary to protect investors and to effectuate the purposes underlying the Williams Act. According to the Commission, once a contemplated tender offer is announced at a price significantly higher than the then prevailing market price, shareholders are confronted with the immediate investment decision of either selling in the rising market or holding their stock in the hope that the offer will be successful. Under such circumstances, “[p]rotection of investors requires that when confronted with these decisions, the shareholders have the protection of the Williams Act, including full disclosure concerning the offer, and the opportunity to accept it rather than being held in limbo for some considerable period of confusion before the offer is

REG. & L. REP. (BNA) No. 605, at F-1 (May 27, 1981). One such route toward possible harmonization has been described as follows:

Although some states appear determined to fight out the Rule 14d-2 battle, they have little to lose by adopting the Wisconsin approach which permits the offer to go forward but precludes the tender offer from being concluded until the state commissioner has had an opportunity to review it under the appropriate state standards. The SEC's staff has said that it does not object to conditioning a tender offer on such a review. In that event, the constitutionality of state tender offer legislation will have to be determined in the general context of whether the state statutes which tip the balance between bidder and the target differently from the Williams Act conflict with the Williams Act, and whether the extraterritorial application of such statutes imposes an unreasonable burden on interstate commerce.

Bloomenthal, supra note 98, at 61-62. The constitutionality of rule 14d-2 has not been definitively settled. A number of courts, however, have upheld the validity of the rule and accordingly have held that the applicable state takeover statute was preempted. See, e.g., Hi-Shear Indus., Inc. v. Campbell, [1981 Transfer Binder] FED. SEC. L. REP. (CCH) ¶97,804 (D.S.C. 1980). In a recent decision, the Supreme Court, in Edgar v. MITE Corp., 102 S. Ct. 2629 (1982), held the Illinois Business Takeover Act unconstitutional under the commerce clause. See generally Langevoort, State Tender Offer Legislation: Interests, Effects, and Political Competency, 62 CORNELL L. REV. 213 (1977).

132 The Commission also relied on §§ 3(b), 14(e), and 23(a) of the Exchange Act. See SEC Sec. Act Release No. 6,158, supra note 131; Brief of the SEC as Amicus Curiae, GM Sub Corp. v. Liggett Group, Inc., No. 98, at 15 (D. Del. filed April 24, 1980).

133 The Commission stated:

Such pre-commencement public announcements cause security holders to make investment decisions with respect to a tender offer on the basis of incomplete information and trigger market activity normally attendant to a tender offer, such as arbitrageur activity. Since they constitute the practical commencement of a tender offer, such pre-commencement public announcements cause the contest for control of the subject company to occur prior to the application of the Williams Act and therefore deny security holders the protections which that Act was intended by Congress to provide.

SEC Release, supra note 131, at 82,582-83 (footnote omitted).
actually made.”

Rule 14d-2(b) may help to neutralize the advantage that target management enjoyed under these state takeover statutes. State statutes, particularly those providing for extensive precommencement delays or for substantive fairness determinations, gave the subject company time to implement defensive measures and to find a “white knight.” Thus, rule 14d-2(b) may have a significant impact on a target corporation’s internal processes when it is the subject of a hostile tender offer.

One of the more significant measures that the SEC has recently taken in “nonenforcement” substantive regulation has been to require a majority of a registrant’s directors to sign the Form 10-K. In adopting this measure as part of its integration package, the Commission reasoned that the shift in emphasis toward relying on periodic disclosure under the 1934 Act demands that the attention of the private sector, including directors and professionals, must also be refocused toward Exchange Act filings. Such increased attention to Exchange Act filings is needed to instil adequate discipline for the integrated system to properly function. By implementing the signature requirement, the Commission “anticipate[d] that directors will be encouraged to devote the needed attention to reviewing the Form 10-K and to seek the involvement of other professionals to the degree necessary to give themselves sufficient comfort.”

The effect of the signature requirement on directors’ standard of care in reviewing the Form 10-K and on their reliance on counsel and accountants should be substantial. By signing the Form 10-K,

134 SEC Brief, supra note 132, at 20. See note 112 supra.
135 See generally Langevoort, supra note 131. Such a consequence appears to be contrary to the purposes underlying the Williams Act. Both the House and Senate Reports stated that the bill “is designed to require full and fair disclosure for the benefit of investors while at the same time providing the offeror and management equal opportunity to fairly present their case.” H.R. REP. No. 1711, 90th Cong., 2d Sess. 4, reprinted in 1968 U.S. CODE CONG. & AD. NEWS 2811, 2813; S. REP. No. 550, 90th Cong., 1st Sess. 3 (1967).
137 Id. These amendments are designed to facilitate integration of the Securities Act and Exchange Act disclosure systems. The annual report to shareholders, under the amendments, may become the cornerstone disclosure document upon which the integrated system is to be built.
138 No. 569 at SS-7. The Commission concluded that “this added measure of discipline is vital to the disclosure objectives of the federal securities laws, and outweighs the potential impact, if any, of the signature on legal liability.” Id. The Commission did state, however, that “[i]t has . . . instructed the staff to report to it on the results of imposing the requirement after an appropriate time has passed, and the Commission will revisit the question if such action appears necessary or appropriate at that time.” Id.
the subject directors have presumably reviewed the document with care.\textsuperscript{139} Accordingly, increased liability upon such directors may be premised on the following rationales: (1) that under section 18(a) of the Exchange Act,\textsuperscript{140} the directors "caused" the filing;\textsuperscript{141} (2) that such signing indicates that the directors may have acted with scienter,\textsuperscript{142} or at least recklessly,\textsuperscript{143} for recovery purposes in private damage and SEC injunctive actions under section 10(b)\textsuperscript{144} and at least negligently in SEC injunctive actions under section 17(a)(2) and 17(a)(3) of the Securities Act;\textsuperscript{145} and (3) that, with respect to control person liability under section 20(a) of the Exchange Act,\textsuperscript{146} such signing may indicate that the subject directors did not act in good faith and may have induced the acts causing the violation.\textsuperscript{147} Although the courts may ultimately reject the above rationales, thereby signifying that the signature requirement may not alter existing legal liabili-

\textsuperscript{140} 15 U.S.C. § 78r(a) (1976).
\textsuperscript{141} Section 18(a) imposes liability upon any person "who shall make or cause to be made" any materially false or misleading statement contained in a document filed with the SEC. Relief may be granted only to purchasers and sellers. Strict standards of reliance and causation apply, with the result that, in no reported case, has the plaintiff obtained relief. See Greene, Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System, 56 Notre Dame Law. 755, 758 (1981). For discussion on § 18(a), see Steinberg, The Propriety and Scope of Cumulative Remedies Under the Federal Securities Laws, 67 Cornell L. Rev. 557 (1982).
\textsuperscript{143} The Court in both Hochfelder and Aaron expressly left this issue open. See 446 U.S. at 686 n.5; 425 U.S. at 194 n.12. Subsequent to Hochfelder, the overwhelming majority of courts have held that recklessness constitutes sufficient scienter. See, e.g., Healey v. Catalyst Recovery of Pa., Inc., 616 F.2d 641 (3d Cir. 1980); Mansbach v. Prescott, Ball & Turben, 598 F.2d 1017 (6th Cir. 1979); Nelson v. Serwold, 576 F.2d 1332 (9th Cir.), cert. denied, 439 U.S. 970 (1978); Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), cert. denied, 439 U.S. 1039 (1978). See generally Steinberg & Gruenbaum, Variations on "Recklessness" After Hochfelder and Aaron, 8 SEC. REG. L.J. 179 (1980).
\textsuperscript{144} In Aaron, 446 U.S. 680 (1980), the Supreme Court held, \textit{inter alia}, that the SEC must prove scienter in SEC injunctive actions brought for violations of § 10(b) and § 17(a)(1) of the Securities Act. In Hochfelder, 425 U.S. 185 (1976), the Court held that scienter must be proved in private damage actions under § 10(b).
\textsuperscript{145} In Aaron, the Court held, \textit{inter alia}, that the SEC need not prove scienter in injunctive actions based on violations of § 17(a)(2) or § 17(a)(3). See Steinberg, SEC and Other Permanent Injunctions—Standards for Their Imposition, Modification, and Dissolution, 66 Cornell L. Rev. 27 (1980).
\textsuperscript{147} See Ferrara, \textit{supra} note 139, at 766.
ties, the signature requirement will likely impel directors to examine and review the Form 10-K and to rely on corporate counsel and accountants to a much greater extent than has previously been the practice.

A further issue relating to SEC "non-enforcement" substantive regulation is whether the Commission has the authority under section 19(c) of the Exchange Act to compel self-regulatory organizations to alter their listing standards that relate to the internal corporate affairs of listed companies. In the Corporate Governance Report, the staff contended that Commission authority under section 19(c) seems clear on its face. The Report stated that the exchanges' listing standards, including provisions such as the New York Stock Exchange's audit committee rule, currently affect the internal governance of listed companies by requiring such companies to take corporate action that they may not otherwise pursue. While the listing standards of individual exchanges may become less important in the context of a national market system, the staff observed that the Commission's authority under section 19(c) extends to all national securities exchanges as well as to the National Association of Securities Dealers. In addition, the staff noted that the Commission has broad and direct rulemaking power under section 11A(a)(2) of the Exchange Act to designate the securities or classes of securities that are deemed qualified for trading in the national market system. If

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148 See note 138 supra.
149 15 U.S.C. § 78s(c) (1976). Pursuant to § 19(c), the Commission "by rule, may abrogate, add to, and delete from . . . the rules of a self-regulatory organization . . . as the Commission deems necessary or appropriate to insure the fair administration of the self-regulatory organization, to conform its rules to requirements of this chapter and the rules and regulations thereunder applicable to such organization, or otherwise in furtherance of purposes of this chapter. . . ."
150 SEC STAFF CORPORATE ACCOUNTABILITY REPORT, supra note 28, at 643-44.
152 SEC STAFF CORPORATE ACCOUNTABILITY REPORT, supra note 28, at 646. In this regard, the Staff concluded that self-regulatory organizations are confronted with somewhat of a dilemma between their marketing efforts to attract companies to list or otherwise qualify their securities for trading and their regulatory efforts to enhance investor confidence through corporate accountability requirements. Thus, while they cannot be expected to be at the forefront of changes in corporate accountability, they should continue to be concerned about the governance of their listed companies and can play an important role in assuring communication among their listed companies, their member firms and shareholders.

The Commission, for its part, should consider carefully further suggestions for SRO rule changes related to the internal corporate structure of listed companies, but, as a matter of policy, should not require such changes at this time.

Id. at 647.
criteria for qualification were to extend to conduct of corporate internal affairs, and not merely suitability for trading, the Commission's leverage "to move the world of corporate governance" would be even stronger. It seems highly unlikely, however, that the present Commission would move in this direction.

Indeed, an argument can be made that the current Commission has exhibited considerable concern for facilitating the capital formation process. The recent adoption of Regulation D, particularly certain aspects of rule 506 contained therein, reflects this concern. Essentially, Regulation D contains new rules which govern certain offers and sales of securities without registration under the Securities Act. One such rule, rule 506, replaces rule 146 and relates to

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154 Rule 506 is one of six rules adopted by the Commission pursuant to Regulation D. As outlined by the Commission:

Rules 501-503 set forth definitions, terms, and conditions that apply generally throughout the regulation. The exemptions of Regulation D are contained in Rules 504-506. Rules 504 and 505 replace Rules 240 and 242, respectively, and provide exemptions from registration under Section 3(b) of the Securities Act. Rule 506 succeeds Rule 146 and relates to transactions that are deemed to be exempt from registration under Section 4(2) of the Securities Act.

SEC Sec. Act Release No. 6,389 (March 8, 1982), 14 SEC. REG. & L. REP. (BNA) 495, 496 (March 17, 1982).

155 As stated previously, rules 504 and 505 were promulgated pursuant to § 3(b) of the Securities Act, which empowers the Commission to exempt from the registration requirements any issue of securities provided that the aggregate amount at which the issue is offered to the public does not exceed $5,000,000. Under rule 504, securities not exceeding $500,000 may be sold during any twelve-month period to an unlimited number of investors. The rule contains no specific disclosure requirements and is available only to companies that are neither subject to reporting obligations under the Exchange Act nor defined as investment companies under the Investment Company Act of 1940. Under rule 505, an issuer may sell up to $5,000,000 of securities during any twelve-month period to thirty-five purchasers and to an unlimited number of accredited investors. The rule contains certain informational delivery requirements and prohibits the use of general advertising or solicitation. See note 154 supra.

For discussion of rule 506, see notes 158-59 infra and accompanying text.


Section 4(2) of the Securities Act of 1933 provides that offers and sales of securities by an issuer not involving any public offering are exempt from the registration provisions of the Act. Rule 146 provides objective standards for determining when the exemption is available. The main conditions of the rule require that (1) there be no general advertising or soliciting in connection with the offering; (2) offers be made only to persons the issuer reasonably believes have the requisite knowledge and experience in financial and business matters or who can bear the economic risk; (3) sales be made only to persons as described above except that persons meeting the economic risk test must also have an offeree representative capable of providing
transactions that are exempt under section 4(2) of the Securities Act.\textsuperscript{157} Under rule 506, offers and sales are exempt from registration when the securities are purchased by no more than thirty-five purchasers. Accredited investors, including individuals meeting certain financial standards,\textsuperscript{158} are excluded in computing the number of purchasers. The rule eliminates the economic risk test and requires that only purchasers meet the sophistication standard.\textsuperscript{159}

The Commission's release in adopting Regulation D makes clear that rule 506 transactions are deemed to be exempt under section 4(2).\textsuperscript{160} As the Supreme Court in an analogous situation held in Ernst \& Ernst v. Hochfelder,\textsuperscript{161} the rule's scope cannot exceed that given to its statutory source.\textsuperscript{162} Viewed from this perspective, a plausible, if

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the requisite knowledge and experience; (4) offerees have access to or be provided information comparable to that elicited through registration; (5) there be no more than 35 purchasers in the offering; and (6) reasonable care be taken to ensure that the securities are not resold in violation of the Act's registration provisions.


\textsuperscript{157} Section 4(2) states that the provisions of § 5 shall not apply to "transactions by an issuer not involving any public offering." \textit{See} note 154 supra. \textit{Note that under § 19(c)(3)(C) of the Securities Act the Commission is empowered to adopt for federal securities law purposes "a uniform exemption from registration for small issuers which can be agreed upon among several States or between the States and the Federal Government." Significantly, the Commission did not rely on this provision as the basis for promulgating rule 506. This position is correct. Even if the rule were ultimately adopted by some states, rule 506, unlike the exemptive authority provided by § 19(c)(3)(C), applies to all issuers regardless of size.}

\textsuperscript{158} Rule 501 defines an "accredited investor"\textsuperscript{1} to include, among others, any person who purchases at least $150,000 of the securities if the total purchase price does not exceed twenty percent of the person's net worth at the time of sale, any natural person who has an income greater than $200,000 during each of the prior two years and who reasonably anticipates an income greater than $200,000 for the current year, and any natural person whose net worth, individually or in combination with the spouse, at the time of purchase is $1,000,000. \textit{See} SEC Release, \textit{supra} note 154, at 498-99.

\textsuperscript{159} \textit{Id.} at 503. \textit{Cf.} rule 146, \textit{supra} note 156.

\textsuperscript{160} \textit{See} note 149 \textit{supra}.

\textsuperscript{161} 425 U.S. 185 (1976) (concluding that despite the language of rule 10b-5, which could be read as not requiring scienter, the language of § 10(b) was controlling and required scienter).

\textsuperscript{162} By its terms, however, § 4(2) does not confer rulemaking authority upon the Commission. It would appear that § 19(a) of the Securities Act gives the Commission that authority:

The Commission shall have authority from time to time to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of this title, including rules and regulations governing registration statements and prospectuses for various classes of securities and issuers, and defining accounting, technical, and trade terms used in this title.
not persuasive, argument can be made that rule 506 is invalid because it contravenes established judicial construction of section 4(2), dating back nearly thirty years to the Supreme Court's seminal decision in SEC v. Ralston-Purina Co.\footnote{346 U.S. 119 (1953) \((\text{the } \S 4(2) \text{ exemption turns on, } \text{inter alia}, \text{ whether the offerees were able to fend for themselves and whether they had access to the kind of information that registration would have disclosed).}\)\] Under such judicial interpretation, courts have uniformly held that the section applies not only to purchasers but to offerees as well, and that the financial sophistication or wealth of an offeree is not a sufficient basis for a subject issuer to qualify for the exemption.\footnote{See, \textit{e.g.}, SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980); Swenson v. Engelstad, 626 F.2d 421 (5th Cir. 1980); Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978); SEC v. Asset Management Corp., [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) \$97,278 (S.D. Ind. 1979); Barrett v. Triangle Mining Corp., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) \$95,438 (S.D.N.Y. 1976). \textit{Cf.} ALI \textit{FEDERAL SECURITIES CODE} \$ 202(4)(B) (focusing on the number of \textit{purchasers} rather than offerees).\] Moreover, promulgation of rule 506 will provide certain inves-15 U.S.C. \$ 77s(a) (1976).\] 

163 SEC v. Ralston-Purina Co.\footnote{346 U.S. 119 (1953) \((\text{the } \S 4(2) \text{ exemption turns on, } \text{inter alia}, \text{ whether the offerees were able to fend for themselves and whether they had access to the kind of information that registration would have disclosed).}\)\] 

164 See, \textit{e.g.}, SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980); Swenson v. Engelstad, 626 F.2d 421 (5th Cir. 1980); Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978); SEC v. Asset Management Corp., [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) \$97,278 (S.D. Ind. 1979); Barrett v. Triangle Mining Corp., [1975-1976 Transfer Binder] FED. SEC. L. REP. (CCH) \$95,438 (S.D.N.Y. 1976). \textit{Cf.} ALI \textit{FEDERAL SECURITIES CODE} \$ 202(4)(B) (focusing on the number of \textit{purchasers} rather than offerees).\] 

165 See, \textit{e.g.}, Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978); Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977); Hill York Corp. v. American Int'l Franchises, Inc., 448 F.2d 680 (5th Cir. 1971); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971); United States v. Guster Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967).\] 

166 Indeed, in 1975, the American Bar Association's Section of Corporation, Banking and Business Law stated that the Commission's administrative authority with respect to the \$ 4(2) \text{ exemption "is somewhat circumscribed by relevant judicial decisions."} \textit{Section 4(2) and Statutory Law—A Position Paper of the Federal Regulation of Securities Committee, 31 BUS. LAW. 483, 486 (1975) \cite{Position Paper}.} Interestingly, the Commission's former rule 146 was apparently more restrictive than the statutory case law construing \$ 4(2). As the Fifth Circuit stated:\footnote{See Doran v. Petroleum Management Corp., 545 F.2d 893, 902 (5th Cir. 1977); Schneider, supra note 156, at 874-75. \textit{But see Position Paper, supra, at 491 ("[U]nder Statutory Law as well as Rule 146, we believe that both the total amount of money invested, and also the likelihood that all or part of it will be lost, must be considered.")}; \textit{NASAA Uniform Limited Offering Exemption}, 14 SEC. REG. \& L. REP. (BNA) 834, 835-36, 836 n.7 (May 7, 1982) (requiring, unlike rule 506, that for an accredited investor as discussed above, "the issuer and any person acting on its behalf shall have reasonable grounds to believe and after making reasonable inquiry shall believe that the purchaser either alone or with his/her purchaser representative(s) has such knowledge and experience in financial and business matters that he/she is or they are capable of evaluating the merits and risk of the prospective investment and that the investment does not exceed 20% of the investor's net worth (excluding principal residence, furnishings therein and personal automobiles).") The exemption does provide, however, that "[i]n those states where facts and circumstances permit, it
tors with far less protection than they previously had enjoyed. The Fourth Circuit's decision in \textit{Lawler v. Gilliam}\textsuperscript{167} graphically illustrates this consequence. In \textit{Lawler}, 100 investors lost approximately $21,000,000.\textsuperscript{168} The defendants claimed that the private offering exemption of section 4(2) was available. The Fourth Court disagreed, relying on the Supreme Court's decision in \textit{Ralston Purina} as well as a long line of federal appellate cases.\textsuperscript{169} Accordingly, investors' status as wealthy or financially sophisticated was not sufficient for the exemption to apply. The court recognized that such status "is not a substitute for 'access to the kind of information which registration would disclose,'"\textsuperscript{170} and held the defendants liable under section 12(1) of the Securities Act.\textsuperscript{171} In contrast, under the SEC's rule 506, the defendants in \textit{Lawler} apparently could have successfully claimed the exemption, thereby precluding the plaintiffs from their section 12(1) remedy. The plaintiffs apparently would have been considered would not be inconsistent with the regulatory objectives of this exemption to omit this section.\textsuperscript{#}).

Some commentators also have implied that rule 506 exceeds the Commission's statutory authority. \textit{See} Note, \textit{Regulation D: Coherent Exemptions for Small Businesses Under the Securities Act of 1933,} 24 \textit{Wm. & Mary L. Rev.} 121, 156 (1982) ("By extending the accredited investor concept to Rule 506 . . . the SEC authorizes issuers to sell large amounts of unregistered securities without requiring specific disclosure to investors who may lack access to information. This results in a definition of 'nonpublic offering' that is inconsistent with case law interpreting section 4(2).'\textsuperscript{#}). \textit{See also} Donahue, \textit{New Exemptions from the Registration Requirements of the Securities Act of 1933: Regulation D}, 10 \textit{Sec. Reg. L.J.} 235 (1982); Ketels, \textit{Regulation D—The New Regulation World for Limited Offerings}, 5 \textit{Corp. L. Rev.} 268 (1982); Schneider, \textit{Introduction to Regulation D}, 15 \textit{Rev. Sec. Reg.} 990 (1982).

\textsuperscript{167} 569 F.2d 1283 (4th Cir. 1978).

\textsuperscript{168} \textit{Id.} at 1290.

\textsuperscript{169} \textit{Id.} at 1289-91 (citing SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Doran v. Petroleum Management Corp., 545 F.2d 893 (5th Cir. 1977); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967); Gilligan, Will & Co. v. SEC, 267 F.2d 461 (2d Cir. 1959)).

\textsuperscript{170} 569 F.2d at 1289 (quoting United States v. Custer Channel Wing Corp., 376 F.2d 675, 678 (4th Cir. 1967), quoting SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1953)). \textit{Accord} Doran v. Petroleum Management Corp., 545 F.2d 893, 902 (5th Cir. 1977) ("[E]vidence of a high degree of business or legal sophistication on the part of all offerees does not suffice to bring the offering within the private placement exemption.\textsuperscript{#}).

\textsuperscript{171} 569 F.2d at 1289-91. Section 12(1) provides that "[a]ny person who offers or sells a security in violation of section 5 . . . shall be liable to the person purchasing such security from him . . . ." Some courts have limited liability under \textsection{12} to only those persons who are in privity with the aggrieved purchaser. \textit{See, e.g.}, McFarland v. Memorex Corp., 493 F. Supp. 631, 647-48 (N.D. Cal. 1980). The Fifth Circuit in \textit{Lawler} rejected this rationale, holding that liability may be imposed under \textsection{12} upon those who are integrally connected with or substantially involved in the offer or sale. 569 F.2d at 1287-88 (following Lewis v. Walston & Co., 487 F.2d 617, 621-22 (5th Cir. 1973)). In addition, some courts have premised liability under the section on an aiding and abetting basis. \textit{See generally} Collins v. Signetics Corp., 605 F.2d 110, 112-13 (3d Cir. 1979).
"accredited investors" as defined in Regulation D. Because rule 506 presumes that such investors can fend for themselves, the plaintiffs would not be entitled to delivery of any information.

Rule 506's departure from established case law construing section 4(2) as well as the Commission's own prior rules calls into question whether the rule will ultimately be upheld by the courts. Rule 506, perhaps more than any other recent SEC action, with the possible exception of temporary "shelf" registration rule 415, brings into focus the apparently changed philosophy at the Commission, at least with respect to its concern for the capital raising process. Although promotion of the capital formation process is certainly a laudable objective, Congress was far more concerned with

172 Since investors lost an average of $210,000 each, this conclusion seems supportable. The decision, however, does not discuss each investor's loss. For Regulation D's definition of "accredited investor," see rule 501 and note 158 supra.
173 See rule 502(b), SEC Release, supra note 154, at 500-01.
174 See notes 156 and 166 supra and note 178 infra.
175 The Commission's adoption of rule 415, the temporary "shelf" registration rule, SEC Act Release No. 6,383, 24 SEC Docket 1318 (March 16, 1982), and the Commission's subsequent extension of that rule, SEC Act Release No. 6,423, 12 SEC. REG. & L. REP. (BNA) 1593 (Sept. 17, 1982), have come under attack. Generally, rule 415 governs the registration of securities to be offered and sold on a delayed or continuous basis in the future. Significantly, for the first time, the rule permits primary at-the-market offerings of equity securities which the issuer expects to offer within two years of the registration statement's effective date. Following public hearings and comment regarding rule 415, the Commission extended the effective period for the rule until December 31, 1983, to obtain additional experience before taking final action on the rule. SEC Act Release No. 6,423 (Sept. 2, 1982).

Arguing that the rule should be limited to debt offerings, Commissioner Thomas dissented. She asserted that rule 415, when applied to equity offerings, jeopardizes the liquidity and stability of our primary and secondary securities markets by encouraging greater concentration of underwriters, market-makers, and other financial intermediaries and by discouraging individual investor participation in the capital markets thereby furthering the trend toward institutionalization of securities holders, and (2) reduces the quality and timeliness of disclosure available to investors when making their investment decisions. Incurring these risks is antithetical to the statutory duty of the Commission to protect investors and to maintain the integrity of our capital markets.

14 SEC. REG. & L. REP. (BNA) at 1597. An even more critical view is held by John C. Whitehead, senior partner of Goldman, Sachs & Co., who criticized the rule in the following terms: "There have been times when its zealous protection of the interests of investors have seemed to make it unduly difficult for corporations to raise needed capital. But now the Commission has seemingly taken a 180-degree turn, abandoning its traditional role of protecting investors . . . ." Whitehead, SEC Abandons Investor Protection, FINANCIER (CORRESPONDENCE), Apr. 1982, at 59, 60. See generally Ferrara & Sweeney, Shelf Registration Under SEC Temporary Rule 415, 5 CORP. L. REV. 308 (1982).

176 A former SEC Commissioner has recommended that the preambles of the 1933 and 1934 Acts be amended to elevate the promotion of the capital formation process as one of the Commission's specified objectives. R. KARMEL, REGULATION BY PROSECUTION: THE SECURITIES & EXCHANGE COMMISSION VERSUS CORPORATE AMERICA 298-304 (1982).
the SEC’s role in protecting the investing public and the integrity of the marketplace. Accordingly, the Commission’s promulgation of rule 506, although perhaps beneficial by replacing the cumbersome and much criticized rule 146, goes too far in facilitating capital formation at the expense of the investing public.

V. Enforcement

During the 1970’s, the trilogy of (1) the Commission’s enforcement program, (2) the voluntary disclosure program, and (3) the Foreign Corrupt Practices Act had a profound collective impact on corporate accountability. The enforcement program in the area of questionable payments is well known and need not be detailed here. Equally well known are the many cases brought for violations involving other misconduct. These and other cases were brought, however, to respond to perceived wrongdoings and specific deficiencies, and not with an aim to influence internal corporate affairs. While the Commission sought in such cases the express statutory remedy of an injunction against future violations, the Commission also obtained a variety of ancillary or other equitable relief. Such relief was designed to establish mechanisms by which to


177 See Preamble to the Securities Act of 1933, Securities Act of 1933, ch. 38, 48 Stat. 74 (1933) ("To provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof, and for other purposes."); Preamble to the Securities Exchange Act of 1934, Securities Exchange Act of 1934, ch. 404, 48 Stat. 881 (1934) ("To provide for the regulation of securities exchanges and over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes."). Interestingly, when Congress amended the Securities Act in 1980, it urged “greater Federal and State cooperation in securities matters, including . . . minimum interference with the business of capital formation . . . .” 15 U.S.C.A. § 77s(c)(2)(C) (West 1981) (emphasis added). The term “interference” is far different than the terms “facilitating” or “encouraging,” which Congress could have elected to employ.

178 Thus, rule 146 was subject to two major criticisms: "(1) It [did] not relieve all ambiguity and uncertainty regarding the necessary requirements for the private placement exemption, and (2) full compliance with the Rule [was] a time consuming and financially expensive procedure." Thomforde, supra note 156, at 21. See also note 156 supra. As noted beforehand, former rule 146 apparently was more restrictive than the statutory case law construing § 4(2). See note 166 supra. Whether or not the courts ultimately uphold rule 506, the rule’s adoption by the Commission may in itself represent a change in focus.

179 See SEC QUESTIONABLE PAYMENTS REPORT, supra note 25.

180 See generally Hazen, Administrative Enforcement: An Evaluation of the Securities and Exchange Commission’s Use of Injunctions and Other Enforcement Methods, 31 HASTINGS L.J. 427, 428 (1979) (exploring the “SEC’s exercise of enforcement authority both in terms of efficiency and the legal standards applying that authority.”).
avoid repetition of the questionable conduct. In this process, the Commission influenced internal corporate mechanisms, sometimes dramatically. For example, corporate boards were restructured, independent directors were appointed, audit and other committees were established, and corporate officials were removed or ordered not to serve in public companies.

While the SEC has often procured ancillary or equitable relief through the consent negotiation process, usually with the defendant neither admitting nor denying the allegations of the complaint, the Commission has also obtained these orders through litigation. In addition, pursuant to section 15(c)(4) of the Exchange Act, the Commission through the administrative process has obtained far-reaching relief that affects internal corporate processes. The Commission has also affected internal corporate


processes by issuing section 21(a) reports under the Exchange Act.\textsuperscript{190}

The present Commission will apparently continue, at least to a certain extent, the policy of seeking ancillary or other equitable relief. For example, in recent actions the Commission has obtained, through the consent process, court orders requiring that independent directors and special agents be appointed.\textsuperscript{191} Moreover, the Commission in a section 21(a) report recently summarized the importance of a corporation’s timely disclosure of material developments where persons, having access to nonpublic corporate information, may be trading in the subject company’s securities.\textsuperscript{192} Thus, the Commission’s enforcement program, perhaps due in part to the widely accepted propriety of ancillary relief, will continue to affect corporate internal processes. Nonetheless, as will be discussed, the magnitude of this impact may well be smaller than it has been in the past.

Respecting enforcement developments that affect internal corporate affairs and the Commission’s perceived authority to address this subject, an interesting evolution appears to have taken place. The \textit{Franchard} decision\textsuperscript{193} reflected the Commission’s corporate governance philosophy in 1964. In \textit{Franchard}, the Commission asserted that state law governed the obligations and responsibilities of direc-

\textsuperscript{190} In pertinent part, § 21(a) of the Exchange Act, 15 U.S.C. § 78u(a) (1976), provides:

\begin{quote}
The Commission is authorized in its discretion, to publish information concerning any such violations, and to investigate any facts, conditions, practices, or matters which it may deem necessary or proper to aid in the enforcement of such provisions, in the prescribing of rules and regulations under this chapter, or in securing information to serve as a basis for recommending further legislation concerning the matters to which this chapter relates.
\end{quote}


tors. The Commission also indicated that it did not wish to address this area.\textsuperscript{194} The Commission’s philosophy changed, however, in the 1970’s. The staff report in the \textit{Penn Central} matter\textsuperscript{195} illustrates the beginning of this process. In that report, the staff, not the Commission, addressed what it perceived to be the directors’ deficient conduct although it did not set any prescriptive standards.\textsuperscript{196}

The next significant development was the \textit{Stirling Homex} report\textsuperscript{197} in 1975. In a section 21(a) report, the Commission commented upon the inadequate performance of the outside directors, stating that they “did not play any significant role in the direction of [the] company’s affairs even though they possessed considerable business experience and sophistication.”\textsuperscript{198} The Commission adhered to this approach in \textit{SEC v. Shiell},\textsuperscript{199} where the Commission alleged that the subject directors violated the antifraud provisions by neglecting to perform their directorial duties. The Commission’s complaint in \textit{Shiell}, along with the staff’s affidavit in support of the motion for preliminary injunctive relief, evidenced the continuing evolutionary development since \textit{Franchard}.\textsuperscript{200}

In 1978, the Commission continued this process in \textit{National Telephone}.\textsuperscript{201} Rather than opining on the role of directors qua directors, the Commission identified structural deficiencies in National Telephone’s corporate governance machinery. For example, the audit committee, which consisted of three outside directors, never met.\textsuperscript{202} At about the same time that \textit{National Telephone} was handed down, the

\textsuperscript{195} HOUSE SPECIAL SUBCOMM. ON INVESTIGATIONS, 92D CONG., 2D sess., STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (Subcomm. Print 1972).
\textsuperscript{196} \textit{Id.} at 7-8.
\textsuperscript{198} \textit{Id.} at 7-8.
\textsuperscript{199} 7 SEC Docket at 300.
\textsuperscript{202} 13 SEC Docket at 1395, ¶81,410, at 88,878. The Commission also stated:

\textit{The Commission is not saying that the directors of a company are responsible for approving every line of every press release and periodic filing made by the company; rather the Commission is saying that, at a time of distress in a company’s existence, the directors have an affirmative duty to assure that the market place be provided accurate and full disclosure concerning the basic viability of the company and the continuity of its operations.}

\textit{Id.} at 1393.
Commission brought an injunctive action against Killearn Properties.\textsuperscript{203} There, in a consent judgment, the company was ordered to restructure its board of directors to consist of a majority of outside directors and to maintain an audit committee comprised solely of outside directors.\textsuperscript{204}

Subsequently, the Commission in the \textit{Woods}\textsuperscript{205} and \textit{Spartek}\textsuperscript{206} proceedings embarked on the latest stage in this evolutionary process. In these cases, the Commission restructured specific transactions, finding that the companies' Exchange Act reports "were materially deficient in failing to disclose the full facts and circumstances surrounding the structure of the sale of assets transaction[s], including the purposes, and the determination of the price to be offered to shareholders."\textsuperscript{207} To remedy these situations, the Commission ordered the respective companies to comply with the reporting requirements and to retain a "Special Review Person" to negotiate on behalf of the public shareholders.\textsuperscript{208}

The above discussion supports the conclusion that the Commission through its enforcement actions and the ancillary or other equitable relief obtained in such actions has significantly affected corporate internal affairs. In so doing, however, the Commission has not stretched its statutory mandates. Commission actions have been based principally on federal disclosure violations, rather than on breaches of fiduciary duty\textsuperscript{209} and hence come well within the Commission's jurisdiction.\textsuperscript{210}

Although it is premature to state with certainty, future SEC enforcement policies may have an increasingly narrower scope. One such area, as previously discussed, may concern the duty to disclose


\textsuperscript{204} \textit{Id.} at 92,694-95.


\textsuperscript{207} 16 SEC Docket at 172.

\textsuperscript{208} 16 SEC Docket at 1100, \textsection 81,961, at 81,407; 16 SEC Docket at 172. \textit{See} Ferrara, \textit{The Duty to Disclose Qualitative Material Information}, in \textit{TWELFTH ANNUAL INSTITUTE ON SECURITIES REGULATION} 145, 155-56 (1980); Ferrara, \textit{supra} note 139, at 768-70. \textit{See also} SEC v. Wej-It Corp., SEC Litig. Release No. 3,299 (D.D.C. 1979) (in a consent judgment, the SEC alleged that Wej-It violated § 14(e) of the Exchange Act by failing to disclose to its shareholders the full facts and circumstances regarding the manner and method by which the Wej-It board arrived at the offering price).

\textsuperscript{209} \textit{See} note 110 \textit{supra}.

\textsuperscript{210} \textit{See generally} notes 78-114 \textit{supra} and accompanying text.
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qualitatively material information, including unadjudicated illegalities. Moreover, present Enforcement Director John M. Fedders has initiated a comprehensive review of the Commission's enforcement policies and practices. He has enumerated three specific areas for "renewed enforcement vigilance": trading while in possession of material nonpublic information, manipulation of the securities markets, and fraudulent disclosure practices by reporting companies. Because these three areas directly affect the investing public and the securities markets, they undoubtedly require vigorous SEC enforcement. For better or worse, however, the enumerated areas of concern, although also an essential part of the Sporkin era enforcement program, may well represent different "rhetoric and policies."

During the Sporkin era, the Commission relied on the disclosure rationale underlying the federal securities laws as the basis for bringing enforcement actions that affected a wide range of substantive corporate conduct. In so doing, the Commission employed such polices as requiring disclosure of certain information because it bears on the integrity or competency of management, irrespective of the information's economic materiality, holding that professionals,

211 See notes 115-24 supra and accompanying text.

212 John M. Fedders, Director, Division of Enforcement, Securities and Exchange Commission, Remarks to the 1981 SEC Accounting Conference, Foundation for Accounting Education of the New York State Society of Certified Public Accountants 4-8 (Nov. 16, 1981). Mr. Fedders announced that the initiation of this study was encouraged by Chairman Shad and the other Commissioners. Id. at 4. The study is intended to encompass such matters as the internal standards employed by the Commission when determining whether to litigate or settle cases, the internal standards used for authorizing formal orders of investigation, and whether such formal orders should automatically expire after a specified period, unless renewed by the Commission. Id. at 5. Mr. Fedders also initiated a study of the sanctions and remedies that are available to the Commission. This study will cover three areas: whether the present remedies and sanctions are adequate and, if not, whether the Commission should seek legislation; whether, in appropriate circumstances, the Commission should seek injunctions that expire after a specified period or upon the fulfillment of certain conditions; and whether the Commission should publish criteria that it would apply when deciding whether to consent to a request for modification or dissolution of an outstanding injunction. Id. at 6-7. The results of this study may portend a significant change in SEC enforcement policy. The Commission's position, at this time, apparently is consistent with prior policy, namely, that upon making a proper showing, it is entitled as a matter of statutory right to the ordering of a permanent injunction, Brief of the SEC at 10, SEC v. Associated Minerals, Inc., Nos. 79-1449, 79-1450 (6th Cir. 1980), and that permanent injunctions should be difficult for subject parties to modify or dissolve. SEC v. Clifton, [1981-1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶99,477 (D.D.C. 1982).

213 Remarks of John M. Fedders, supra note 212, at 8-11.

214 See Hudson, supra note 42, at 18.

215 See notes 115-24 supra and accompanying text. See generally Ferrara, Starr & Steinberg, supra note 61.
such as attorneys and accountants, who act as the “passkey” to securities offerings and other key corporate transactions, must be cognizant of and responsible to the interests of the investing public, and bringing enforcement actions for nondisclosure of management perquisites and for violation of the accounting provisions of the Foreign Corrupt Practices Act.

Continued vigorous advancement of the above enforcement policies appears unlikely under the present Commission. Although a conclusive determination cannot yet be made, the present Commission’s ultimate stance in pursuing these policies will significantly influence the extent to which the in terrorem impact of potential SEC enforcement action will continue to affect corporate internal affairs.

VI. Legislative Programs

With the exception of the Foreign Corrupt Practices Act of 1977 (FCPA), the Commission’s recent legislative program has not directly affected internal corporate affairs. Indeed, recent Commission policy has encouraged legislation to aid small issuers and capital formation. As noted previously in regard to the Metzenbaum Bill, for-

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219 A recent article stated that “[s]ome securities lawyers say clients, sensing ‘a new mood in Washington’ favorable to business, are becoming more reluctant to disclose unflattering facts about their dealings. But other lawyers say they haven’t detected any change in corporate attitudes.” Hudson, supra note 42, at 1.

mer Chairman Williams testified in opposition to imposing federal minimum standards upon internal corporate structures.\textsuperscript{221}

A graphic illustration, however, of how an SEC program can influence the effectuation of fundamental changes in corporate internal affairs is the Commission's involvement in the area of questionable foreign payments. During the mid-1970's, the Commission investigated companies that had channelled large sums of money to foreign officials in order to obtain business in those countries. The Commission not only discovered that such payments were widespread, but also learned that in many instances payments were made without the knowledge of top corporate officers and directors, thus reflecting a more fundamental breakdown in the process of corporate accountability.\textsuperscript{222} In May of 1976, the Commission reported to Congress the results of its investigations and enforcement actions, as well as data submitted by corporations pursuant to the Commission's voluntary disclosure program.\textsuperscript{223}

Reacting to these and related developments, Congress enacted the Foreign Corrupt Practices Act of 1977. The FCPA outlaws "corrupt" payments to foreign officials or political parties that are designed to obtain or retain business for the company in question or to direct business to any other person. In responding to the broader accountability concerns, Congress amended section 13(b) of the Securities Exchange Act to require publicly-held companies to make and keep books, records and accounts that "in reasonable de-

\begin{footnotes}
\textsuperscript{221} See notes 36-39 supra and accompanying text.
\textsuperscript{223} Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess., Report of the Securities and Exchange Commission on Questionable and Illegal Corporate Payments and Practices (Comm. Print 1976). Generally, a company participating in this program was encouraged to investigate carefully the facts under the auspices of persons not involved in the questionable conduct and to discuss the question of appropriate disclosure of the matters uncovered with the Commission's staff prior to filing any documents with the Commission. \textit{Ibid.} at 6-13. As stated by the Commission in its Report, "Although participation in the voluntary program does not insulate a company from Commission enforcement action, it does diminish the possibility that the Commission will, in its discretion, institute an action." \textit{Ibid.} at 8 n.7.
\end{footnotes}
tail” accurately and fairly reflect the issuer’s transactions and dispositions of assets, and (2) devise and maintain systems of internal accounting controls sufficient to provide “reasonable assurances” that transactions are executed in accordance with management’s authorization and recorded in conformity with generally accepted accounting principles, and that access to and accountability for assets are adequately controlled. While primarily reflecting investor protection and disclosure concerns, these accounting requirements have a direct substantive impact on day-to-day corporate management.224

A fairly recent study by the General Accounting Office showed that the FCPA’s accounting provisions have forced publicly-held companies to reevaluate and, in many cases, to improve their systems of internal accountability.225 The business community has concurrently expressed serious concerns about the law, particularly the vagueness of certain requirements, and the attendant costs of compliance.226 During the last Congress, the Senate passed a bill that attempted to provide greater clarity to the Act.227 The House of


225 Impact of Foreign Corrupt Practices Act on U.S. Business, GENERAL ACCOUNTING OFFICE, REPORT TO THE CONGRESS (March 4, 1981). The GAO did state, however, that the Commission should provide further guidance with respect to the concept of “reasonableness” contained in the FCPA’s accounting provisions. In this respect, the GAO suggested that the “SEC must elicit the views and work closely with the corporate community and the accounting profession, in determining what additional guidance is needed and the format of the guidance.” Id. at 25.


227 S. 708, 97th Cong., 1st Sess. (1981). Generally, the Senate-passed bill would have, inter alia, eliminated criminal liability premised on a violation of the Act’s accounting provisions; provided issuers, under the accounting provisions, with an affirmative “good faith” defense; adopted a mental state for individual liability under the accounting provisions similar to a scienter standard; adopted a definition of materiality to specify that the threshold standard for accuracy of corporate books and records and internal controls is that which a “prudent
Representatives, however, declined to act.\textsuperscript{228}

The Commission's position in response to these developments has remained basically the same during both the Williams and Shad Chairmanships. For example, during the Williams era, the Commission issued a release designed to reassure the business community that minor or unintentional errors would not be the subject of enforcement action and that substantial deference would be accorded to reasonable business judgments by management as to what constitutes an appropriate accountability system for a given enterprise.\textsuperscript{229} Chairman Shad expressed views consistent with the above policy statement when he testified before Congress in regard to the proposed legislation on the FCPA. He recommended certain modifications to clarify ambiguities in the Act while preserving the FCPA's vitality.\textsuperscript{230} Several of the Chairman's suggestions were incorporated in the Senate-passed bill.\textsuperscript{231} Although it is premature to state with...
any certainty the ultimate result of these developments, the FCPA clearly remains an important illustration of how Commission efforts to promote effective corporate disclosure can have a direct impact on corporate internal affairs.

VII. SEC as Amicus Curiae

The Commission not infrequently participates as *amicus curiae* in litigation between private parties under the federal securities laws, particularly in the federal appellate courts, in order to express its views with respect to the interpretation of the applicable provisions. Sometimes the issue at bar may affect corporate internal processes. *Burks v. Lasker* presents one such example.

The issue in *Burks* was whether a quorum of four statutorily disinterested directors within the meaning of the Investment Company Act could terminate a nonfrivolous shareholders' derivative action against fellow directors on the basis that, in the exercise of their good faith business judgment, the continuation of the litigation was not in the company's best interests. The district court, relying on the business judgment rule, held that such termination was proper. The Second Circuit reversed, holding that “disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties.”

Participating as *amicus curiae* before the Supreme Court, the Commission disagreed with the Second Circuit's position, reasoning that the court's approach neglected the vital statutory role served by disinterested directors as “watch-dogs” under the Investment Company Act. In order to preserve this function, yet ensure that the disinterested directors act in the best interests of the shareholders, the Commission asserted that the traditional business judgment rule should be applied within a framework of certain safeguards. Specifically, the Commission urged that a determination by disinterested directors to terminate a nonfrivolous derivative suit should be given

234 Id. at 473-74.
236 567 F.2d 1208, 1212 (2d Cir. 1978).
effect only where the court finds that the directors were independent, fully informed, and had acted reasonably.238

In its decision, the Supreme Court referred to the primary role of disinterested directors under the Investment Company Act to protect the interests of shareholders. The Court stated that "[t]here may well be situations in which the independent directors could reasonably believe that the best interests of the shareholders call for a decision not to sue."239 Rather than directly answering the inquiry before it, the Court promulgated a two-stage test upon which lower courts have elaborated:240 (1) whether the applicable state law allows the disinterested directors to terminate a shareholders’ derivative suit, and (2) whether such a state rule is consistent with the policies underlying the federal securities laws.241

After Burks, the Commission during both the Williams and Shad Chairmanships has continued to appear as amicus curiae. For example, in Maldonado v. Flynn242 and Abramowitz v. Posner,243 the Commission argued that, in view of the important function served by private enforcement of the federal antifraud and proxy provisions, derivative actions against a corporation’s directors for violation of these provisions “may be terminated by the board of directors only if the board’s decision is an independent, fully informed, and reasonable

238 Id. at 7.
239 441 U.S. at 485.
241 441 U.S. at 480, 486.
business judgment." Regardless of whether this standard will ultimately prevail in the courts, the Commission's participation in these cases indicates that the positions advanced through *amicus curiae* participation at times will continue to have a substantial impact on corporate internal affairs.245

VIII. Advisers to Corporate Management—Lawyers and Accountants

The Commission does not take action against lawyers or accountants because it wishes to influence the internal affairs of their corporate clients. Nor, contrary to some unkind suggestions from members of these learned professions, does it do so for the sheer joy of the hunt. The Commission's concern with these professional groups stems from the important role they, together with professionals in the securities business itself, play in securities transactions. Indeed, it can be most difficult for an issuer of securities to raise money from the public without the assistance of a securities broker or dealer, an opinion from counsel, and a certificate from an auditor. These persons possess the "passkeys" to the securities markets.246


The decision to terminate derivative suits against their fellow directors is peculiarly one which is fraught with conflicting interests. There is a substantial risk that directors may harbor a subconscious if not conscious bias in favor of their colleagues. . . .

Abramowitz Brief at 17. See Maldonado Brief at 14-15. The Second Circuit in both Maldonado and Abramowitz disagreed with the Commission's position, holding that Delaware law is consistent with the policies underlying §§ 10(b) and 14(a). See [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,458, at 92,692; [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,457, at 92,687. See also Brief for the SEC as Amicus Curiae at 12, Grossman v. Johnson, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,457 (1st Cir. 1982) (Although the First Circuit did not resolve the issue, the Commission argued that "[t]he congressional purpose in enacting Section 36(b) of the Investment Company Act, giving investment company shareholders an express right of action to recover on behalf of the investment company excessive advisory fees received by an investment adviser, precludes termination of such actions pursuant to the business judgment decision of the investment company's board of directors.").

245 See, e.g., Brief for the SEC as Amicus Curiae, General Steel Indus., Inc. v. Walco Corp., No. 81-2345 (8th Cir.) (equitable relief such as rescission and divestiture may be granted, pursuant to the court's discretion, to remedy violations of § 13(d) of the Exchange Act).

246 See Shipman, *The Need for SEC Rules to Govern the Duties and Civil Liabilities of Attorneys Under the Federal Securities Statutes*, 34 Ohio St. L. J. 231 (1973); see also notes 216-17 supra and accompanying text.
In light of the essential functions performed by lawyers and accountants, it is scarcely surprising that when things go wrong and the Commission investigates the conduct of the promoters, officers, directors, and other direct participants, the actions of the broker, the lawyer, and the accountant sometimes also come into question. Just as the process by which corporations account to their investors constituted a legitimate subject of inquiry under the Corporate Accountability Staff Study and of regulation under the Foreign Corrupt Practices Act, the relationship of the corporation to its legal and accounting advisers transcends particular cases and also warrants systemic study and comment.

A. Attorneys

Commission actions regarding the lawyer's relationship to the corporate client's internal processes are most often, though not always, products of SEC enforcement or disciplinary proceed-

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247 Two such prior examples were the Commission's and Staff's response to the "Georgetown Petition" and the Discussion Draft of the Model Rules of Professional Conduct. The Institute for Public Representation affiliated with Georgetown University Law Center in Washington, D.C., submitted the Georgetown Petition pursuant to the Administrative Procedure Act, 5 U.S.C. § 553(e) (1976). The petition contained a request that the Commission engage in rulemaking and adopt three proposed rules. The rules would have amended the Commission's disclosure forms to require corporations to disclose (i) that the board of directors has instructed all attorneys employed or retained by the corporation to report to the board certain corporate activities discovered by the attorney that, in the attorney's opinion, violate or probably violate the law; (ii) written agreements between corporations and outside counsel that specify, among other things, the frequency and nature of counsel's contacts with the board of directors; and (iii) the circumstances of resignations or dismissals of general counsel or securities attorneys of the corporations. SEC Sec. Exch. Act. Release No. 16,045 (July 25, 1979), [1979 Transfer Binder] FED. SEC. L. REP. (CCH) 82,144, 17 SEC Docket 1376. On July 25, 1979, the Commission put out the request for public comment, without taking any position on the merits of the proposal. Id. The Commission received over 300 public comments regarding this proposal. On April 30, 1980, the Commission determined to deny the petition. SEC Sec. Exch. Act Release No. 16,769, 19 SEC Docket 1300 (April 30, 1980).

In its release denying the petition, the Commission noted that one of the several reasons for denial urged by commentators was that the private sector was addressing many of the questions concerning "the nature of the obligations of attorneys to make appropriate disclosure of corporate illegularities they discover." 19 SEC Docket at 1301. Thus, the Commission expressed the views that "it would be inappropriate, at this time, to consider further the rules proposed by the Institute" in light of the concerns expressed by the commentators, "particularly with respect to . . . the initiative in this area being taken by the legal profession . . . ." Id. at 1302. The Commission, however, stated that it would continue to monitor developments in this area. Id. at 1303.

The Commission's reference to the "initiative in this area being taken by the legal profession" was directed at the ongoing work of the Commission on Evaluation of Professional Standards of the American Bar Association ("Standards Commission"). On January 30, 1980, after more than two years of work, that group circulated for public discussion the discussion draft of the "Model Rules of Professional Conduct," which comprehensively reformu-
ings.\textsuperscript{249} In these actions, the Commission has commented on the role that attorneys play in the disclosure process and, at times, has ordered law firms' internal procedures to be restructured. For example, in \textit{In re Emanuel Fields},\textsuperscript{250} the Commission asserted that securities lawyers occupy a strategic position in the investment process and that the SEC, with its limited resources, "is peculiarly dependent on the probity and diligence of the professionals who practice before it."\textsuperscript{251} The Commission has ordered that law firms' inadequate internal procedures be revised, and has made clear that "[a] law firm has

\textsuperscript{249}\textsuperscript{251} Noted the ABA Model Code of Professional Responsibility for lawyers. Subsequently, the Standards Commission in May, 1981 issued its "Proposed Final Draft."

On October 30, 1980, the Commission staff filed, in the name of the General Counsel, extensive comments on the Draft Model Rules. Included were detailed staff views of the circumstances under which the lawyer representing a corporation may or should go over the head of the corporate official with whom he is dealing and refer the matter to higher authority, up to and including the board of directors. The staff also proffered recommendations on the related question of when it would be appropriate for the lawyer to give unsolicited advice to his corporate client. The staff comments also included discussion of situations that may arise when the board fails to act in the best interests of the shareholders of the corporation, such as where directors have conflicts of interests. Under these circumstances, according to the comments, counsel's responsibilities may run directly to the shareholders. Finally, although the staff stated that its comments were limited to professional responsibility questions and were not addressed to legal liability issues, it recognized the tension which often exists between the disclosure requirements inherent in the relationship between the corporation and its lawyer. Comments of the General Counsel at 48-75. Contrast these views with those of the subsequent SEC General Counsel. \textit{See} Edward F. Greene, Remarks to the New York County Lawyers' Association (Jan. 13, 1982), 14 SEC. REG. & L. REP. (BNA) 168 (Jan. 20, 1982). \textit{See} note 266 infra.

It was noted in the staff document that the comments were not submitted to or reviewed by the Commission, formally or informally, and that the Commission, as a matter of policy, disclaimed responsibility for the private publication of its employees. The staff chose not to submit the comments to the Commission because they focused in part upon proposed rules concerning issues arguably present in the \textit{Carter-Johnson} rule 2(e) administrative disciplinary proceeding, which was then pending \textit{sub judice} before the Commission. The staff wished to avoid even injecting the question of a possible \textit{ex parte} contact or similar collateral issue in the proceeding. \textit{Id.}


\textsuperscript{251} \textit{[1973 Transfer Binder] Fed. SEC. L. REP. (CCH) \textsuperscript{79,407}, at 83,174-75 n.20. The Commission also stated that the securities lawyer "works in his office where he prepares pro-
a duty to make sure that disclosure documents filed with the Commission include all material facts about a client of which it has knowledge as a result of its legal representation of that client.\textsuperscript{252}

Undoubtedly, the most significant administrative disciplinary proceeding recently brought pursuant to rule 2(e) of the SEC's Rules of Practice\textsuperscript{253} is that of \textit{In the Matter of Carter and Johnson}.\textsuperscript{254} In Carter-Johnson, the Commission's Office of General Counsel had argued that where management has repeatedly rejected a lawyer's advice and persists in exposing the corporation to substantial risk of legal liability, the lawyer may have an obligation to go up the hierarchal structure within the corporation to the board of directors in order to prevent what the lawyer believes to be present or future violations of the law. The General Counsel argued that this duty to go to the board may be necessary in order to fulfill the lawyer's obligation adequately to advise the corporate client.\textsuperscript{255}

In February 1981, the Williams Commission handed down its opinion in the \textit{Carter-Johnson} case.\textsuperscript{256} It reversed the decision of the administrative law judge, who had found that Carter and Johnson, lawyers who were experienced in corporate and securities matters, had violated the federal securities laws and had engaged in improper

\begin{itemize}
\item spectuses, proxy statements, opinions of counsel, and other documents that we, our staff, the financial community, and the investing public must take on faith." \textit{Id.}
\end{itemize}


\textsuperscript{253} Rule 2(e), 17 C.F.R. § 201.2(e) (1982), provides that the Commission may temporarily suspend or permanently bar from practice before it any person found (1) to lack the requisite qualifications to represent others, (2) to lack character or integrity or to have engaged in improper or unethical professional conduct, or (3) to have willfully violated or aided and abetted a violation of any provision of the federal securities laws or a rule or regulation thereunder. An original proceeding pursuant to rule 2(e), such as the Carter-Johnson proceeding, is conducted as an administrative proceeding before a federal administrative law judge with a right to administrative review by the Commission and judicial review by a United States Court of Appeals. Some orders imposing restrictions on practice, however, are entered as a result of an injunction or felony conviction, or by consent in settlement of outstanding charges. These cases are disposed of summarily.


professional conduct.\textsuperscript{257}

The Commission dismissed the proceeding against the two lawyers. While asserting once again its jurisdiction to conduct these kinds of proceedings,\textsuperscript{258} the Commission found that the lawyers were neither direct violators nor aiders and abettors of their client's violations.\textsuperscript{259} Moreover, the Commission found that the attorneys had not violated standards of professional responsibility because it could not conclude that the attorneys' conduct transgressed standards that were generally accepted at the time.\textsuperscript{260} The Commission did, however, discuss the general standards of professional conduct that should guide lawyers in the future:

\begin{quote}
[A] lawyer must, in order to discharge his professional responsibilities, make all efforts within reason to persuade his client to avoid or terminate proposed illegal action. Such efforts could include, where appropriate, notification to the board of directors of a corporate client.\textsuperscript{261}
\end{quote}

The Commission emphasized that the articulation of principles of professional conduct that are applicable to the special role of the securities lawyer giving disclosure advice to a corporate client was not a simple task. It pointed out that the lawyer is only an adviser and that the client must make the final decision. The Commission

\textsuperscript{257} [1979 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) ¶82,175 (March 7, 1979).

\textsuperscript{258} [1981 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) ¶82,847, at 84,146-50. \textit{See} \textit{Touche Ross & Co. v. SEC}, 609 F.2d 570 (2d Cir. 1979), where the Second Circuit concluded:

\begin{quote}
To summarize: we reject appellant's assertion that the Commission acted without authority in promulgating Rule 2(e). Although there is no express statutory provision authorizing the Commission to discipline professionals appearing before it, Rule 2(e), promulgated pursuant to its statutory rulemaking authority, represents an attempt by the Commission to protect the integrity of its own processes. It provides the Commission with the means to ensure that those professionals, on whom the Commission relies heavily in the performance of its statutory duties, perform their tasks diligently and with a reasonable degree of competence. As such the Rule is "reasonably related" to the purposes of the securities laws. Moreover, we hold that the Rule does not violate, nor is it inconsistent with, any other provision of the securities laws. We therefore sustain the validity of the Rule as a necessary element adjunct to the Commission's power to protect the integrity of its administrative procedures and the public in general.
\end{quote}


\textsuperscript{259} [1981 Transfer Binder] \textit{FED. SEC. L. REP.} (CCH) ¶82,847, at 84,167-69.

\textsuperscript{260} \textit{Id.} at 84,169-70.

\textsuperscript{261} \textit{Id.} at 84,170.
acknowledged that disclosure issues often present difficult choices between multiple shades of gray, and stated that the client’s pressure on its lawyer for the minimum disclosure required by law is, by itself, not an appropriate basis for finding that a lawyer must resign or take some extraordinary action. The opinion emphasized that the SEC would not seek to hold lawyers responsible for the good faith exercise of professional judgment even if, in view of hindsight, the advice turned out to be wrong. The Commission was concerned that stiffer requirements might drive a wedge between reporting companies and their outside lawyers and that, under certain circumstances, management would soon realize that there was nothing to be gained from consulting such lawyers.262 The Commission stated:

The Commission is of the view that the lawyer engages in “unethical or improper professional conduct” under the following circumstances: When a lawyer with significant responsibilities in the effectuation of a company’s compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps [“that lead to the conclusion that the lawyer is engaged in efforts to correct the underlying problem, rather than having capitulated to the desire of a strong-willed, but misguided client”] to end the client’s non-compliance. . . . Initially, counseling accurate disclosure is sufficient, even if [the lawyer’s] advice is not accepted. But there comes a point at which a reasonable lawyer must conclude that his advice is not being followed, or even sought in good faith, and that his client is involved in the continuing course of violating the securities laws. At this critical juncture, the lawyer must take further, more affirmative steps in order to avoid the inference that he has been co-opted, willingly or unwillingly, into the scheme of nondisclosure. . . . So long as a lawyer is acting in good faith in exerting reasonable efforts to prevent violations of the law by his client, his professional obligations have been met.263

The Commission also remarked that it intended to solicit public comment in regard to the standard adopted.264 Although the Commission subsequently solicited public comment,265 it appears questionable whether the SEC will issue a release in response to the

262 Id. at 84,169-72.
263 Id. at 84,172-73. The case did not decide whether the lawyer had a duty to make public disclosure of the corporate client’s confidences and secrets.
264 Id. at 84,170.
comments received. Such a release, if issued, could well portend the extent to which the present Commission intends to follow or depart from the principles of *Carter-Johnson.*

B. Accountants

In the past several years, public and congressional concerns have been voiced regarding the extent to which the accounting profession has fulfilled its responsibility to promote public confidence in the integrity and credibility of financial reporting by publicly-owned companies. During the Williams Chairmanship, the Commission responded both by intensifying its oversight of the accounting profession and by encouraging initiatives by the profession designed to increase public confidence (1) in the independence of accountants, (2) in the process by which accounting and auditing standards are established, and (3) in the profession's ability and resolve to develop and maintain a viable system of self-regulation. The Commission's increased oversight resulted in significant and accelerated changes in the corporate structure for dealing with outside accountants and focused corporate attention on significant aspects of the company's re-

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266 See Greene, *supra* note 247, where a former SEC General Counsel presented his personal views on lawyer disciplinary proceedings before the Commission, stating:

> My initial tentative view is that as a general matter the Commission should ordinarily only institute Rule 2(e) proceedings if the misconduct alleged is (i) a violation of established state law ethical or professional misconduct rules and (ii) has a direct impact on the Commission's internal processes, such as where the lawyer participates directly or indirectly in the preparation of disclosure documents filed with the Commission.

Id. at 168.


The Moss Report recommended, *inter alia,* that the SEC should prescribe by rule: a framework of uniform accounting principles; penalties for falsification of books and records; elimination of procedures that allow corporations to develop off-the-books accounts; verification in the annual report by independent auditors of the quality of internal controls and the quality of the enforcement of those controls; a requirement that a majority of the board of directors must be independent of management; and a requirement that the board's auditing and nominating committees be composed of a majority of independent directors. **Moss Report, supra,** at 51-52.

The Metcalf Report recommended, *inter alia,* that "[t]he Federal Government should restore public confidence in the actual independence of auditors who certify the accuracy of corporate financial statements under the Federal securities laws by promulgating and enforcing strict standards of conduct for such auditors." **Metcalf Report, supra,** at 22.

relationship with its accountants. Many of the Commission’s initiatives were designed to assure the independence of outside accountants and to heighten corporate sensitivity to situations which may compromise such independence. One of the most successful efforts in this area related to the establishment of independent audit committees of the boards of directors of publicly-held companies. The Commission has continued to urge companies to establish such audit committees, both to reinforce and assure the independence of outside auditors by providing a buffer to insulate auditors from inordinate management pressures and to enhance the ability of the board of directors to monitor the issuer’s accounting, financial reporting, and internal control systems.

To date, the response of both individual companies and the stock exchanges to the Commission’s suggestions has obviated the need for the Commission to require publicly-held companies to establish audit committees. While the Commission reported to Congress on July 1, 1978, that “the concept of an independent audit committee... [had] begun to gain acceptance only recently, principally in the large companies,” the Commission’s analysis of 1981 proxy statements indicated that 86.4 percent of all of the companies maintain audit committees and, significantly, that 73.4 percent of the relatively small (under $50 million in assets) over-the-counter companies have audit committees. The proxy statements further indi-

270 This article does not address the several initiatives taken by the profession itself.
271 See note 31 supra and accompanying text; see also notes 274-76 infra and accompanying text.
272 Id.
273 Although the Commission does not require companies to maintain audit committees, registrants must state in their proxy materials whether they maintain an audit committee, and, if so, the composition of the committee in terms of membership, the number of meetings held during the latest fiscal year, and a brief description of the functions of the committee. Rule 14a-101 of the Proxy Rules (item 6(d)(1), 17 CFR § 240.14a-101 (1982)).

Regarding the Commission’s authority to require publicly-held companies to maintain independent audit committees, see the June 10, 1977, and March 2, 1978, memoranda from Harvey L. Pitt, General Counsel of the Securities and Exchange Commission, to Chairman Harold M. Williams, which are reprinted in Securities and Exchange Commission (First) Report to Congress on the Accounting Profession and the Commission’s Oversight Role, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶62,120 (June 28, 1979).
cated that the new audit committees have assumed significant oversight responsibilities, with 70.4 percent engaging and discharging the outside auditors, 67.2 percent reviewing the audit plan, 84.5 percent reviewing the audit results, and 73.9 percent reviewing the adequacy of internal controls.\textsuperscript{276} Clearly, the widespread emergence of audit committees, accelerated by the Commission’s exhortations, has significantly altered the structure of corporate relationships with outside auditors.

The present Commission has significantly retreated, however, with respect to the disclosure of nonaudit services performed by auditors. The Williams Commission focused corporate attention on the potential negative impact on auditor independence when nonaudit services, such as management advisory services, accounting and review services, and tax services, are also performed for the audit client. In 1978, Accounting Series Release No. 250\textsuperscript{277} required registrants to disclose in their proxy statements the nature of nonaudit services performed by their independent auditors and the percentage relationships of the fees incurred for such services to total fees incurred for audit services. This release was followed in 1979 by Accounting Series Release No. 264,\textsuperscript{278} in which the Commission discussed the primary factors that management, the audit committee, and the outside auditor should consider in determining whether the auditor’s independence will be compromised by providing management advisory services (“MAS”) to an audit client. These factors included the relationship between revenues generated from MAS and from audit services, whether the MAS engagement improperly encompassed managerial and decisionmaking functions that were the client’s responsibility, whether the services provided could ultimately result in auditor self-review, and whether audit quality might benefit from the performance of MAS which increased the auditor’s understanding of the client’s business. Viewing these Commission pronouncements as significant barriers to providing MAS, the accounting profession’s response was highly negative.\textsuperscript{279} Nonetheless, former Chairman Williams in a January 1980 address to the accounting profession stated that he was “somewhat disappointed at the tone and focus of the

\textsuperscript{276} 24 SEC Docket at 1235.
\textsuperscript{277} [Accounting Series Transfer Binder] FED. SEC. L. REP. (CCH) ¶72,272 (June 29, 1978).
\textsuperscript{278} [Accounting Series Transfer Binder] FED. SEC. L. REP. (CCH) ¶72,286 (June 14, 1979).
profession's response" and stressed that "there is significant public interest and concern surrounding this issue." 280

Only two years after the adoption of ASR 264 and less than five years after the Metcalf Report recommended that "[d]irect and indirect representation of clients' interests and performance of non-accounting management advisory services for public or private clients are two activities which are particularly incompatible with the responsibilities of independent auditors, and should be prohibited by Federal standards of conduct," 281 the Commission rescinded ASR's 250 and 264. 282 In so doing, the Commission stated:

Notwithstanding this action, the Commission believes it should continue to monitor the nonaudit service activity by accountants as a part of its oversight of the accounting profession. Other people may also want to monitor this activity. The Commission is satisfied with the information that will be available because of recent revision of the membership requirements of the SEC Practice Section of the Division for Firms of the American Institute of Certified Public Accountants. 283

Thus, the Commission relied in part upon the promulgation of self-regulatory standards which, although not as extensive as the SEC pronouncements, 284 require member accounting firms in lieu of registrants to disclose information about nonaudit management advisory services.

IX. Conclusion

The Commission's role in influencing how corporations should be governed and how management should account to shareholders has been multi-varied, controversial, and, at times, quite effective. Two variables, both of which are significantly changing, affect the ongoing process of influencing corporate internal affairs; one is the membership of the Commission and certain of its senior staff, and the other is the larger context of American political and corporate life.

280 Williams, supra note 269, at 14.
281 METCALF REPORT, supra note 267, at 22.
282 Accounting Series Release No. 304, 24 SEC Docket 938, 6 FED. SEC. L. REP. (CCH) ¶72,326 (Jan. 28, 1982). The Commission rescinded the rule also because it believed that the disclosure requirement was "not generally of sufficient utility to investors to justify continuation of [this] requirement." Id. at 62,985.
283 Id. at 62,986.
284 See Wall St. J., supra note 279 (stating that the AICPA's rule does not require as extensive disclosure as the SEC's pronouncements did, because, "[a]mong other things, the institute's rule requires auditors rather than companies, to disclose their nonaudit services, and doesn't require them to name the companies for which they provide the services.")
Although it is difficult to predict with certainty the future of the ongoing process, it is probable that, with the possible exception of the American Law Institute's Tentative Draft Restatement on Corporate Governance, the Staff's Corporate Accountability Report represents the highwater mark. Nonetheless, irrespective of the present Commission's interest in promoting corporate accountability, the very nature of the SEC's processes signifies that SEC programs and policies will continue to significantly affect corporate internal affairs.

285 Principles of Corporate Governance and Structure: Restatement and Recommendations (Tent. Draft No. 1, 1982). See also American Law Institute Begins Debate on Corporate Governance Project, 14 SEC. REG. & L. REP. (BNA) 1025 (June 4, 1982) (discussing provisions of and debate regarding the reporters' tentative draft).