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THE OBSCOLESCENCE OF WALL STREET: A CONTEXTUAL APPROACH TO THE EVOLVING STRUCTURE OF FEDERAL SECURITIES REGULATION

Joel Seligman*

This article is dedicated to Professor Al Conard, a wonderful colleague, who after many years as an active emeritus member of the University of Michigan Law School has recently retired to a new home away from Ann Arbor. Many of us miss him daily, and I offer this article in the spirit of a Festschrift contribution in his honor.

At its core, the primary policy of the federal securities laws¹ involves the remediation of information asymmetries. This is most obviously true with respect to the mandatory disclosure system, which compels business corporations and other securities issuers to disseminate detailed, generally issuer-specific information when selling new securities to the public and requires specified issuers² to file annual and other periodic reports containing the same or simi-

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1. There are seven federal securities laws: The Securities Act of 1933, 15 U.S.C. § 77a (1988); the Securities Exchange Act of 1934, 15 U.S.C. § 78a (1988); the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 (1988); the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa (1988); the Investment Company Act of 1940, 15 U.S.C. § 80a-1 (1988); the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 (1988); and the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa (1988). For general descriptions, see 1 LOUIS LOSS & JOEL SELIGMAN, *SECURITIES REGULATION* 226-70 (1989). This article addresses the Securities Act and the Securities Exchange Act, which are the two federal securities statutes of greatest enduring significance.

2. The Securities Exchange Act requires annual, quarterly, and, on occasion, monthly reports to be filed by firms that satisfy specified criteria. Most notably, these firms must have (i) a security registered on a national securities exchange, *see* § 12(a), 15 U.S.C. § 78l(a) (1988); (ii) total assets of \$5 million or more *and* a class of equity security held of record by 500 or more security holders when its securities are not traded on a national securities exchange and are traded in the alternative over-the-counter market, *see* § 12(g)(1), 15 U.S.C. § 78l(g)(1) (1988); Rule 12g-1, 17 C.F.R. § 240.12g-1 (1994); or (iii) a security registered under the Securities Act, unless and until the security is held by fewer than 300 persons, *see* § 15(d), 15 U.S.C. § 78o(d) (1988). Regarding the categories of issuers required to file mandatory annual and periodic reports under the Securities Exchange Act, *see* generally 4 LOSS & SELIGMAN, *supra* note 1, at 1733-1916.

There are currently about 13,400 issuers that file annual and periodic reports under the Securities Exchange Act. *See Private Litigation under the Federal Securities Laws: Hearings Before the Subcomm. on Sec. of the Senate Comm. on Banking, Hous., and Urban Affairs*, 103d Cong., 1st Sess. 341 (1993) (statement of A.A. Sommer, Jr.).

lar information.³ This system was, in essence, a response to the failure of business and foreign government issuers sufficiently to disclose information material to investment decisions in the period preceding the enactment of the Securities Act of 1933 (Securities Act)⁴ and the Securities Exchange Act of 1934 (Exchange Act).⁵

The remediation of information asymmetries is also a primary policy objective of the Securities and Exchange Commission's regulation of broker-dealers.⁶ The Securities and Exchange Commission (SEC) uses a variety of reporting,⁷ record keeping,⁸ minimum net capital,⁹ and inspection¹⁰ techniques to deter broker-dealers from charging securities customers excessive commissions or "markups" in individual transactions¹¹ and to protect customers from entrusting their securities or monies to broker-dealers on the verge of insolvency.¹²

While the theory and techniques of federal securities regulation are relatively straightforward, the scope of the mandatory disclosure system and broker-dealer regimens has been fluid over time.

3. The textual content of the mandatory disclosure system is specified in Regulation S-K, 17 C.F.R. § 229 (1994). The SEC's accounting requirements are detailed in Regulation S-X, 17 C.F.R. § 210 (1994). Regarding both, see generally 2 LOSS & SELIGMAN, *supra* note 1, at 620-743.

4. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. § 77 (1988)).

5. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. § 78 (1988)); see Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983); see also 1 LOSS & SELIGMAN, *supra* note 1, at 171-229.

6. Section 15(a)(1) of the Exchange Act requires registration with the SEC of broker-dealers that "effect any transactions in, or . . . induce or attempt to induce the purchase or sale of, any security," other than specified exempted securities. § 15(a)(1), 15 U.S.C. § 78o(a)(1) (1988). Regarding the registration requirement, see 6 LOSS & SELIGMAN, *supra* note 1, at 2965-76. A registered broker-dealer must also be a member of a self-regulatory organization. This usually means the National Association of Securities Dealers (NASD) or a securities exchange. See 6 *id.* at 2815-16.

7. Broker-dealers are required both to report periodically about the finances of their firm, see 7 LOSS & SELIGMAN, *supra* note 1, at 3117-28 (describing Rule 17a-5, 17 C.F.R. § 240.17a-5 (1994), and Form X-17A-5), and to provide confirmation statements and other reports to securities customers, see 8 *id.* at 3803-16 (discussing Rule 10b-10, 17 C.F.R. § 240.10b-10 (1994)).

8. See 7 *id.* at 3107-16.

9. See 7 *id.* at 3128-57.

10. See 7 *id.* at 3190-98.

11. Cf. *Charles Hughes & Co. v. SEC*, 139 F.2d 434, 437 (2d Cir. 1943) ("The essential objective of securities legislation is to protect those who do not know market conditions from the overreachings of those who do."), *cert. denied*, 321 U.S. 786 (1944).

12. There are other regulations also applicable to broker-dealers, such as the securities customer insurance scheme established in 1970 by the Securities Investor Protection Act, 15 U.S.C. § 78aaa-78lll (1988), see 7 LOSS & SELIGMAN, *supra* note 1, at 3306-28, and the prohibitions of fixed brokerage commission rates, see 6 *id.* at 2831-97.

Exemptions for intrastate¹³ and private — rather than public — initial sales,¹⁴ municipal¹⁵ and federal government securities,¹⁶ as well as unanticipated new financial products¹⁷ have limited or expanded the scope of federal securities regulation with increased celerity in recent years.

The immediate future of federal securities regulation is likely to be devoted in considerable part to the resolution of boundary questions. The reasons for this are less matters of statutory construction than they are matters of politics and context. In terms of information asymmetries, there is often little practical difference between financial instruments subject to the federal securities laws and those that are exempt. In many instances, the exemptions to securities laws were adopted because of the success of political lobbies such as those that championed state securities regulation or municipal issuers.¹⁸ Yet, once adopted, laws do not endure eternally because of inertia. As the factual context against which Congress and the SEC have acted changes, an ongoing process of law revision continuously occurs.

This article begins in Part I by describing the dynamic elements in federal securities regulation. These include (i) changes in the investor community, (ii) internationalization of issuers and investors, (iii) computer technology, and (iv) the maturing of financial economics.

Part II illustrates how these dynamics will continue to change the boundaries of federal securities regulation in three illustrative

13. See Securities Act § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1988); 3 LOSS & SELIGMAN, *supra* note 1, at 1274-1307; see also Exchange Act § 15(a)(1), 15 U.S.C. § 78o(a)(1) (1988); 6 LOSS & SELIGMAN, *supra* note 1, at 3009-12. See generally *infra* text accompanying notes 112-44 (discussing state securities regulation).

14. Securities Act § 4(2), 15 U.S.C. § 77d(2) (1988); 3 LOSS & SELIGMAN, *supra* note 1, at 1350-450.

15. Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1988); Exchange Act §§ 3(a)(12), 15B, 15 U.S.C. §§ 78c(a)(12), 78o-4 (1988); see also 3 LOSS & SELIGMAN, *supra* note 1, at 1159-73; 4 *id.* at 1782-89; 6 *id.* at 3086-95. See generally *infra* text accompanying notes 198-215 (discussing municipal securities).

16. Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1988); Exchange Act § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1988); Exchange Act § 15C, 15 U.S.C. § 78o-5 (1988); see also 3 LOSS & SELIGMAN, *supra* note 1, at 1158-59; 4 *id.* at 1782-86; 6 *id.* at 3095-103.

17. Examples of this phenomenon include variable annuities, which are considered to be securities despite the exemption for insurance products in Securities Act § 3(a)(8), 15 U.S.C. § 77c(a)(8) (1988), see 2 LOSS & SELIGMAN, *supra* note 1, at 1000-20, and employee benefit plans, many of which are not securities, see 2 *id.* at 1031-50. More recently, over-the-counter (OTC) derivatives have emerged as a major concern. See *infra* text accompanying notes 100-111.

18. See JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 65, 187-88 (1982).

areas: (i) state securities regulation, or so-called blue sky laws; (ii) the scope of the Securities Act of 1933; and (iii) municipal securities regulation. Each of these topics illustrates a different type of boundary problem. First, state securities regulation was intended to be concurrent with federal securities law. But its initial *raison d'être* — regulating the merits of new securities offerings — has increasingly been called into question because of the growing significance of international securities trading. Second, the scope of the Securities Act of 1933 has recently been effectively narrowed because of congressional and SEC initiatives in response to competitive international securities markets and the growth of institutional investors. Here, however, matters are more complicated than they may seem at first.¹⁹ In part, what may appear to be a significant reduction of a mandatory disclosure regime may involve instead a substitution of ongoing obligations, implied by financial economics theory. Finally, the logic of the exemption for new securities issuances by municipalities has dissipated over time, at least for certain categories of municipal securities as they have come more closely to resemble corporate issuances.²⁰

When these boundary questions are viewed jointly, three basic themes emerge:

First, the remediation of information asymmetries endures as a policy justification for important aspects of federal securities regulation. But the need for a *mandatory* disclosure system varies significantly from context to context and is not static over time.

Second, there are coordination and “level playing field” advantages to subjecting like firms and financial products to a single regulator. But the probability of this logical outcome occurring is highly dependent on political factors.

Third, the single factor most likely to change fundamentally the scope of securities regulation in the foreseeable future is internationalization. Increasingly, U.S. securities markets are being inte-

19. In a recent article in the *Duke Law Journal*, Second Circuit Judge and former Yale law professor Ralph K. Winter expressed the view that the federal securities laws registration and periodic disclosure provisions “will die of their own accord because they are inefficient enough that they deter foreign companies from choosing to register their stock in this country.” Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 *DUKE L.J.* 945, 947 n.7 (1993). This, as I elaborate *infra* at text accompanying notes 146-97, appears, at most, to be only partially correct.

20. Similarly, in 1993, Congress requested a study of whether regulation of government securities dealers should continue to be subject to joint SEC-Treasury oversight or, like SEC broker-dealer regulation, should solely involve the SEC as the federal government’s regulator. Government Securities Act Amendments of 1993, Pub. L. No. 103-202, § 112, 107 Stat. 2344, 2354 (1993).

grated into world trading markets. This may portend the evolution of a new type of federalism in which national securities regulation is "local" and international regulation is the equivalent to national regulation today. But this outcome seems unlikely to occur for a considerable period of time. The vast preponderance of U.S. securities are unlikely to be of much interest to international investors. More importantly, significant differences between the U.S. investor community and those abroad would make it highly difficult to integrate regulatory regimes without considerable sacrifice of the primary techniques for protecting noninstitutional investors in the United States.

As a matter of analytical style, this article illustrates a contextualist approach. For a considerable period of time, the dominant analytical style in corporate and securities law has been a variant of economic, or law and economics, analysis. The virtue of this type of analysis is that it focuses on what its authors deem to be crucial variables and reaches conclusions derived from the core of a specific legal problem. The defect of this type of analysis is that so much is assumed or often assumed away.

In contrast, the contextualist approach attempts a more ambitious description of the legal — meaning statutory, rule, and agency interpretation — historical, and empirical framework of specific problems. The defect of this type of approach is that when a problem is accurately set against its full context, analysis is less likely to reach simple, far-reaching conclusions. This is also the virtue of contextual analysis. To put matters directly, the world of corporate and securities law is often a more complicated, more slowly evolving one than the law and economics theorists would have us believe. While there is great value in economic analysis in this and many other fields, this value is best appreciated against a broader historical and empirical framework than some of its votaries have provided.

I. THE OBSOLESCENCE OF WALL STREET

Formally, many aspects of securities trading before the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 are familiar. To define *security* in terms such as "any note, stock, treasury stock, bond, debenture."²¹ is to employ a contemporary vocabulary. Similarly, the mechanisms of securities trading —

21. Securities Act § 2(1), 15 U.S.C. § 77b(1) (1988); Exchange Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1988).

the underwriter,²² broker,²³ dealer,²⁴ or securities exchange²⁵ — are denoted in these sixty-year-old laws in terms that, while sometimes vague, are easily parsed by today's readers.

But the factual context in which securities trading occurred before the New Deal's enactment of the federal securities laws is much less familiar. It was a simpler world. In 1930 the United States had a population of approximately 123 million,²⁶ of whom approximately 1.5 million — or 1.2% — had securities accounts.²⁷ Institutional investment was in its infancy. In the years 1926-1929, investment companies — the best known of which today is the mutual fund — increased their total assets to over \$8 billion,²⁸ an amount equal to less than ten percent of the New York Stock Exchange's \$89.7 billion valuation on September 1, 1929.²⁹ Nonetheless, the innovation of buying a portfolio of securities, rather than individual stocks, made the investment trust, in the mellifluous judgment of John Kenneth Galbraith, "the most notable piece of speculative architecture of the late twenties, and the one by which, more than any other device, the public demand for common stocks was satisfied."³⁰ Public demand, it cannot be overemphasized, was limited to just over one percent of the overall population.

The period before the New Deal's adoption of the federal securities laws also witnessed the first significant, and distinctly unsatisfactory, experience of public investment in foreign securities. Between 1923 and 1930, American investors purchased close to \$6.3 billion of foreign bonds.³¹ Then, in rapid order, the collapse of the world economy led to substantial depreciation of over ninety percent of all foreign bonds sold in the United States. By December 1931, the aggregate market price for fourteen Latin-American na-

22. See Securities Act § 2(11), 15 U.S.C. § 77b(11) (1988).

23. See Exchange Act § 3(a)(4), 15 U.S.C. § 78c(a)(4) (1988).

24. See Exchange Act § 3(a)(5), 15 U.S.C. § 78c(a)(5) (1988).

25. See Exchange Act § 3(a)(1), 15 U.S.C. § 78c(a)(1) (1988).

26. WORLD ALMANAC AND BOOK OF FACTS 377 (1995).

27. This figure refers to the number of accounts in 1929. See S. REP. NO. 1455, 73d Cong., 2d Sess. 9 (1934).

28. SELIGMAN, *supra* note 18, at 222.

29. S. REP. NO. 1455, *supra* note 27, at 7.

30. SELIGMAN, *supra* note 18, at 222 (quoting JOHN KENNETH GALBRAITH, THE GREAT CRASH 51 (1955)). The Senate's Stock Exchange Practices Report was less gracious, writing in 1934: "A veritable epidemic of investment trusts afflicted the Nation." S. REP. NO. 1455, *supra* note 27, at 339.

31. S. REP. NO. 1455, *supra* note 27, at 89. This equaled approximately ten percent of new security sales in the United States during those years. 2 BUREAU OF THE CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES: COLONIAL TIMES TO 1970, at 1006 (1975).

tions' bonds was twenty-six percent of their face value. Peruvian bonds were selling at less than seven percent of their par value.³²

Before the 1930s, Wall Street had already experienced technological revolutions. The nineteenth century had witnessed the arrival of the telegraph, the telephone, and the stock quotation ticker, which made it possible for securities broker-dealers outside New York City to be aware of last sale prices on the New York Stock Exchange (NYSE) floor and to place orders on a timely basis.³³ Similarly, before the Securities Exchange Act of 1934 was enacted, securities were often traded in broker-dealer offices in an over-the-counter market "unified only by 'a nationwide web of telephone and telegraph wires.'"³⁴ Nonetheless, to modern eyes, the trading mechanisms of the early 1930s were quite primitive. Stock quotations in the over-the-counter market, for example, were published only once a day in National Quotation Bureau publications, with popular names such as the "pink sheets," which listed buy and sell quotations for each securities dealer in each stock at the close of the *previous* trading day.³⁵ This guaranteed that these quotes were stale on the day that they were used. The pink sheets were, in fact, more a telephone directory than a quotation service. Even the august NYSE did not appear to be much more technologically advanced. To execute a trade, a floor broker had to pick up an order from an off-the-floor trading booth and walk the order to the middle of the floor for execution by a reciprocal floor broker or specialist — a "marketmaker." The floor broker would then scribble down the details of the transaction on an order ticket, exchange tickets with the reciprocal floor broker or specialist, and walk the completed order ticket off the floor.³⁶ Much of this human intermediation was capable of automation.

Underlying stock trading at that time were theories of securities analysis that in retrospect appear similarly simple. The leading published work in the field, Graham and Dodd's *Security Analysis*,³⁷ included the premise:

32. *Sale of Foreign Bonds or Securities in the United States: Hearings Before the Senate Comm. on Fin.*, 72d Cong., 1st Sess. 324-27 (1931) (statement of Hon. Fiorello H. LaGuardia); 75 CONG. REC. 6057 (1932); Henry Grattan Doyle, *Investors' Losses in South America*, 35 CURRENT HIST. 720, 721 (1932).

33. ROBERT SOBEL, *INSIDE WALL STREET* 30-33 (1977).

34. SELIGMAN, *supra* note 18, at 141.

35. 5 LOSS & SELIGMAN, *supra* note 1, at 2579.

36. 5 *id.* at 2508-09.

37. Benjamin Graham & David L. Dodd's *Security Analysis: Principles and Technique* was initially published in 1934. I quote BENJAMIN GRAHAM ET AL., *SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE* (4th ed. 1962).

The most important single factor determining a stock's value is now held to be the *indicated average future earning power*, i.e., the estimated average earnings for a future span of years. Intrinsic value would then be found by first forecasting this earning power and then multiplying that prediction by an appropriate "capitalization factor."³⁸

This type of analysis has long been familiar to students of corporate law as a valuation technique employed in the appraisal or calculation of fair market value for dissenting shareholders in mergers and other fundamental transactions.³⁹ This technique is, as Graham and Dodd candidly acknowledged, "not an exact science,"⁴⁰ involving estimates of both past average earnings power *and* multipliers or capitalization rates. Calculation of a multiplier could be particularly subjective.⁴¹ As one critic was quoted as saying in 1977, "[S]uch a valuation is usually 'a guess compounded by an estimate.'" ⁴² Nonetheless, the Graham and Dodd valuation technique provided intellectual support for the proposition that shrewd investment analysts could outtrade most of the market by careful study of a corporation's financial statements and other relevant records. Graham and Dodd's work also strengthened the hand of those who urged that stock acquisition and sale was an investment process, not a matter of speculation or gambling.⁴³

Financial innovation during this period was also primitive. In the 1934 version of their work, Graham and Dodd essentially examined just four types of securities: bonds, preferred stock, common stock, and stock option warrants.⁴⁴ Warrants had only been

38. GRAHAM ET AL., *supra* note 37, at 28.

39. See Joel Seligman, *Reappraising the Appraisal Remedy*, 52 GEO. WASH. L. REV. 829, 851-54 (1984).

40. GRAHAM ET AL., *supra* note 37, at 24.

41. Delaware courts long selected multipliers in reliance on A.S. Dewing's historical data in his two-volume treatise, A.S. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* (5th ed. 1953). See, e.g., *Levin v. Midland-Ross Corp.*, 194 A.2d 50, 57 (Del. Ch. 1963). By the mid-1960s, Delaware ceased to rely on Dewing. See, e.g., *David J. Greene & Co. v. Dunhill Intl., Inc.*, 249 A.2d 427, 433-34 (Del. Ch. 1968); *Swanton v. State Guar. Corp.*, 215 A.2d 242, 244-46 (Del. Ch. 1965).

42. H.R. REP. NO. 595, 95th Cong., 2d Sess. 222 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6181 (quoting Peter Coogan).

43. In that day, these were crucial distinctions. In 1937, SEC Chairman (later Supreme Court Justice) William O. Douglas stung the NYSE by analogizing exchanges to "private clubs" and noting of the NYSE short sale regulations in particular: "In a market in which there is such an enormous public interest . . . it is essential that no element of the casino be allowed to intrude . . ." SELIGMAN, *supra* note 18, at 163 (quoting WILLIAM O. DOUGLAS, *DEMOCRACY AND FINANCE* 70 (1940)). In part because the NYSE felt vulnerable to such charges, it soon reorganized.

44. GRAHAM ET AL., *supra* note 37, at 620-26.

authorized for Delaware corporations in March 1929.⁴⁵ To a considerable extent, the world of corporate finance before the New Deal was dominated by three types of securities. The Stock Exchange Practices Report of 1934 reported: "As of July 31, 1933, there were listed on [thirty-four organized] exchanges 6,057 common and preferred stock issues with a total market value of \$95,051,876,295; and 3,798 bond issues with a total market value of \$49,080,819,993."⁴⁶

In essence this was Wall Street: a securities trading market for a very small percentage of the population, dominated by natural persons rather than institutional investors, and featuring domestic securities, human trading intermediation, primitive financial economics, and relatively few types of securities.

This simple structure has long been obsolete. To appreciate the extent to which the underlying factual context of federal securities regulation has changed, let me separately treat the most significant contextual elements.

A. *Changes in the Investor Community*

It is now a commonplace understanding that institutional investors — most notably public and private pension plans, mutual funds and other investment companies, bank trust departments, and insurance companies — own slightly over one-half of the United States' equities⁴⁷ and are now responsible for approximately sixty

45. SELIGMAN, *supra* note 18, at 43-44.

46. S. REP. NO. 1455, *supra* note 27, at 5.

47. The increase in institutional investor ownership has been slow but steady during the 60-year period after the enactment of the Securities Exchange Act of 1934.

In 1940, for example, an SEC study made for the Temporary National Economic Committee (TNEC) and covering the period through 1937 found that of the seven million separate holdings of common stock in its list of the SEC's 200 largest nonfinancial corporations, 88% were of 100 shares or less — strongly suggestive of low institutional investment. TEMPORARY NATL. ECONOMIC COMM., MONOGRAPH NO. 29, DISTRIBUTION OF OWNERSHIP IN THE 200 LARGEST NONFINANCIAL CORPORATIONS 30 (1940).

Between 1955 and 1980, the NYSE estimated that holdings of its listed stocks by selected institutional investors — insurance companies, investment companies, noninsured pension funds, foreign institutions, nonprofit institutions, common trust funds, and mutual savings banks — grew from 15% to 35.4%. NEW YORK STOCK EXCH., FACT BOOK 55 (1985).

In November 1988, a study prepared for the Columbia University School of Law Institutional Investor Project, in consultation with the New York Stock Exchange, updated data concerning institutional investment. CAROLYN KAY BRANCATO & PATRICK A. GAUGHAN, COLUMBIA UNIVERSITY SCHOOL OF LAW, THE INSTITUTIONAL INVESTOR PROJECT, THE GROWTH OF INSTITUTIONAL INVESTORS IN U.S. CAPITAL MARKETS (Nov. 1988). The study calculated that as of 1987, five categories of institutional investors held total assets of \$4,644.4 billion, with pension funds holding \$2,018.8 billion (or 43.5% of the total institutional investor assets); investment companies, \$790.4 billion (17%); insurance companies, \$1,011.2 billion (21.8%); bank trusts, \$693.4 billion (14.9%); and foundations and endowments, \$130.6 billion (2.8%). *Id.* at 7. As of 1986, institutional investors had equity holdings of \$1,327.2 billion, or

to eighty percent of public trading on the New York Stock Exchange.⁴⁸ As long ago as 1980, 133 million persons indirectly owned stock through institutional intermediaries.⁴⁹

The implications of this increased rate of institutional trading are profound. Between 1962 and 1993, the *average* size of a trade grew from 204 to 1441 shares, with "block" trading — usually trades of 10,000 shares or more — accounting for 53.7% of reported volume in 1993.⁵⁰

At the same time, the unfixing of stock brokerage commission rates on the NYSE in 1975 significantly furthered an earlier process of reducing the transaction costs of institutional investor equity trades.⁵¹ The Presidential Task Force on Market Mechanisms, popularly known as the Brady Report, estimated that between April 1975, just before the unfixing of commission rates, and 1986, commissions paid by institutions dropped from 26 to 7.5 cents per share.⁵² Lower transaction costs contributed to the stimulation of an enormous surge in reported share volume. Between 1975 and 1993, the annual reported volume on the NYSE increased from

approximately 42.7% of total equities. *Id.* at 13. A later update to the project estimated that by 1990, institutional investors accounted for 53.3% of public and private outstanding equity. COLUMBIA SCHOOL OF LAW, THE INSTITUTIONAL INVESTOR PROJECT, INSTITUTIONAL INVESTORS AND CAPITAL MARKETS: 1991 UPDATE 8 (1991). Institutional equity holdings in the largest 100 corporations as of that date were slightly higher at 54.8%. *Id.* at 16.

Similarly, as of the end of the first quarter in 1992, an official of the Securities Industry Association calculated, on the basis of Federal Reserve Board data, that institutions held 54.2% of the \$4.96 trillion market value of outstanding stock. *Institutions Hold Dominant Stake in Equities Market, Fed Board Data Show*, 25 Sec. Reg. & L. Rep. (BNA) No. 27, at 943 (July 9, 1993).

48. See NEW YORK STOCK EXCH., FACT BOOK 56 (1985).

Data covering the period from May to December of 1985 found that institutional investors accounted for 61.1% of NYSE publicly traded stock, with retail customers accounting for 38.9%. BRANCATO & GAUGHAN, *supra* note 47, at 16. Institutional investor participation rates are lower in other markets. The same study estimated that they accounted for approximately 30-35% of the trades on the American Stock Exchange (Amex) and specifically 18.9% of the OTC market for the period January through June 1988. *Id.* at 15.

These data ignore proprietary trading by stock exchange members. When proprietary trading is thrown into the scales, the percentage of trading by both institutional investors and other retail customers declines. For example, in October 1987, the Securities Industry Association estimated that institutions accounted for 39% of purchases on the NYSE; proprietary traders, 27%; retail — meaning natural persons who were not proprietary traders — 34%. DIVISION OF MKT. REG., SEC, THE OCTOBER 1987 MARKET BREAK 2-8 n.26 (1988).

49. NEW YORK STOCK EXCH., SHAREOWNERSHIP 1980, at 1 (1981).

50. NEW YORK STOCK EXCH., FACT BOOK 17, 100 (1994). In 1988, the average size of trade reached an annual high of 2303 shares per trade. *Id.* at 100.

51. See generally 6 LOSS & SELIGMAN, *supra* note 1, at 2831-97.

52. REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS II-15 (1988) [hereinafter BRADY REPORT].

4,693.4 to 67,461 billion shares,⁵³ or an increase in average daily volume from 18.55 to 264.52 million shares.⁵⁴

While institutional ownership has increased spectacularly in the post-New Deal period, this trend is less important than the far more dramatic increase in individual ownership of U.S. securities. It was understood, even before the enactment of the Securities Act of 1933, that institutional investors did not need the mandatory disclosure system of that Act to protect themselves when acquiring securities.⁵⁵ These investors could "fend for themselves."⁵⁶

Between 1929 and 1990, the number of U.S. investors increased over thirty-fold, from 1.5 to 51.44 million, and the proportion of the U.S. population owning stock rose from 1.2% to 21.1%.⁵⁷ Equally significant is the fact that the vast majority of these investors appears to hold relatively modest portfolios. In 1990, the average size equity portfolio was \$11,400; 34.5% of individual shareholders had portfolios valued at less than \$5,000.⁵⁸ These data are consistent with the further fact that the 1990 median income of adult shareholders was \$43,800, not notably higher than the \$32,000 median

53. Cf. NEW YORK STOCK EXCH., FACT BOOK 102 (1994); NEW YORK STOCK EXCH., FACT BOOK 73 (1988).

54. NEW YORK STOCK EXCH., FACT BOOK 101 (1994).

55. As James Landis, one of the drafters of the Securities Act, wrote in a reminiscence: The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government. That bureaucracy, untrained in these matters as it was, could hardly equal these investors for sophistication, provided only it was their own money that they were spending. James Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 37 (1959).

56. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

57. Regarding 1929 datum, see *supra* note 27 and accompanying text. The NYSE has periodically published studies of shareownership. Two of these studies report the following data on shareholders as a percent of the population:

Year	Millions of shareholders	Shareholders as percent of population
1952	6.49	4.2
1956	8.63	5.2
1959	12.49	7.1
1962	17.01	9.2
1965	20.12	10.4
1970	30.85	15.1
1975	25.27	11.9
1980	30.20	13.5
1981	32.26	14.4
1983	42.36	18.5
1985	47.04	20.1
1990	51.44	21.1

NEW YORK STOCK EXCH., SHAREOWNERSHIP 1985, at 3 (1986); NEW YORK STOCK EXCH., SHAREOWNERSHIP 1990, at 10 (1991).

58. The NYSE further elaborated:

income for the adult U.S. population in that year.⁵⁹ A NYSE study further elaborated: "While the average number of stocks in the mid-1990 median portfolio was 3.2 . . . most shareholders engaged in little buying and selling activity. For the year mid-1989 to mid-1990, three out of five investors had one transaction or less; only 14.9% had six transactions or more."⁶⁰

These data suggest that a considerably greater number of unsophisticated individual investors trade today than did so in the early 1930s. What is notable about individual investor trading activity is the extent to which it has diversified in the recent past, apparently largely in response to tax considerations. An exhibit to the SEC's Market 2000 study illustrates:

Allocation of Household Liquid Financial Assets
(not including pension fund reserves)⁶¹

	<u>1970</u>	<u>1980</u>	<u>1992</u>
Liquid Financial Assets (Billions)	\$1,453	\$3,115	\$8,164
Bank Deposits and CDs	37.4%	48.6%	35.4%
Equities	47.0%	35.7%	31.1%
U.S. Govt. Securities	6.9%	7.7%	11.0%
Mutual Fund Shares	3.1%	1.7%	8.0%
Muni Bonds	3.2%	3.3%	7.3%
MM Funds	—	2.1%	5.7%
Corporate Bonds	2.3%	1.0%	1.6%

Nonetheless, when "risk-free" or near "risk-free" investments are removed from this chart, the enduring significance of equities, generally the riskiest type of security, is evident.

Stock Portfolio Size of Individual Shareowners

<u>Size</u>	<u>% of Total</u>
Under \$5,000	34.5%
\$5,000 - \$9,999	12.8%
\$10,000 - \$24,999	20.9%
\$25,000 - \$49,999	11.8%
\$50,000 - \$99,000	9.6%
\$100,000 and over	10.4%

NEW YORK STOCK EXCH., SHAREOWNERSHIP 1990, at 19 (1991).

59. *Id.* at 18.

60. *Id.* at 19.

61. This information is taken from DIVISION OF MKT. REG., SEC, MARKET 2000: AN EXAMINATION OF CURRENT EQUITY MARKET DEVELOPMENTS ex. 2 (1994) [hereinafter MARKET 2000].

Allocation of Household Liquid Financial Assets
(not including pension fund reserves, bank deposits and CDs,
U.S. Government securities, and MM funds)

	<u>1970</u>	<u>1992</u>
Equities	84.5%	67.0%
Mutual Fund Shares	5.6%	17.2%
Muni Bonds	5.8%	15.8%
Corporate Bonds	4.1%	3.4%

B. *Internationalization*

A second principal factor in transforming the factual context of federal securities regulation is internationalization. In 1987, U.S. investors purchased and sold \$187 billion of foreign stocks, while foreign investors purchased and sold \$481.5 billion of U.S. stocks.⁶² In contrast, as recently as 1975, U.S. investors purchased and sold a mere \$3.3 billion of foreign stock; in that year foreign investors purchased and sold over \$26 billion of U.S. stock.⁶³

A variety of mechanisms facilitated this rapid increase in cross-border trading activity. By October 1987, it was estimated that approximately 800 foreign equities were traded on the London International Stock Exchange, of which approximately 200 were actively traded.⁶⁴ An increasing number of both U.S. and overseas brokerage firms are foreign controlled. In 1986, for example, the General Accounting Office (GAO) estimated that 30 of the approximately 600 NYSE members were foreign controlled.⁶⁵

Cross-border stock investment is further facilitated by significantly improved computer and telecommunications technology. As the Brady Report stated in January 1988, "The communications networks of four key data providers alone cover over 100,000 equi-

62. Offshore Offers & Sales, Securities Act Release No. 33-6779, 41 SEC Docket (CCH) 126, 131 (June 10, 1988).

63. SECURITIES & EXCH. COMM., STAFF REPORT ON INTERNATIONALIZATION OF THE SECURITIES MARKETS II-73 (1987) [hereinafter REPORT ON INTERNATIONALIZATION].

In 1994, the SEC staff reported that approximately 17 million shares in U.S. securities were traded in after-hours or off-share trading each day. MARKET 2000, *supra* note 61, at VII-1. Approximately seven million of these shares were "faxed" abroad for execution outside of the United States each day. After-hours trading in the United States, in contrast, involves foreign investors forwarding orders in U.S. securities to U.S. securities markets for execution after the normal trading hours. *Id.* at VII-5 to VII-9.

Neither the "fax market" nor the initial steps toward 24-hour-a-day trading has yet had a significant impact on U.S. securities trading.

64. Robert Aderhold et al., *International Linkages among Equities Markets and the October 1987 Market Break*, 13 FED. RESERVE BANK N.Y. Q. REV. 34, 37 (Summer 1988).

65. GAO, SECURITIES AND FUTURES: HOW THE MARKETS DEVELOPED AND HOW THEY ARE REGULATED 17 (1986).

ties, connect over 110 exchanges and include 300,000 terminals in over 110 countries."⁶⁶ Still in an incipient phase are stock market-to-market international linkages.⁶⁷ These mechanisms have increasingly made it possible to shift funds from country to country in order to take advantage of changes in national corporate price-to-earnings ratios, interest rate levels, currency exchange rates, and other fundamental factors.⁶⁸

Concomitant with the increased levels of cross-border equity investment has been a significant decline in the overall share of U.S. stock markets, measured in terms of capitalization. Between 1978 and 1986, U.S. stock markets declined from 51.6% to 42.6% of world stock market capitalization. During these same years, Japan, the second-ranked nation by stock market capitalization, increased from 19.4% to 29.1%.⁶⁹ These data are not particularly stable. In 1989, the U.S. stock markets were responsible for 30.1% of world capitalization; Japan was the leader with 37.7%.⁷⁰

If the present trend toward internationalization of the securities markets continues, it ultimately will become commonplace for securities to be distributed simultaneously in the United States and abroad.

What is most striking at the current time, however, is the number of fundamental differences in regulatory approach that exist between the United States and other nations with sophisticated

66. BRADY REPORT, *supra* note 52, at 9-10. "Reuters has developed an Integrated Digital Network known as Equities 2000 that provides real-time prices on more than 100,000 stocks, bonds, mutual funds, futures and options traded on more than 137 exchanges worldwide." Joseph A. Grundfest, International Cooperation in Securities Enforcement: A New United States Initiative, Address at King's College, London, England 10 (Nov. 9, 1988).

67. See 5 LOSS & SELIGMAN, *supra* note 1, at 2567-70.

68. See, e.g., BRADY REPORT, *supra* note 52, at I (discussing market activity in the United States, the United Kingdom, and Japan from 1982-87).

69. REPORT ON INTERNATIONALIZATION, *supra* note 63, at II-12.

70. MARKET 2000, *supra* note 61, ex. 6. This exhibit generalized:

Global Equity Markets Capitalization

(In Billions of Dollars)

<u>Country</u>	<u>1989</u>	<u>1992</u>
United States	3,506	4,758
Japan	4,393	2,399
United Kingdom	827	839
Germany	365	346
France	365	351
Canada	291	243
Italy	169	115
G-7 Nations	<u>9,916</u>	<u>9,051</u>
All Other Nations	<u>1,725</u>	<u>2,046</u>
WORLD	11,641	11,097

securities markets. A 1985 SEC staff study, for example, compared the distribution systems and statutory and regulatory requirements of the United Kingdom and certain provinces of Canada with those in the United States for foreign issuers registering securities with the SEC on the then-most-basic form for foreign issuers, Form F-1.⁷¹

The staff survey found several material differences: First, Canada and the United States were reported to have similar securities distribution or underwriting methods. At that time, neither the United Kingdom nor Canada generally provided for "shelf registration."⁷² Underwriting methods in the United Kingdom were strikingly different from those used in the United States and Canada.⁷³

Second, substantial differences existed among the United Kingdom, Canada, and the United States with respect to required disclosure relating to the nature and character of the issuer, its business, and its management.⁷⁴

Third, basic differences existed among the United Kingdom, Canada, and the United States in each jurisdiction's generally accepted accounting principles and in the requirements to reconcile financial statements of foreign issuers.⁷⁵

Fourth, comparatively, the United States had the most comprehensive liability provision concerning the sale of securities.⁷⁶

71. Facilitation of Multinational Securities Offerings, Securities Act Release No. 33-6568, 32 SEC Docket (CCH) 707, 709-11 (Feb. 28, 1985).

72. *Id.* at 709. Shelf registration allows an issuer of securities to complete the formalities of staff review of a registration statement and then to place securities "on the shelf," from where, in a relatively short period of time, they can be taken down and sold to the public. Because shelf registration gives an issuer greater control over when an issue will be sold to the public, it has proven very popular. See *infra* text accompanying notes 160-72.

73. 32 SEC Docket (CCH) at 709-10.

74. As noted in the SEC's 1985 Release,

[A]ll three countries require disclosure of the nature of the issuer's business. In the United States, Regulation S-K provides specific guidelines as to what should be disclosed. In the United Kingdom and Canada, however, only a general instruction is given (e.g., describe the issuer's business) without providing further guidance as to the specific facts which may be material to an understanding of the issuer's business (e.g., backlog of customer orders or sources and availability of raw materials). Other notable differences among the jurisdictions surveyed include, but are not limited to: variations in the requirements for Management's Discussion and Analysis of Financial Condition and Results of Operations; disclosure of industry segment data; and disclosure of management's business experience, remuneration, and its beneficial ownership of securities of the issuer.

Id. at 710.

75. *Id.*

76. *Id.* at 710-11. To date, the SEC has achieved only limited success in encouraging multijurisdictional issuances with its adoption in 1991 of a multijurisdictional disclosure system, limited to the United States and Canada. See Multijurisdictional Disclosure and Modification to the Current Registration and Reporting System for Canadian Issuers, Securities Act Release No. 33-6902, 49 SEC Docket (CCH) 260 (June 21, 1991).

Finally, somewhat later in 1992, SEC Chairman Richard Breeden called attention to what were then unbridgeable differences between the United States and other nations that were members of the International Organization of Securities Commissions (IOSCO) in minimum capital required of broker-dealers.⁷⁷

To some extent, these types of differences are inevitable. The United States has a larger number — and a larger percentage — of individual investors than any other nation. Its securities law requirements are generally more demanding because of the weaker ability of individual investors to bargain for the type of information that in the United States is mandatorily disclosed.

At the same time, however, as other national securities markets evolve, the ability of the SEC or Congress to insist on our securities regulatory requirements has lessened. It is not inevitable either that U.S. or foreign issuers sell securities in the United States or that U.S. investors buy here. Ultimately, the trend toward internationalization of securities transactions may pose a type of "Hobson's choice" for U.S. securities regulation: either there will be an insistence on maintenance of traditional standards to protect individual investors, with the risk that U.S. securities issuers will increasingly sell abroad and foreign issuers will not sell here, or there will be a lessening of the stringency of U.S. mandatory requirements with greater risks for individual investors. But this type of choice so far has resulted in only limited significant changes in the mandatory disclosure system.⁷⁸ It is as yet uncertain whether foreign issuers will generally comply with the more demanding U.S. disclosure requirements to secure access to our markets or whether the United States will need to sacrifice standards to ensure that securities trading will remain here.

77. In a letter of October 21, 1992, SEC Chairman Breeden discussed deficiencies in the "building block" approach to capital adequacy used by IOSCO:

Speaking from the point of view of the [SEC], we have come to the conclusion that the building block approach will not yield sufficient levels of capital to protect markets in the face of major disruptions. At its most extreme, the approach currently under consideration would allow capital levels of 2 percent for highly liquid equities that are part of a diversified portfolio and are offset by unrelated equities on the opposite side. The SEC rule would require capital equal to 15 percent of long positions plus 30 percent of the excess of short positions over 25 percent of long positions. The SEC is not prepared to accept 2 percent, and other members have made clear that they will not accept 15 percent.

SEC Letter to IOSCO on Capital Adequacy, 5 INTL. SEC. REG. REP., Nov. 3, 1992, at 11, 11. The IOSCO subsequently abandoned its efforts to reach a compromise on this issue. IOSCO Panel Drops Compromise Effort Regarding Global Capital Standards, 25 Sec. Reg. & L. Rep. (BNA) 216 (Feb. 12, 1993). See generally Nancy Worth, *Harmonizing Capital Adequacy Rules for International Banks and Securities Firms*, 18 N.C. J. INTL. L. & COM. REG. 133 (1992).

78. See *infra* text accompanying notes 146-97.

C. Computerization

Much of the recent history of the stock markets involves the transition from manual to computer transactions.⁷⁹ This transition became a matter of regulatory concern in the late 1960s, when nearly two hundred broker-dealer firms that were members of the NYSE experienced difficulties with clearance and settlement — or “back office” — operations as a result of a volume surge from 4.89 million shares per day in 1964 to 14.9 million shares in December 1968, aggravated by often self-defeating efforts to engage in “instant computerization” of back offices.⁸⁰ In the early 1970s, over-the-counter trading was revolutionized by the replacement of the daily pink sheets with the NASDAQ electronic system, which permits brokers to read up-to-the-minute marketmakers’ quotations from desk top terminals.⁸¹ Other computer information systems such as Autex and Instinet permit institutional investors to communicate directly — off the exchange floor — their interest in buying or selling blocks of securities.⁸²

Computers have also performed a significant role in order execution. Several exchanges, led by the NYSE, use telecommunications to forward orders to specialists, replacing manual transmission by floor brokers.⁸³ The Intermarket Trading System (ITS) similarly links several stock exchanges and the NASD.⁸⁴ More elaborate proposals to create a national market system with system-wide computerized order execution have thus far not been realized,⁸⁵ although a largely unsuccessful experiment with computerized order execution has been conducted on the Cincinnati Stock Exchange since the late 1970s.⁸⁶

In recent years, the computer has performed an increasingly significant role in order origination. Index arbitrage⁸⁷ would not be

79. See Lewis D. Solomon & Louise Corso, *The Impact of Technology on the Trading of Securities: The Emerging Global Market and the Implications for Regulation*, 24 J. MARSHALL L. REV. 299 (1991).

80. See SELIGMAN, *supra* note 18, at 450-66.

81. 5 LOSS & SELIGMAN, *supra* note 1, at 2580-84; SELIGMAN, *supra* note 18, at 353, 490-95.

82. For further discussion of Autex and Instinet, see 5 LOSS & SELIGMAN, *supra* note 1, at 2577-78.

83. See 5 *id.* at 2554-64 (discussing several order execution systems).

84. For a discussion of the background of ITS, see 5 *id.* at 2564-67.

85. See SELIGMAN, *supra* note 18, at 524-25, 531-34.

86. For a discussion of the Cincinnati Stock Exchange, see 5 LOSS & SELIGMAN, *supra* note 1, at 2562-64.

87. Index arbitrage exploits the price differences between a stock index future, such as the S&P 500, and the composite value of the underlying stocks. 5 *id.* at 2648.

possible without computers to identify spreads between futures and the cash market. Portfolio insurance⁸⁸ uses computers to generate orders employing technical trading rules. Today, computers can print order tickets, submit orders, clear transactions, and maintain records virtually simultaneously. Federal Reserve Chairman Alan Greenspan is hardly alone in observing that "[t]he speed of information flow together with institutionalization of equity holdings imply that new information can very promptly induce a heavy imbalance of orders on one side or the other of the market."⁸⁹

D. Financial Economics

It is by now a thrice-told tale that investment management has been transformed by modern financial economics.⁹⁰ In the simplest sense, the combination of the efficient market hypothesis,⁹¹ warts

88.

"Portfolio insurance" is a term that refers to a number of dynamic hedging strategies to limit losses in a stock market during a market decline. A typical program might attempt to ensure a minimum of 95 percent of a current portfolio's value. When a market index such as the S&P 500 declines to a trigger point, a computer might generate an order to sell S&P 500 stock index futures as a technique to ensure against further declines. Portfolio insurance is not free. The SEC Staff reported that the cost of maintenance of a minimum of 95% of a current portfolio's value 'was estimated to be potentially underperforming a rising market by two to four percent.' DIVISION OF MKT. REG., SEC., THE OCTOBER 1987 MARKET BREAK I-3 (1988). But if an institution is willing to pay that price, it can participate in any market advance (net of the cost of the stock index futures) and 'insure' a portfolio against broad market declines.

5 LOSS & SELIGMAN, *supra* note 1, at 2650-52.

89. *The Conclusions and Recommendations of the President's "Working Group on Financial Markets": Hearing before Senate Comm. on Banking, Hous., and Urban Affairs*, 100th Cong., 2d Sess. 37 (1988) (statement of Chairman Alan Greenspan); *see also* DIVISION OF MKT. REG., SEC., THE ROLE OF INDEX-RELATED TRADING IN THE MARKET DECLINE OF SEPTEMBER 11 AND 12, 1986, at 20 (Mar. 1987).

90. For illustrative accounts of this saga, see PETER L. BERNSTEIN, *CAPITAL IDEAS: THE IMPROBABLE ORIGINS OF MODERN WALL STREET* (1992); JAMES H. LORIE ET AL., *THE STOCK MARKET: THEORIES AND EVIDENCE* (2d ed. 1985); BURTON G. MALKIEL, *A RANDOM WALK DOWN WALL STREET* (5th ed. 1990). For a leading academic work, see RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* (4th ed. 1991).

91. A market in which prices generally reflect available information is called "efficient." To the extent that securities prices "instantly" or rapidly adjust to new information, the opportunities for investors to outtrade the market is eliminated or reduced. It is generally believed that at least the most actively traded securities are traded in informationally efficient markets because of such mechanisms as computerized quotation and information systems and competition among financial analysts and brokerage house research departments. *See, e.g.,* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984).

The SEC explicitly relied on the efficient market hypothesis in adopting its integrated disclosure system, as well as Rule 415, its "shelf registration" rule. *See, e.g.,* Shelf Registration, Securities Act Release No. 33-6499, 29 SEC Docket (CCH) 169, 171-77 (Nov. 29, 1983). Similarly, the Supreme Court implicitly deferred to the hypothesis in securities fraud litigation when it held that the element of reliance in cases involving Exchange Act § 10(b), 15 U.S.C. § 77(b) (1988), could be presumed by dint of the concept of fraud on the market, which holds that market prices reflect publicly available information, including credible false information. *See* Basic Inc. v. Levinson, 485 U.S. 224, 241-49 (1988).

and all,⁹² and portfolio theory⁹³ have generally triumphed in defeat-

92. The efficient market hypothesis does not prove that securities are correctly priced. As one federal district court aptly put it:

[F]air market price . . . may unfortunately and inaccurately suggest that application of the fraud-on-the-market theory requires proof that the market *correctly* reflects some "fundamental value" of the security. To apply the fraud-on-the-market theory, it is sufficient that the market for a security be "efficient" only in the sense that market prices reflect the available information about the security.

In re Verifone Sec. Litig., 784 F. Supp. 1471, 1478-79 n.7 (N.D. Cal. 1992) (citations omitted), *aff'd*, 11 F.3d 865 (9th Cir. 1993).

Commentators have raised other, often quite substantial, concerns about the efficient market hypothesis. These include the following:

(i) *The Efficiency Paradox*: As Grossman and Stiglitz urge, a perfectly efficient market is impossible because securities analysts and other market professionals cannot be expected to gather information beyond the point at which they can earn a positive return. Hence the norm should be an "equilibrium level of disequilibrium," in which securities prices reflect new information rapidly, but not so quickly that market professionals cannot earn a positive return. See Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980). Professor Jensen also makes this point: A market is efficient when prices reflect information to the point where the marginal benefits of acting on information — the profits to be made — do not exceed the marginal costs. See Eugene F. Fama, *Efficient Capital Markets: II*, 46 J. FIN. 1575, 1575 (1991) (discussing Jensen's efficiency hypothesis and citing Michael C. Jensen, *Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95, 96-97 (1978)).

(ii) *Noise Theory*: As articulated in a much-cited article by Andrei Shleifer and Lawrence Summers:

Our approach rests on two assumptions. First, some investors are not fully rational and their demand for risky assets is affected by their beliefs or sentiments that are not fully justified by fundamental news. Second, arbitrage — defined as trading by fully rational investors not subject to such sentiment — is risky and therefore limited. The two assumptions together imply that changes in investor sentiment are not fully countered by arbitrage and so affect security returns. We argue that this approach to financial markets is in many ways superior to the efficient market paradigm.

Our case for the noise trader approach is threefold. First, theoretical models with limited arbitrage are both tractable and more plausible than models with perfect arbitrage. The efficient market hypothesis obtains only as an extreme case of perfect riskless arbitrage that is unlikely to apply in practice. Second, the investor sentiment/limited arbitrage approach yields a more accurate description of financial markets than the efficient markets paradigm. The approach not only explains the available anomalies, but also readily explains broad features of financial markets such as trading volume and actual investment strategies. Third, and most importantly, this approach yields new and testable implications about asset prices, some of which have been proved to be consistent with the data. It is absolutely *not true* that introducing a degree of irrationality of some investors into models of financial markets "eliminates all discipline and can explain anything."

Andrei Shleifer & Lawrence H. Summers, *The Noise Trader Approach to Finance*, J. ECON. PERSPECTIVES, Spring 1990, at 19, 20. For the work of an earlier noise theorist who focused extensively on excess price volatility, see ROBERT J. SHILLER, *MARKET VOLATILITY* (1989). For the work of a legal scholar who posits that once we assume heterogeneous investor beliefs, we have broken the link between stock market price efficiency and the fundamental value of a firm, see Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1245-48, 1286-88, 1292-95 (1990).

(iii) *The Joint Hypothesis Testing Problem*: Professor Langevoort has urged that "[i]n the 1980s, using more sophisticated data sets and computer technology, a number of economists began to question the accuracy of the tests that were thought to validate the efficiency model," to the point where "theorists began seriously to question whether the efficient market model could ever really be validated or discredited." Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851, 853-54 (1992); see also Thomas Lee Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70

ing the earlier, quite popular belief that shrewd investors could "outtrade the market" by careful study of fundamental economic data.

One practical consequence of modern financial economics has been to change the emphasis of investment advice. Because, at

N.C. L. REV. 137 (1991); cf. Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 41 DUKE L.J. 977 (1992).

Professor Fama celebrated the twentieth anniversary of his initial literature survey on the efficient market hypothesis with a new resume of the by-then "thornier" literature. See Fama, *supra*. He emphatically defended the theory:

Ambiguity about information and trading costs is not, however, the main obstacle to inferences about market efficiency. The joint-hypothesis problem is more serious. Thus, market efficiency *per se* is not testable. It must be tested jointly with some model of equilibrium, an asset-pricing model. This point, the theme of the 1970 review, says that we can only test whether information is properly reflected in prices in the context of a pricing model that defines the meaning of "properly." As a result, when we find anomalous evidence on the behavior of returns, the way it should be split between market inefficiency or a bad model of market equilibrium is ambiguous.

Does the fact that market efficiency must be tested jointly with an equilibrium-pricing model make empirical research on efficiency uninteresting? Does the joint-hypothesis problem make empirical work on asset-pricing models uninteresting? These are, after all, symmetric questions, with the same answer. My answer is an unequivocal no. The empirical literature on efficiency and asset-pricing models passes the acid test of scientific usefulness. It has changed our views about the behavior of returns, across securities and through time. Indeed, academics largely agree on the facts that emerge from the tests, even when they disagree about their implications for efficiency. The empirical work on market efficiency and asset-pricing models has also changed the views and practices of market professionals.

Id. at 1575-76 (citation omitted).

Less sanguine is Fischer Black, who has argued that a reasonable definition of an efficient market is "one in which price is within a factor of 2 of value, i.e., the price is more than half of value and less than twice value." Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986).

93. Portfolio theory divides the risk of each portfolio of securities into alpha risk — nonmarket or firm-specific risk — and beta risk — sensitivity of the portfolio to movements of an overall market. Because virtually all of a portfolio's alpha risk can be diversified away, modern portfolio management has long focused on what degree of beta or market risk is appropriate. For example, a high-risk or "performance" portfolio might move 15% each time the market as a whole moves 10%, thus having a beta of 1.5, while a low-risk portfolio might move 7.5% and have a beta of .75.

In effect, portfolio theory transforms the logic of investment analysis. Rather than studying individual securities for bargains, the focus is on calculation of risk levels. In a period in which a securities market rises, the assembling of a high-beta portfolio offers one technique by which you can outtrade the market.

The leading work on this theory has long been WILLIAM F. SHARPE, *PORTFOLIO THEORY AND CAPITAL MARKETS* (1970). Portfolio theory depends upon the accurate prediction of beta. Historical stock price data are obviously of value in making beta predictions. But there is controversy as to whether such predictions are likely to be as accurate as beta predictions based both on stock price data and on fundamental information about the specific securities held in a portfolio. See Barr Rosenberg & James Guy, *Prediction of Beta from Investment Fundamentals: Part One*, FIN. ANALYSTS J., May-June 1976, at 60 [hereinafter Rosenberg & Guy, *Part One*]; Barr Rosenberg & James Guy, *Prediction of Beta from Investment Fundamentals: Part Two*, FIN. ANALYSTS J., July-Aug. 1976, at 62 [hereinafter Rosenberg & Guy, *Part Two*]. Rosenberg and Guy have argued that "[b]ecause the portfolio revision decision entails the sale of specific securities within the portfolio and the purchase of others, it becomes necessary to predict the betas of individual securities." Rosenberg & Guy, *Part One*, *supra*, at 69. Barr Rosenberg and Vinay Marathe's studies of firm "fundamental variables . . . were substantially better predictors (of risk) than the historical beta in the sense that they achieved a smaller measurement error." Rosenberg & Guy, *Part Two*, *supra*, at 68.

least in theory, it is no longer possible to outrade the market, there have evolved a wide variety of techniques for risk management. For individual investors, this has stimulated a gradual increase in mutual funds rather than in individual equities.⁹⁴ For institutional investors this has triggered interest in, among other techniques, overseas investment to achieve international diversification,⁹⁵ and portfolio insurance to hedge against portfolio price declines.⁹⁶

What is most intriguing about the recent past, however, is the extent to which financial risk management has more generally permeated corporate finance. During the past two decades, two strands of this development have been most evident. The first such strand, "securitization," involves the transformation of illiquid debt into securities.⁹⁷ Through 1991, over \$900 billion in government and private mortgages had been "securitized" and offered to investors through various forms of "structured financings."⁹⁸ For banks and other traditional mortgage lenders, mortgage-backed securities offer significant opportunities for risk reduction. Their assets are now more liquid, or easily resalable, and their loan portfolios can be more fully diversified in terms of geography or loan categories.⁹⁹ Second has been the growing use by nonfinancial business corporations of derivative financial instruments to hedge risk. There are three general categories of derivatives: futures, options, and swaps.

94. See *supra* text and chart accompanying note 61. Between 1970 and 1992, mutual funds increased from 3.1% to 8.0% of household liquid financial assets; during the same period, individual investment in equities declined from 47% to 31.1%. *Id.*

95. See *supra* text accompanying note 62.

96. See *supra* note 88 and accompanying text. In 1993, program trading techniques averaged 11.9% of the trading volume on the NYSE. MARKET 2000, *supra* note 61, ex. 23. Portfolio insurance apparently accounted for well over half of that total. See *id.* exs. 26-27.

97. See generally TAMAR FRANKEL, SECURITIZATION: STRUCTURED FINANCING, FINANCIAL ASSET POOLS, AND ASSET-BACKED SECURITIES (1991).

98. 1 FRANKEL, *supra* note 97, at 39; cf. Exclusion from the Definition of Investment Company for Certain Structured Financings, Investment Co. Act of 1940, Release No. IC-18736, 51 SEC DOCKET (CCH) 940, 942 (May 29, 1992) ("Structured financings backed by residential mortgages dominate the structured finance market; in 1991, publicly offered mortgage-backed securities issuances in the United States totalled approximately \$246.21 billion, or eighty-four percent of the structured finance market.").

99. There are other advantages. As Professor Frankel has generalized:

Securitization also enables the holder of loans to raise funds at a lower cost than had it borrowed on its own credit. Some loans may have a higher credit rating than the credit of the holder, and investors will demand lower returns for securities backed by such loans. Opportunities for profit have mobilized the securities industry to develop securitization techniques. Legal requirements, such as capital requirements, induced banks to sell their assets, reduce their short-term liabilities, and thereby increase their equity and long-term debt. Thus, for holders of loans, securitization can lower the cost of funding, and for banks, it can also reduce the costs of legally required capital.

1 FRANKEL, *supra* note 97, at 40.

The initial type of derivative was the agricultural futures contract. In traditional agricultural markets, a futures contract provided for the future delivery of a specified quantity of a particular commodity on a specified delivery date, using prices suggested by the current price. Thus a farmer might enter into a futures contract to sell a stated quantity of wheat due to be harvested in a distant month, using a current price. This protects the farmer against a price drop, while at the same time depriving the farmer of an additional profit if wheat prices should rise. Similarly, a grain merchant or a speculator might enter into a contract to buy a stated quantity of wheat in the same distant month, using a current price. The grain merchant, like the farmer, might attempt to hedge against future price rises while conceding the ability to buy at a lower price if wheat prices fall.¹⁰⁰ More recently, active futures markets have been established for such financial futures as foreign currencies, government securities, and stock indexes.¹⁰¹

Trading in individual stock options predates the SEC. Initially options were typically called "puts" and "calls":

A put is an option to sell at a certain price within a certain period, and a call is a similar option to buy. The economic *raison d'être* of these options is to serve as a hedge (a form of insurance) against future market movements. For example, a person who [owns stock might] buy a put as insurance that he will be able to sell if the market falls to a certain level¹⁰²

Until 1973, these instruments were generally written in bearer form by more-or-less professional investors, endorsed by stock exchange houses, and then bought and sold in the over-the-counter market.¹⁰³

Trading in securities options underwent a radical change after the creation of the Chicago Board Options Exchange (CBOE) in 1973, soon followed by options trading on the American, Philadelphia, and Pacific Stock Exchanges, with the New York Stock Ex-

100. The speculator, in contrast, might simply be gambling that he or she can better predict future price movements than the current market price does. Regarding futures, see generally 5 LOSS & SELIGMAN, *supra* note 1, at 2634-52.

101. See generally 1 PHILIP MCBRIDE JOHNSON & THOMAS LEE HAZEN, *COMMODITIES REGULATION* § 1.01 (2d ed. 1989).

102. 2 LOSS & SELIGMAN, *supra* note 1, at 1066. See generally 2 *id.* at 1064-72; 5 *id.* at 2602-34.

103. Almost all of this trading was done in New York by some 20 members of the Put and Call Brokers and Dealers Association, a purely voluntary association that adopted rules for the conduct of the business and that polices the affairs of its members. See *Vandervelde v. Put & Call Brokers & Dealers Assn.*, 344 F. Supp. 118, 125-30 (S.D.N.Y. 1972) (antitrust action); DIVISION OF TRADING & EXCHS., SEC, REPORT ON PUT AND CALL OPTIONS (1961).

change joining the fray in 1982.¹⁰⁴ The CBOE pioneered two concepts: "(1) contract standardization so that options were made fungible by fixing the exercise months and exercise ("striking") prices, and (2) establishment (and now joint ownership by all the options exchanges) of The Options Clearing Corporation (OCC), which is the issuer as well as the guarantor of the traded options."¹⁰⁵

Currently there are four basic types of listed options traded by options exchanges: stock options, stock index options, debt options, and foreign currency options.¹⁰⁶ Futures and options are federally regulated respectively by the Commodities Futures Trading Commission (CFTC) and the SEC. Financial swaps, in contrast, are not.¹⁰⁷

Professor Hu has explained interest rate and currency swaps:

In its most basic form, an interest rate swap involves: (1) one party (typically called the "fixed rate payor") agreeing to make periodic payments to the other party which are fixed in amount in return for (b) the other party (typically called the "floating rate payor" or the "variable rate payor") agreeing to make periodic payments to the first party that vary with the "prime rate," "LIBOR," or some other benchmark of market interest rates. The payments exchanged by the parties are analogous to interest payments on a purely hypothetical principal amount (typically called "notional principal amount" or "notional amount"). No payments analogous to principal payments are made.

....

With interest rate swaps, the parties never make any payments of principal. The only payments made can be characterized as de facto interest payments on a purely hypothetical principal amount. With the currency swap, however, there are exchanges of both interest and principal. By carefully structuring these exchanges, parties can hedge against both currency and interest rate fluctuations. The currency swap also may offer arbitrage possibilities. If a company has a comparative advantage in the fixed interest rate Deutsche mark capital market but prefers floating rate United States dollars, it could reduce its borrowing costs through a currency swap. The company can borrow in the fixed rate Deutsche mark capital market and then, through a currency swap, transform the fixed rate Deutsche marks to floating

104. See Exchange Act Releases Nos. 19125-19134, 26 SEC Docket (CCH) 464, 464-92 (Oct. 14, 1982).

105. 2 LOSS & SELIGMAN, *supra* note 1, at 1067-68 (citations omitted).

106. See 5 *id.* at 2602-34.

107. See generally Henry T.C. Hu, *Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism*, 102 YALE L.J. 1457 (1993) [hereinafter Hu, *Derivatives*]; Henry T.C. Hu, *Swaps, the Modern Process of Financial Innovation and the Vulnerability of a Regulatory Paradigm*, 138 U. PA. L. REV. 333 (1989) [hereinafter Hu, *Swaps*].

rate United States dollars. Obtaining such funds indirectly can be cheaper than doing so directly.¹⁰⁸

Swaps are largely outside the scope of existing securities and futures regulation. But the April 1994 announcement by Procter & Gamble that it would take a \$102 million loss on a complex swap¹⁰⁹ reenforced earlier concerns about the solvency risks of the banks that are the principal dealers in swap transactions.¹¹⁰ By August 1994, a total loss of as much as \$6.4 billion in derivatives was reported in the popular press.¹¹¹

E. Conclusion

In fine, the context of securities regulation is progressively more rapidly changing. Each of these factors works simultaneously — meaning, for example, that a change in computer technology can rapidly inspire changes in financial products and international order origination. Against this background, the current boundaries of federal securities law are often called into question.

108. Hu, *Swaps*, *supra* note 107, at 347, 353 (citations omitted).

109. Kelley Holland et al., *A Black Hole in the Balance Sheet*, *Bus. Wk.*, May 16, 1994, at 80.

110. See, e.g., OCC Banking Circular 277, Risk Management of Financial Derivatives, 5 Fed. Banking L. Rep. (CCH) ¶ 58,717 (Oct. 27, 1993); Group of Thirty Report Recommends Methods to Manage Derivatives Activity, 25 Sec. Reg. & L. Rep. (BNA) 1042, 1043 (July 30, 1993).

In the United States, Congressman Leach published a 900-page report on financial derivatives, including several recommendations. The CFTC has independently recommended an interagency council to study over-the-counter derivatives further. *Gonzalez Bill Would Force Banks to Disclose More Derivatives Data*, 26 Sec. Reg. & L. Rep. (BNA) 544 (Apr. 15, 1994); *Levitt Tells House Banking Panel SEC Is Seeking Data on Hedge Funds*, 26 Sec. Reg. & L. Rep. (BNA) 539 (Apr. 15, 1994); *Rep. Leach's Derivatives Study Calls for More Regulation and Accountability*, 25 Sec. Reg. & L. Rep. (BNA) 1608 (Dec. 3, 1993); *Rep. Leach Introduces Derivatives Bill for All Financial Institutions, End-Users*, 26 Sec. Reg. & L. Rep. (BNA) 168 (Feb. 4, 1994); see also Thomas L. Friedman, *Soros Gives House Panel Hedge Fund Lesson*, *N.Y. TIMES*, Apr. 14, 1994, at C1.

In 1994, the SEC, the CFTC, and the British Securities & Investment Board issued a joint statement on OTC Derivatives Oversight. Statement of the Securities Exchange Commission, the Commodity Futures Trading Commission, and the Securities and Investments Board, Intl. Series, Release No. IS-642, 56 SEC Docket (CCH) 759 (Mar. 15, 1994). The statement identified the following joint concerns: (i) exchanges of information, (ii) netting arrangements, (iii) capital standards, (iv) management controls, (v) customer protection, (vi) multilateral credit risk management arrangements, and (vii) accounting standards. Subsequently, the Financial Accounting Standards Board (FASB) also issued an exposure draft. *FASB Issues Proposed Statement Requiring More Derivative Disclosure*, 26 Sec. Reg. & L. Rep. (BNA) 602 (Apr. 22, 1994).

111. Randall Smith & Steven Lipin, *Beleaguered Giant: As Derivatives Losses Rise, Industry Fights To Avert Regulation*, *WALL ST. J.*, Aug. 25, 1994, at A1. See generally COMMODITY FUTURES TRADING COMM., OTC DERIVATIVE MARKETS AND THEIR REGULATION (1993); GENERAL ACCOUNTING OFFICE, FINANCIAL DERIVATIVES: ACTIONS NEEDED TO PROTECT THE FINANCIAL SYSTEM (1994).

II. BOUNDARY ISSUES

A. State Securities Regulation

[In 1911,] the failure of lax state corporation statutes to prevent securities fraud gave rise to the first significant legislative response when Kansas enacted the first well-known state securities law, popularly known as a "blue sky" law, since it was intended to check stock swindlers so barefaced they "would sell building lots in the blue sky."¹¹²

By its terms, the Kansas statute provided that no investment company could sell securities in Kansas until it filed a description of its operations with the bank commissioner and received a permit. The bank commissioner was given broad discretion not to grant a permit if he found any aspect of a company's business to be "unfair, unjust, inequitable or oppressive to any class of contributors, or if he decides from his examination of its affairs that said investment company is not solvent and does not intend to do a fair and honest business, and in his judgment does not promise a fair return on the stocks, bonds or other securities by it offered for sale."¹¹³

This type of statute is popularly known today as "merit regulation" because it vests an administrator with the ability to block the marketing of a security when he finds it to be "unfair, unjust, inequitable, or oppressive." After the Kansas-type blue sky law was held constitutional by the U.S. Supreme Court in 1917,¹¹⁴ the blue sky movement swept the country. By 1933, every state except Nevada had a securities law in effect.¹¹⁵

Rarely have statutes enacted with such fanfare and general support subsequently been so universally deprecated. In the brutal glare that followed the 1929-1932 stock market crash, it was apparent to virtually all commentators and congressional witnesses on the subject that the blue sky laws never really had a chance to succeed. As early as 1915, the Investment Bankers Association reported to its members that they could "ignore" all blue sky laws by

112. SELIGMAN, *supra* note 18, at 44-45; see also LOUIS LOSS & EDWARD M. COWETT, *BLUE SKY LAW* 7-10 (1958); MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 5-7 (1970); cf. Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEXAS L. REV. 347 (1991) (questioning the initial need for blue sky statutes).

113. Act of Mar. 10, 1911, ch. 133, 1911 Kan. Sess. Laws 210, 212, *repealed by* Act of Mar. 16, 1929, ch. 140, 1929 Kan. Sess. Laws 212.

114. See *Merrick v. N.W. Halsey & Co.*, 242 U.S. 568 (1917) (upholding Michigan's blue sky law); *Caldwell v. Sioux Falls Stock Yards Co.*, 242 U.S. 559 (1917) (upholding South Dakota's blue sky law); *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917) (upholding the constitutionality of an Ohio blue sky law similar to that of Kansas).

115. 1 LOSS & SELIGMAN, *supra* note 1, at 39. Today all 50 states, the District of Columbia, Guam, and Puerto Rico have blue sky laws in force. The individual statutes are reproduced by state in *Blue Sky L. Rep.* (CCH) (1992).

making offerings across state lines through the mails.¹¹⁶ Unscrupulous securities promoters soon adopted the technique. A 1933 Department of Commerce study found, "The most effective and widely used method of evading the provision of State blue sky laws consists in operating across State lines."¹¹⁷ Robert E. Healy, chief counsel to the Federal Trade Commission, testified before Congress that same year that over ninety percent of the securities sold in Pennsylvania were sold through the mails.¹¹⁸

Nor were purely intrastate securities sales much better policed. Effective lobbying, principally by the Investment Bankers Association (IBA), had riddled most state blue sky laws with exemptions.¹¹⁹

Typically, an act might exempt the securities of all corporations listed on a stock exchange and all securities issued by a public utility subject to the regulation of a federal or state agency. The more porous statutes also exempted the securities of all firms incorporated intrastate, bank corporations, insurance companies, investment companies, co-operative associations, building and loan associations, [and] business trusts, as well as issues "guaranteed by friendly foreign governments," mortgage bonds and notes secured by property within the state, short-term commercial paper, "isolated" securities transactions, one-year debentures, and a myriad of other types of securities or transactions.¹²⁰

Only eight states appropriated sufficient funds to support securities commissions that could work full time investigating suspected frauds and prosecuting violators. In forty states, administration of the blue sky act was a "football of politics" as the chairman of the Conference on Prevention of Fraudulent Transactions in Securities put it in 1931. Enforcement responsibilities were assigned to unspecialized attorneys working for state officials as disparate as the railroad commission or the state auditor. When political administrations changed, responsibility for blue sky enforcement frequently was also reassigned.¹²¹

116. PARRISH, *supra* note 112, at 29.

117. DEPARTMENT OF COMMERCE, A STUDY OF THE ECONOMIC AND LEGAL ASPECTS OF THE PROPOSED FEDERAL SECURITIES ACT, reprinted in *Federal Securities Act: Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. 110 (1933) [hereinafter *Federal Securities Act Hearings*].

118. *Federal Securities Act Hearings*, *supra* note 117, at 228 (testimony of Robert E. Healy).

119. VINCENT P. CAROSSO, INVESTMENT BANKING IN AMERICA: A HISTORY 165-73 (1970) (describing the formation and purpose of the IBA); PARRISH, *supra* note 112, at 21-28.

120. SELIGMAN, *supra* note 18, at 45-46 (footnote omitted); see also *Federal Securities Act Hearings*, *supra* note 117, at 96; FORREST BEE ASHBY, THE ECONOMIC EFFECT OF BLUE SKY LAWS 46-47 (1926).

121. SELIGMAN, *supra* note 18, at 46; see also ASHBY, *supra* note 120, at 43-45; HOMER V. CHERRINGTON, THE INVESTOR AND THE SECURITIES ACT 56 (1942); PARRISH, *supra* note 112, at 28-29.

Even in New York, which was widely regarded as having the most effective blue sky agency, enforcement was inadequate. In 1932, the attorney general's Bureau of Securities employed more than a hundred [individuals,] secured injunctions against 1522 persons and firms, and instituted 146 criminal prosecutions. At approximately the same time, officials of the New York Stock Exchange estimated that of the billion dollars or so of fraudulent securities annually sold in the United States, about half were sold in New York State.¹²²

After Congress enacted federal securities laws, primarily in 1933 and 1934, the intriguing question is why did the blue sky laws endure? In my view, there are three general reasons.

First, political sentiment favored retention of a state role. The SEC legislation specifically preserved the blue sky laws. Far from preempting a field when interstate commerce is involved, Congress in this case affirmatively yielded to local regulation by inserting a number of intrastate exemptions even when the mails or facilities of interstate commerce are used¹²³ and more broadly adopted provisions generally "preserving the jurisdiction of the state securities commissions."¹²⁴

The states' enthusiasm for these laws can in part be traced to the fact that blue sky laws, like corporation statutes, are implicitly tax statutes: "A 1984 study of reports from thirty state jurisdictions illustrate[d] that in many jurisdictions blue sky laws [were] primarily revenue measures."¹²⁵ In twenty-six of these jurisdictions, revenues, largely from registration statement filings, exceeded expenses. In three of these jurisdictions — Nebraska, South Dakota, and Vermont — revenues were greater than ten times blue sky expenses; in six other jurisdictions — Florida, Idaho, Illinois, Minnesota, Montana, and Texas — revenues were at least five times expenses. In twenty-two of the thirty reporting jurisdictions, blue sky revenues were at least twice blue sky expenses.¹²⁶

Second, the state statutes have generally been rewritten to reduce compliance burdens at the state level when a securities issu-

122. SELIGMAN, *supra* note 18, at 46. Compare *Federal Securities Act Hearings*, *supra* note 117, at 166 (testimony of William Breed) with CHERRINGTON, *supra* note 121, at 52.

123. See 3 LOSS & SELIGMAN, *supra* note 1, at 1274-1307 (discussing the § 3(a)(11) exemption from the Securities Act of 1933). Nonetheless, commentators periodically have recommended total federal preemption of state securities laws. See, e.g., Rutherford B. Campbell, Jr., *An Open Attack on the Nonsense of Blue Sky Regulation*, 10 J. CORP. L. 553 (1985); see also *Carney v. Hanson Oil Co.*, 690 S.W.2d 404 (Mo. 1985).

124. 1 LOSS & SELIGMAN, *supra* note 1, at 272. For a discussion of the provisions in the relevant statutes, see *id.* at 271-77.

125. 1 *id.* at 149-50 (citing North American Securities Administrators Association (NASAA)). See generally 1 *id.* at 149-51.

126. The following data were supplied by the NASAA:

ance is registered at the federal level. Today, over forty state jurisdictions authorize registration by coordination.¹²⁷ Most of these jurisdictions follow the coordination procedure specified in section 303 of the Uniform Securities Act of 1956¹²⁸ and limit this procedure to issuers that have filed a registration statement employing the Securities Act of 1933. In essence, the coordination procedure requires filing at the state level of copies of the registration statement filed with the SEC. If specified conditions are met, the registration statement automatically becomes effective at the state level at the moment the federal registration statement becomes effective.¹²⁹

State	Revenues (in 000s)	Expenses (in 000s)	Total no. employees	Attorneys CPAs
Ala.	\$ 1,668.	\$ 663.	23	1
Cal.	9,139.	7,000.	161	42
Conn.	2,280	891.	31	4
Del.	377	112.	3	1
Fla.	3,730.	738.	24	15
Ga.	1,819.	748.	22	5
Idaho	799.	152.	8	3
Ill.	5,481.	776.	30	8
Iowa	1,590	335.	13	7
Kan.	918.	485.	13	3
Ky.	1,434.	540.	15	1
Mass.	1,236.	N.A.	18	N.A.
Minn.	4,309.	542.	15	1
Mont.	1,589.	229.	9	1
Neb.	2,219.	213.	11	3
Nev.	872.	N.A.	3	0
N.D.	855.	180.	6	1
Ohio	5,485.	2,729.	58	17
Okla.	2,469.	904.	30	13
Or.	1,445.	413.	12	7
Pa.	3,101.	1,684.	50	13
P.R.	120.	186.	11	1
S.D.	1,443.	129.	6	1
Tenn.	2,102.	N.A.	24	6
Tex.	10,651.	2,133.	67	19
Utah	963.	350.	12	5
Vt.	545.	54.	2	1
Va.	583.	762.	20	N.A.
Wash.	4,192.	873.	9	7
Wyo.	553.	188.	6	1

1 *id.* at 150. In this table, "N.A." means Not Ascertainable.

See also Mark A. Sargent, *Blue Sky Law: Regulation of Investment Companies — Sources of the Current Controversy*, 13 SEC. REG. L.J. 167, 172 n.24 (1985) (estimating that in another state, Missouri, fees paid by investment companies alone were ten times blue sky expenses).

127. See 1 LOSS & SELIGMAN, *supra* note 1, at 102 n.216 (citing authority).

128. UNIF. SEC. ACT § 303, 7B U.L.A. 515, 559 (1985).

129. In 1985, a revised Uniform Securities Act was promulgated. See UNIF. SEC. ACT § 303, 7B U.L.A. 515, 559 (1985). Section 303 of the revised Act also includes registration by coordination for securities registered under the Securities Act.

The 1982 adoption by the Securities and Exchange Commission of Rule 415, permitting the shelf registration of securities (that is, offer and sale at any time within two years after the effective date of the registration statement) inspired a new form of registration

Third, at least some states have performed a significant enforcement role with respect to fraud in local securities offerings. But the results vary significantly from state to state. In many jurisdictions, parsimonious state budgets have meant understaffing of state securities law programs. In ten of the thirty jurisdictions covered by the 1984 survey described earlier,¹³⁰ only one blue sky employee was an attorney or certified public accountant, and Nevada boasted no professionals in either category. Inevitably, the state programs have developed an erratic enforcement record. California — the largest reporting state, with over 160 employees — was responsible for sixty criminal convictions in 1984; twelve other states — including such major jurisdictions as Connecticut, Florida, Pennsylvania, and Virginia — reported either one or no criminal convictions that year.¹³¹

by coordination (although it is often not called that). Currently over 30 jurisdictions have either a registration by coordination procedure or an exemption for securities registered with the SEC under Rule 415.

1 LOSS & SELIGMAN, *supra* note 1, at 103 n.219 and sources cited therein. In many jurisdictions, when a security is filed for the shelf with the SEC, Form U-1, the Uniform Application to Register Securities, must be filed with the jurisdiction's securities administrator and will remain effective typically either for a period of one year with a right to renew or for two years. Registration at the local level generally becomes effective the moment the federal registration statement becomes effective. See Therese H. Maynard, *Blue Sky Regulation of Rule 415 Shelf-Registered Primary Offerings: The Need for a Limited Form of Federal Preemption*, 22 ARIZ. ST. L.J. 89, 112 n.124, 113 (1990).

130. See *supra* notes 125-26 and accompanying text.

131. The 1984 data obtained from NASAA were as follows:

Today, the most significant augmentative aspect of the state blue sky laws may well be in providing broader private relief in many instances than do the federal securities laws.¹³²

A residual tension between federal and state securities law has endured. While the mandatory disclosure system of the federal securities laws purports only to require full and complete disclosure of material information, virtually all state jurisdictions specify standards for the denial, suspension, or revocation of securities registration.¹³³ In approximately eighteen jurisdictions, traditional "merit" regulations remain in force.¹³⁴ A significant additional number of

State	Cease & Desist Orders	Denials etc.	Injunctions	Crim. Con.	Consent Orders
Ala.	94	15	0	8	29
Cal.	67	95	9	60	N.A.
Conn.	8	2	0	1	2
Fla.	13	3	10	1	N.A.
Ga.	130	0	3	5	0
Idaho	N.A.	5	62	3	2
Ill.	38	8	1	2	N.A.
Iowa	29	10	1	0	10
Kan.	6	0	1	6	7
Ky.	7	3	0	0	3
Minn.	54	10	0	2	9
Mont.	45	4	3	2	4
Neb.	12	10	0	5	0
Nev.	4	0	0	0	0
N.D.	18	3	1	0	0
Ohio	34	3	2	3	2
Okla.	N.A.	103	39	4	1
Or.	19	3	5	1	0
Pa.	N.A.	9	1	0	26
S.D.	8	0	0	0	0
Tenn.	8	16	0	8	20
Tex.	29	4	35	18	N.A.
Utah	0	12	0	0	1
Va.	N.A.	N.A.	10	1	6
Wash.	60	57	0	8	9
Wyo.	6	1	0	0	0

1 LOSS & SELIGMAN, *supra* note 1, at 151. In this table, "Denials etc." represent Denials, Suspensions, and Revocations; "Crim. Con." means Criminal Convictions; and "N.A." means Not Ascertainable.

132. See 9 LOSS & SELIGMAN, *supra* note 1, at 4133-34 n.3; Marc I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 395 (1993).

133. See 1 LOSS & SELIGMAN, *supra* note 1, at 105-07.

134. Typical of these standards are those of Kansas and California. The Kansas Act of 1957 authorizes a stop order on any one of eight grounds, including a finding that the issuer's "plan of business is unfair, inequitable, dishonest or fraudulent" or that "the securities offered . . . in payment for property, patents, formulae, good will, promotion or intangible assets, are in excess of the reasonable value thereof, or the offering has been, or would be, made with unreasonable amounts of options." KAN. STAT. ANN. §§ 17-1260(a)(1), (3) (1988).

In California, the commissioner may refuse to issue a permit unless he finds, among other things, that "the proposed plan of business of the applicant and the proposed issuance of securities are fair, just, and equitable, [and] that the applicant intends to transact its business fairly and honestly." CAL. CORP. CODE § 25140(b) (West 1977). The law also provides, how-

jurisdictions employ a modified form of merit regulation, adopting the language of Uniform Securities Act § 306(a)(2)(F), which permits "merit" regulation only when "the offering has been or would be made with unreasonable amounts of underwriters' and sellers' discounts, commissions, or other compensation, or promoters' profits or participation, or unreasonable amounts or kinds of options."¹³⁵

[I]n recent years, the wisdom of merit standards has emerged as the leading policy debate concerning state securities regulation. As a practical matter, there are two different patterns of merit regulation today. First, there are generic rules aimed at regulating 'cheap stock,' [or] excessive warrants and options Second, separate guidelines regulate specific industries such as real estate[, or] oil and gas¹³⁶

Proponents of merit regulation argue that by giving state securities administrators power to halt nonmeritorious issues, investors are better protected from fraud or overreaching than they would be under a pure disclosure form of regulation like the Securities Act of 1933. Empirical studies by Conrad Goodkind, Deputy Commissioner of Securities in Wisconsin, focusing on that state's merit standards between 1968 and 1971,¹³⁷ and Ernest Walker and Beverly

ever, that when the commissioner takes the initiative to suspend or revoke a permit that has already been issued, or in the first instance when the issuer has used the "notification" or "coordination" procedure, as well as in all nonissuer offerings, the commissioner has the burden of finding that the proposed plan of business or issuance "is not fair, just, or equitable." CAL. CORP. CODE § 25140(a) (West 1977) (emphasis added). Moreover, neither standard applies in the case of a cash offering pursuant to a firm commitment underwriting in which the issue is registered with the SEC under the 1933 Act and all the underwriters are registered with the SEC under the 1934 Act. CAL. CORP. CODE § 25140(d) (West 1977).

135. UNIF. SEC. ACT § 306(a)(2)(F), 7B U.L.A. 515, 575 (1985); see also 1 LOSS & SELIGMAN, *supra* note 1, at 109 n.233 (citing sources).

136. 1 LOSS & SELIGMAN, *supra* note 1, at 110-15. "There is a fairly detailed literature concerning merit regulation." 1 *id.* at 110 n.236; see also 1 *id.* at 110-12 n.236 (citing sources).

In 1986, the ABA's Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee published a *Report on State Merit Regulation of Securities Offerings*, 41 BUS. LAW. 785 (1986). The Report was not intended to be a brief for or against merit regulation but was designed to "improve the quality of debate on this complex subject." *Id.* at 788.

Among other recommendations, the Report urged (1) greater experimentation with blue sky "safe harbors" as an alternative to repeal of merit regulation, (2) more realistic NASAA guidelines, (3) greater SEC-NASAA cooperation[, (4) a broader exemption for publicly traded securities, [such as] those listed in the NASDAQ National Market System List[, (5) a transactional exemption for investment company offerings, and (6) reconsideration of the NASAA guideline on "cheap stock."

1 LOSS & SELIGMAN, *supra* note 1, at 112 n.236.

137. See Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79, 107-23. Goodkind attempted to study all 469 equity securities registered or denied for cause in Wisconsin between 1968 and 1971, with the exception of securities in noncash transactions such as mergers or exchange offers. Of these 469 securities, 121 could not be studied because issuers declined to respond to information requests or the Postal Service was unable to deliver correspondence. During the 1968-1971 period, there were eight reasons for denial of registration: (i) insufficient promoters' equity investment; (ii) ex-

Bailey Hadaway, respectively professors of management and finance, studying Texas issues between 1975 and 1980, suggest that securities approved after merit review tend to have superior subsequent price performance than securities denied for cause or withdrawn from issuance in that state.¹³⁸

Even if one assumes that the case for merit regulation can be persuasively articulated in a national context,¹³⁹ this debate takes on a different character when state law merit standards are applied to domestic or foreign issuers that can sell securities abroad. If enforcement of merit standards tended to encourage the distribution

cessive cheap stock; (iii) excessive options and warrants issued or reserved for issuance; (iv) excessive sales price in relation to market, price-earnings ratio, or other factors; (v) excessive underwriters' compensation and selling expenses; (vi) inequitable shareholders' voting rights; (vii) insufficiency of earnings to cover interest on debt securities or dividends on preferred stock proposed to be issued; and (viii) miscellaneous factors such as unfairness of insider transactions or unsound financial conditions of the issuer. *Id.* at 108-09. The principal results of the study are summarized in the following table:

	Aggregate Performance			
	(percent change)			
	Price 1 Year	Price 3 years	Book 1 year	Dividends for 3 years
All Denied	14.49	(14.23)	(14.68)	.84
All Registered	8.38	14.00	8.9	3.23

In this table, price and book value are expressed as a percentage change from offering price or *pro forma* book value at offering. Dividends for three years are expressed as a percentage of offering price. In the "All Denied" category there were 137 issues measured for price and 127 for book value and dividends; in the "All Registered" category there were 211 issues measured for price and 184 measured for book value and dividends. *Id.* at 111. Goodkind's study was criticized in James S. Mofsky & Robert D. Tollison, *Demerit in Merit Regulation*, 60 MARQ. L. REV. 367, 369-77 (1977) (emphasizing that the Goodkind study ignored costs of merit regulation), and in Hugh H. Makens, *Who Speaks for the Investor? An Evaluation of the Assault on Merit Regulation*, 13 U. BALT. L. REV. 435, 454-55 (1984) (criticizing Goodkind for focusing solely on corporate equity offerings).

138. See Ernest W. Walker & Beverly Bailey Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards*, 7 J. CORP. L. 651, 668-69 (1982).

Walker and Hadaway found that approved securities had a 56.60% return, as a percent of the offering price, over a three-year holding period. Withdrawn securities had a 26.06% return. *Id.* at 675; see also WISCONSIN OFF. OF COMM. OF SEC., MERIT REVIEW: IN THE PUBLIC INTEREST? AN EMPIRICAL AND QUALITATIVE ANALYSIS OF MERIT REGULATION OF COMMON STOCK OFFERINGS IN WISCONSIN 16 (1986-87) ("[T]he Committee has found that the perception that merit review impedes economic growth is generally unfounded."). Compare, for instance, the FEDERAL TRADE COMM., STAFF REPORT, MINIMUM QUALITY VERSUS DISCLOSURE REGULATIONS: STATE REGULATION OF INTERSTATE OPENED-END INVESTMENT COMPANY AND COMMON STOCK ISSUES (June 1987), which states,

Strongly risk averse small investors may have benefitted [from the merit review of common stock issuers], absent consideration of the costs of regulation that were not studied here. Investors with diversified portfolios or small investors with less aversion to risk would have preferred to have access to the issues that the merit states evaluated and so were harmed by the regulations.

Id. at 80-81.

139. See 1 LOSS & SELIGMAN, *supra* note 1, at 120-22 (discussing traditional criticisms of merit regulation); see also Brian J. Fahrney, Comment, *State Blue Sky Laws: A Stronger Case for Federal Pre-emption Due to Increasing Internationalization of Securities Markets*, 86 NW. U. L. REV. 753, 765-68 (1992).

of securities issuances solely abroad, this could not be rationalized as advantaging either U.S. issuers or investors.

To some extent, most states have reduced the conflict between their merit standards and actual or potential international offerings by adopting a "marketplace exemption" from merit review for securities listed on the New York and American stock exchanges.¹⁴⁰ Some states also exempt securities traded in the alternative over-the-counter market in the computerized NASDAQ National Market System list.¹⁴¹

The practical problem, given an increasingly international economy, is more fully to perfect a system of state securities regulation that will not impede registration within the United States. Potentially, this might mean a system of partial preemption by the Securities Act of 1933 for registered offerings. Under such a system, the states would be prohibited from imposing disclosure and other standards more demanding than those enforced under the Securities Act of 1933.¹⁴² In effect, merit regulation for issues registered under the federal Securities Act would be prohibited.

Such partial preemption would have little or no impact on those states that today do not employ merit regulation or on those states where merit regulation is effectively reserved for offerings exempt from the 1933 Securities Act — for example, by dint of the marketplace exemption. Under this proposal, merit regulation would continue to exist in those states that wished to employ it for offerings exempt from the Securities Act of 1933.

More significantly, all states could continue to require registration by coordination — that is, simultaneous with SEC registration — and could continue to play a role in securities law enforcement. But the filing requirements at the state level would essentially be limited to the filing of documents required by the Securities Act of 1933 for registered offerings.

Besides simplifying the often quite burdensome task of "blue skying" a securities issuance in up to fifty states as well as the District of Columbia, Puerto Rico, and Guam, partial preemption along these lines would end concerns of domestic and foreign issuers about the possibility of being able to satisfy federal but not state

140. See 1 LOSS & SELIGMAN, *supra* note 1, at 121; Mark A. Sargent, *A Future for Blue Sky Law*, 62 U. CIN. L. REV. 471, 474-75 (1993) (discussing the marketplace exemption).

141. Criteria for exchange listing and trading in the NASDAQ National Market System List are analyzed in 4 LOSS & SELIGMAN, *supra* note 1, at 1733-2119; 5 *id.* at 2477-652; 6 *id.* at 2653-830. The NASAA Committee approved a model NMS exemption in 1986. State Registration Exemptions, NASAA Rep. (CCH) ¶¶ 4811, 4821 (Mar. 14, 1986).

142. Such a proposal was made earlier in Fahrney, *supra* note 139, at 776-81.

registration requirements, or the possibility that state registration requirements might significantly delay or add to the costs of an issuance.¹⁴³

Inevitably, the application of merit standards to issuers capable of selling securities abroad has and will continue to shrink.¹⁴⁴ This is not a consequence of an academic or purely domestic debate about the wisdom of merit standards. It is, instead, a consequence of the increasingly international context of securities sales. The emergence of a global securities market ultimately should result in the United States' federal level becoming the sole level of concern for issuers capable of selling abroad. A concurrent system that operated well enough when securities sales were generally domestic runs the risk of becoming self-defeating when securities issuers have the option of selling in foreign securities markets.

B. *The Securities Act of 1933*

If the tendency in the boundary between federal and state securities laws is generally in favor of a further diminution of the state role, matters are notably different with respect to the scope of the Securities Act of 1933. This Act requires issuers to file a registration statement when distributing securities to the public.¹⁴⁵ During the past decades, the frequency with which corporate issuers have had to provide a detailed description of their firms and their businesses in a registration statement has significantly declined, primarily as a result of the greater use of truncated, transaction-oriented disclosure requirements and the use of the private placement exemption. The significance of the mandatory disclosure system under the 1933 Act, in effect, has shrunk as a consequence of the combined effect of the efficient market hypothesis, which suggested that disclosure under the 1933 Act is unnecessary if the same disclosure is made to the market under the periodic requirements of the Securities Exchange Act; the rise of foreign capital markets, which created a practical alternative to the domestic sale of securities; and

143. See Sargent, *supra* note 140, at 490 ("Former SEC Chairman Richard Breeden suggested that the states should be out of the international regulatory game, except perhaps for purposes of enforcement."). This article further quotes Breeden: "It is frustrating that as of 1991 Great Britain will allow the use of a prospectus filed in Berlin, but it will not be legal to use automatically a prospectus filed with the SEC in California." *Id.* (quoting *Breeden Repeats Call for Permitting U.S. Firms to Invest in Domestic Banks*, 22 Sec. Reg. & L. Rep. (BNA) 351 (Mar. 9, 1990)). See generally Sargent, *supra* note 140, at 489-92.

144. Cf. Sargent, *supra* note 140, at 482-85 (explaining why merit regulation is becoming irrelevant).

145. See 15 U.S.C. § 77e (1988).

the increased demand for securities by institutions, which effectively broadened the private placement market.

The practical consequence of these forces can be overstated.¹⁴⁶ If a corporation provides the same material information to investors in an annual report that it previously provided in a registration statement, the effect is formal rather than substantive.

There is, however, a larger point that has generally been missed by those who view the mandatory disclosure system as withering. While the internationalization of the securities markets may potentially lead to diminution of what must be disclosed, in the recent past this impact has been dwarfed by a significant expansion of what must be disclosed by all seasoned firms in their annual reports to the SEC.

Let me place this larger point in context. The SEC's "integrated disclosure system" has two major aspects. First, it coordinates required disclosures under the 1933 Act and the 1934 Act, in light of an assumption of the efficient market hypothesis that information effectively disseminated to the public will be rapidly reflected in share prices regardless of the source of the data.¹⁴⁷ This aspect of the system is responsible for streamlined registration forms, notably Forms S-2 and S-3 for registrants subject to the 1934 Act's continuous disclosure obligations. Second, the system also developed generic disclosure items for both 1933 Act registration and 1934 Act registration and continuous reporting by adding a new Regulation S-K (nonfinancial items) to the existing Regulation S-X (financial items).¹⁴⁸ Previously, required disclosures under the two Acts had been developed independently of each other.

The first detailed articulation of the integrated disclosure system concept was a highly influential 1966 law review article by Milton

146. See *supra* note 19 and accompanying text.

147. The efficient market hypothesis is discussed *supra* at notes 91-92 and accompanying text. The applicability of this hypothesis to an integrated disclosure system was considered in several releases. See, e.g., Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6235, 20 SEC Docket 1175, 1177-99 (Sept. 2, 1980); Reproposal of Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6331, 23 SEC Docket 288, 290-91 (Aug. 18, 1981); Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 24 SEC Docket (CCH) 1262, 1267 (Mar. 26, 1982); see also Milton H. Cohen, *The Integrated Disclosure System — Unfinished Business*, 40 BUS. LAW. 987, 992-95 (1985) (expressing concern that the quality of registration statements has been lowered); Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 810-18 (1985); Lynn Nicholas, *The Integrated Disclosure System and Its Impact Upon Underwriters' Due Diligence: Will Investors Be Protected?*, 11 SEC. REG. L.J. 3 (1983).

148. Regulation S-X, 17 C.F.R. § 210 (1994); Regulation S-K, 17 C.F.R. § 229 (1994); Form S-2, 17 C.F.R. § 230.12 (1994); Form S-3, 17 C.F.R. § 230.13 (1994).

H. Cohen, the Special Study's director, entitled "*Truth in Securities*" *Revisited*.¹⁴⁹ Cohen's article begins with the following thesis:

[T]he combined disclosure requirements of these statutes would have been quite different if the 1933 and 1934 Acts (the latter as extended in 1964) had been enacted in opposite order, or had been enacted as a single, integrated statute — that is, if the starting point had been a statutory scheme of continuous disclosures covering issuers of actively traded securities and the question of special disclosures in connection with public offerings had then been faced in this setting. Accordingly, it is my plea that there now be created a new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 Act and treating "1933 Act" disclosure needs on this foundation.¹⁵⁰

To achieve this coordinated — or integrated — disclosure system, Cohen urged that the disclosure process under the 1934 Act, which "appears never to have been taken quite as seriously as under the 1933 Act,"¹⁵¹ should "operate so that the public files contain, at any given time, information substantially equivalent to a current 1933 Act prospectus . . . with regard to any security in which there is active investor interest."¹⁵² He proposed several measures to bring the quality of 1934 Act disclosures closer to the level of 1933 Act filings: (i) the pertinent civil liability provisions in the two Acts should be harmonized rather than retaining a considerably milder standard under the 1934 Act; (ii) SEC review of 1934 Act filings should resemble "in thoroughness and promptness" its review of 1933 Act filings; and (iii) there should be a uniform system for numbering items in the basic registration and report forms.¹⁵³ Further, Cohen urged that once the continuous disclosure system of the 1934 Act has been improved "to the limits of practicability," "continuous registrants" that are fully subject to the reporting, proxy soliciting, and insider trading provision of sections 13, 14, and 16 of the 1934 Act should be subject to "greatly relaxed" special disclosure requirements under the 1933 Act, so that a public offering filing does not merely duplicate what already exists in the public file.¹⁵⁴ In contrast, Cohen also argued that a first-time registrant should, as in the past, make a comprehensive 1933 Act filing.¹⁵⁵

149. See Milton H. Cohen, "*Truth in Securities*" *Revisited*, 79 HARV. L. REV. 1340 (1966).

150. *Id.* at 1341-42.

151. *Id.* at 1361.

152. *Id.* at 1368.

153. *Id.* at 1368-75.

154. *Id.* at 1379, 1406-07.

155. *Id.* at 1407-08.

While Cohen's logical argument was cogent, quite different factors ultimately led to the integration of the mandatory disclosure system. First, it was generally recognized that the mechanisms of an efficient market, in fact, appear to operate, at least with respect to the most actively traded securities. In 1969, the SEC's Disclosure Policy Study concurred with Cohen's proposal for a coordinated disclosure system. In *Disclosure to Investors: A Reappraisal of Administrative Policies under the '33 and '34 Securities Acts*,¹⁵⁶ the SEC argued that information in SEC filings would be rapidly disseminated because of intermediaries in the investment process — such as professional money managers, brokerage firm research staffs, and investment advisers, who would study these filings and “filter” out key new information to a wider public — and also because of advances in the technology of data dissemination.¹⁵⁷ Subsequently, the SEC's 1977 Advisory Committee Report carried these points further, asserting that “competition among analysts results in security prices that reflect a broad set of information.”¹⁵⁸ This competition, in part, is dependent on “a uniquely active and responsive financial press which facilitates the broad dissemination of highly timely and material company-oriented information to a vast readership.”¹⁵⁹ In effect, these SEC studies described mechanisms by which an efficient market could operate. Subsequently, particularly in its consideration of the eligibility requirements for the truncated Form S-3, the SEC conservatively defined the class of companies that it was confident were subject to “efficient” information dissemination and analysis.

156. SEC, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 SECURITIES ACTS (1969).

157. *Id.* at 10, 48, 52-54 (noting that membership in the Financial Analysts Federation had grown from 2422 members in 1950 to 11,752 by the end of 1967); *id.* at 63-64, 313-23 (noting that the new technology at that time was microfiche).

158. REPORT OF THE ADVISORY COMM. ON CORP. DISCLOSURE TO THE SEC, HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, 95th Cong., 1st Sess. 620-21 (Comm. Print 1977) (footnote omitted). See generally *id.* at 618-52. By 1977 there were over 14,000 members in the Financial Analysts Federation. *Id.* at 620. As Professors Ronald Gilson and Reinier Kraakman later wrote:

In today's securities markets, the dominant minority of informed traders is the community of market professionals, such as arbitrageurs, researchers, brokers and portfolio managers, who devote their careers to acquiring information and honing evaluative skills. The trading volume in most securities that these professionals control, directly or indirectly, seems sufficient to assure the market's rapid assimilation into price of most routine information.

Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 571 (1984) (footnotes omitted).

159. Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6235, 20 SEC Docket 1175, 1179 (Sept. 2, 1980). This Release relied on the findings of the Report of the Advisory Committee on Corporate Disclosure to the SEC, Nov. 3, 1977. See *id.* at 1179 n.12.

At approximately the same time, a quite different factor strengthened the momentum for truncating the disclosure requirements under the Securities Act. For several decades the SEC had generally interpreted section 6(a) of that Act to permit registration of only those securities that would be sold soon after the registration statement was declared effective.¹⁶⁰ As a practical matter, this view prevented "shelf registration," by which an issuer would register and leave the securities "on the shelf" until market conditions warranted a "takedown," or sale of the securities.¹⁶¹

"A combination of regulatory and marketplace changes inspired the Commission to reexamine the shelf registration issue early in the 1980s [Most significantly], the growth of a competitive Eurobond market placed SEC regulation of new issues in a new international context."¹⁶² Unless SEC administration of the Securities Act permitted issuers to sell securities as rapidly in the United States as in Europe, it was reasonable to assume that a considerable portion of both American and foreign issues would exclusively be sold abroad. In 1980, the SEC attempted to enable U.S. investors to participate more effectively in the international bond market by publishing a staff interpretation — known at the SEC as the "Kingdom of Sweden" Release — indicating that foreign governments and their political subdivisions would be permitted to sell debt issues "off the shelf" in the United States if they undertook to file posteffective amendments with the SEC.¹⁶³

160. The last sentence of § 6(a) provides: "A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." Securities Act § 6(a), 15 U.S.C. § 77f(a) (1988). For the legislative history of this section, see H.R. REP. NO. 85, 73d Cong., 1st Sess. 7, 18-20 (1933), and H.R. REP. NO. 152, 73d Cong., 1st Sess. 25 (1933). See also Scott Hodes, *Shelf Registration: The Dilemma of the Securities and Exchange Commission*, 49 VA. L. REV. 1106 (1963) (urging that a strict interpretation of § 6(a) prohibits all shelf registrations).

In administrative opinions early in its history, the SEC interpreted this sentence to mean "that Congress contemplated that registration should be effective only in connection with offerings proposed to be made in the proximate future." Shawnee Chiles Syndicate, 10 SEC 109, 113 (1941) (footnote omitted). One of the draftsmen, Benjamin V. Cohen, is said to have confirmed that this was the intention. See Hodes, *supra*, at 1110 n.17.

161. There were limited exceptions to the long-standing prohibition on shelf registration. See 1 LOSS & SELIGMAN, *supra* note 1, at 355-56.

162. 1 *id.* at 357-58.

163. Eurobonds, in essence, are bonds issued abroad — in Europe and elsewhere — effectively outside any national regulatory system. See Interpretative Release Relating to Delayed Offerings by Foreign Governments or Political Subdivisions Thereof, Securities Act Release No. 33-6240, 20 SEC Docket 1358 (Sept. 10, 1980); see also OFFICE OF CHIEF ECONOMIST, SEC, EURODOLLAR BONDS: ALTERNATIVE FINANCING FOR UNITED STATES COMPANIES 10 (1985) (arguing that the most important reason for the growth of the market "is that U.S. firms believe that they can borrow at lower interest costs overseas than in the United States"); REPORT ON INTERNATIONALIZATION, *supra* note 63, at II-8 to II-10, III-4 to III-58; Interpretive Release Relating to Continuous and Delayed Offerings by Foreign Govern-

Cumulatively, the general recognition of the mechanisms of an efficient market for information dissemination and the potential for significant export of U.S. securities sales persuaded the SEC in 1982 to adopt both the current integrated disclosure system and shelf registration Rule 415.¹⁶⁴

The integrated disclosure system permits specified seasoned issuers using a truncated Form S-3¹⁶⁵ to file a brief registration statement primarily describing the securities issuance and recent material changes¹⁶⁶ and then to incorporate by reference the following: (i) its latest Form 10-K annual report, (ii) subsequent quarterly and monthly 1934 Act reports, and (iii) if capital stock is to be registered and the same class is registered under section 12 of the

ments or Political Subdivisions Thereof, Securities Act Release No. 33-6424, 26 SEC Docket (CCH) 20 (Sept. 2, 1982).

The significance of the Eurobond market to the development of Rule 415 is widely recognized. See, e.g., Beth McGoldrick, *Life with Rule 415*, INSTITUTIONAL INVESTOR, Feb. 1983, at 129, 130; Steve Lohr, *Rolling in Money in London*, N.Y. TIMES, Apr. 20, 1986, § 3, at 1.

164. See Adoption of Integrated Disclosure System, Securities Act Release No. 33-6383, 24 SEC Docket (CCH) 1318 (Mar. 3, 1982); see also 17 C.F.R. § 229 (1994) (Regulation S-K disclosures); 47 Fed. Reg. 39,803, amending 47 Fed. Reg. 11, 401 (1982) (codified at 17 C.F.R. § 229.512(a) (1994)) (adoption of Item 512(a) undertakings); 47 Fed. Reg. 11,380, 11,394 (1982) (codified at 17 C.F.R. § 230.415(a)(3) (1994)) (adoption of Rule 415 regarding delayed or continuous offering and sale of securities).

165. Initially the Commission adopted two general types of eligibility requirements for Form S-3:

First, there [were] registrant requirements. American companies (and under certain circumstances foreign private issuers) [were required to] have reported under the 1934 Act for the past 36 calendar months, with a default-free record since the end of the last fiscal year on dividend and sinking fund installments on preferred stock, debt installments, or long-term lease rentals if the defaults in the aggregate were material to the financial position of the registrant. Second, there [were] transaction requirements. A company satisfying the registrant requirements could [then] use Form S-3: (1) for primary cash offerings if it had the requisite \$150 million float [— that is, stock ownership by outside shareholders rather than the inside central group —] or a \$100 million float and annual trading volume of at least 3 million shares; (2) for primary cash offerings of "investment grade" nonconvertible debt or nonconvertible preferred stock; (3) for secondary offerings offered by any person other than the issuer (including underwriters) if securities of the same class were listed on a national securities exchange or quoted in NASDAQ; or (4) for certain rights offerings, dividend or interest reinvestment plans or conversions or warrants.

2 LOSS & SELIGMAN, *supra* note 1, at 615-16. For background on the Release, see 2 *id.* at 608-12.

In 1992, the SEC adopted revisions to Form S-3 that (i) shortened from 36 to 12 months the minimum issuer reporting requirements for all offerings of non-asset-backed securities; (ii) reduced the minimum public float requirement for issuers with at least \$75 million in voting stock held by nonaffiliates; and (iii) added offerings of investment grade asset-backed securities qualified to be registered for automatic effectiveness upon filing of a Form S-3 relating solely to a dividend or interest reinvestment plan. Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 33-6943, 51 SEC Docket (CCH) 1501 (July 16, 1992) (proposal); Securities Act Release No. 33-6964, 52 SEC Docket (CCH) 2015 (Oct. 22, 1992) (adoption).

166. Specifically, a registrant filing on Form S-3 must include Items 202, 501-12, 601, and 702 of Regulation S-K and information on material changes. Each of these items and the concept of material changes are described in 2 LOSS & SELIGMAN, *supra* note 1, at 663-64.

1934 Act, a description of the class of securities that is contained in a registration statement filed under the 1934 Act, including amendments or reports filed to update the description.¹⁶⁷

Rule 415, the new shelf registration rule, permits specified seasoned issuers eligible to file on Form S-3 to register for the shelf for up to two years.¹⁶⁸ A variety of economic benefits have been attributed to the rule. Studies suggest that the opportunity Rule 415 provides to time the issuance of offerings to take advantage of market conditions permits lower issuer costs.¹⁶⁹ Underwriter competition to distribute primary offerings has similarly led to lower underwriting spreads.¹⁷⁰ The issuer's cost of compliance with the Securities Act's registration procedure has also been reduced.¹⁷¹

167. Each of the reports is incorporated by reference and is analyzed in 4 *id.* at 1854-84.

168. Rule 415(a)(1)(x), 17 C.F.R. § 230.415(a)(1)(x) (1994).

Both before and after the final adoption of Rule 415, a considerable proportion of securities registered with the SEC have been registered "for the shelf." In the adoption Release, the SEC summarized experience with Temporary Rule 415 in the following terms: "From March 1982 through September 1983, almost 4,600 shelf registration statements relating to \$181 billion were filed. These shelf filings represent 52% of the over 8,800 registration statements and 52% of \$345 billion of securities registered during this period." Shelf Registration, Securities Act Release No. 33-6499, 29 SEC Docket (CCH) 169, 171-77 (Nov. 17, 1983).

169. See 29 SEC Docket (CCH) at 170 (summarizing several studies); OFFICE OF CHIEF ECONOMIST, SEC, UPDATE — RULE 415 AND EQUITY MARKETS 21 (Dec. 1984) [hereinafter OFFICE OF CHIEF ECONOMISTS (Dec. 1984)] (estimating that shelf-registered equity offerings have lower issuing costs of about 0.630 cents per dollar raised for syndicated offerings and about 1.363 cents per dollar of equity raised for nonsyndicated offerings); OFFICE OF CHIEF ECONOMIST, SEC, EXPLAINING THE SAVINGS FROM RULE 415: THE DEBT MARKET 15 (Sept. 17, 1984) (noting that industrial bond issues sold by shelf registration sell for about 20 basis points less, holding all other important factors constant, than similar negotiated issues); Barbara Ann Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 149-53 (1984) (presenting a survey of several studies); David S. Kidwell et al., *SEC Rule 415: The Ultimate Competitive Bid*, 19 J. FIN. & QUANTITATIVE ANALYSIS 183, 194 (1984) (finding "that debt issues sold under Rule 415 sell between 30 and 40 basis points less than comparable negotiated sales"); David S. Kidwell et al., *Shelf Registration: Competition and Market Flexibility*, 30 J.L. & ECON. 181 (1987) (finding that industrial bond issues sold by shelf registration sell for 20 basis points less than similar nonshelf sales).

170. See OFFICE OF CHIEF ECONOMIST (Dec. 1984) *supra* note 169, at 5-6; Memorandum from the Office of the Chief Economist to the Securities and Exchange Commission, *Spillover Effects of Shelf Registration: Underwriting Spreads on Negotiated Industrial Debt and Equity Issues* (Dec. 5, 1984) (on file with the Office of the Chief Economist) (using a sample of industrial debt and common stock issues sold between January 1977 and June 1983, and concluding that shelf registration had increased competition in the investment banking industry and therefore had resulted in lower underwritten spreads in both shelf and negotiated issues); McGoldrick, *supra* note 163, at 130-31 (examining new risks for underwriters created by Rule 415); see also *supra* note 169 and sources cited therein.

171. See Shelf Registration, Securities Act Release No. 33-6499, 29 SEC Docket (CCH) 169, 171 (Nov. 17, 1983) ("Legal, accounting, printing and other costs are stated to have been reduced, because only a single registration statement need be filed for a series of offerings, rather than a separate registration statement each time an offering is made.")

In all, the SEC "conservatively" estimated total issuer savings of \$280 million in 1983. Memorandum to George Kundahl, [SEC] Executive Director, from David Malmquist, Re: Estimates of Savings to Issuers Resulting from Rule 415 (May 17, 1984), *reprinted in SEC*

At the same time, there is also little question that Rule 415 sharply reduced the ability of the managing underwriter to conduct a due diligence review.¹⁷² The registration statement normally is prepared solely by the issuer in a Rule 415 filing, rather than in conjunction with an underwriter. This reduces the ability of the underwriter to provide an effective review of the registration statement. Whether the issuer's cost savings justify this loss in due diligence is debatable. But, to keep this debate in context, it should

Oversight and Technical Amendments: Hearing Before the Subcomm. on Telecommunications, Consumer Protection, and Fin. of House Comm. on Energy and Commerce, 98th Cong., 2d Sess. 322-24 (1984); see also Banoff, supra note 169, at 145-46; A.F. Ehrbar, Upheaval in Investment Banking, FORTUNE, Aug. 23, 1982, at 90, 92.

172. The SEC has recognized that an underwriter's reasonable investigation will vary depending on such "relevant circumstances" as "the type of underwriting arrangement . . . and the availability of information with respect to the registrant." Rule 176(g), 17 C.F.R. § 230.176(g) (1994).

The effect of Rule 415 on underwriter due diligence was a major point emphasized in Commissioner Thomas's dissent to the SEC's September, 1982 extension of temporary Rule 415. See *Delayed or Continuous Offering and Sale of Securities*, Securities Act Release No. 33-6423, 26 SEC Docket (CCH) 2, 15-16 (Sept. 2, 1982).

In adopting the final version of Rule 415, the SEC responded by noting that some issuers had developed continuous due diligence programs or periodic due diligence meetings. Others, emulating practice under the former Rule 50 of the Public Utility Holding Company Act, 15 U.S.C. § 79 (1988), had begun appointing a law firm to act as underwriters' counsel before the underwriter was selected. See *Shelf Regulation*, 29 SEC Docket (CCH) at 172. While concurring in the majority's decision, Chairman Shad was plainly dubious that these and other procedures would fully compensate for the qualitative loss in underwriter due diligence. See 29 SEC Docket (CCH) at 176.

The former Director of the Special Study of the Securities Markets, Milton H. Cohen, in a thoughtful address, suggested that a new statutory treatment of § 18 of the Securities Exchange Act should be adopted to bring that Section closer to § 11 of the Securities Act as one means to develop appropriate liability standards in an integrated disclosure system. *Compare* Exchange Act § 18, 15 U.S.C. § 77k (1988) *with* Securities Act § 11, 15 U.S.C. § 78c (1988). Cohen then added:

With regard to the due diligence obligation of underwriters, and perhaps others, in connection with a public offering, we must then make a policy choice. Either we must conform the obligation to the practical needs of a marketing system in which competition, speed, and economy are dominant objectives, or else we must insist that those objectives not be pursued to the point that due diligence is impaired. But I would emphasize particularly that this policy choice will be much easier and less painful if the first two steps have been taken, that is, if continuous disclosure files have been brought to the highest practicable levels of quality and currency through appropriate statutory and regulatory changes. On that assumption, there should be little if any impairment of investor protection if the section 11 due diligence obligation at the time of a public offering were moderated; or, going the other way, the burdens and risks to underwriters would be brought within more tolerable limits even if the theoretical obligation were not moderated.

Cohen, *supra* note 147, at 994; cf. Dana B. Kluges, Note, *Expanding the Liability of Managing Underwriters Under the Securities Act of 1933*, 53 *FORDHAM L. REV.* 1063 (1985).

Harvard Business School professors Auerbach and Hayes alternatively proposed that Rule 415 or § 11 or both be amended so that (i) leading issuers would be made solely responsible for Rule 415 issues; (ii) for the least qualified issuers, Rule 415 would remain unmodified; and (iii) for an in-between group, underwriters would be permitted to avoid liability if a reasonable investigation had been made by professional experts or agencies. JOSEPH AUERBACH & SAMUEL L. HAYES, III, *INVESTMENT BANKING AND DILIGENCE: WHAT PRICE DEREGULATION?* 189-98 (1986).

be borne in mind that the type of distribution involved in a non-traditional Rule 415 issue typically will be a debt offering filed on Form S-3. Both because of the usually reduced investor risk in debt offerings and because of the integrated disclosure system, this would appear to be the type of distribution for which some sacrifice in due diligence could most readily be accommodated.

During the same period, when Form S-3 and Rule 415 were being adopted, a third significant change in the scope of the registration requirements of the 1933 Act also occurred. It had always been an underlying premise of the Securities Act that "private placements" of securities to institutional investors or a limited number of sophisticated investors would not have to be registered.¹⁷³ During the last few decades, the proportion of new corporate financing conducted through private placement, rather than public sale, has increased substantially. In 1970, for example, approximately 17% of all corporate securities sales were private. Between 1984 and 1987, the figure ranged from 30% to 39%.¹⁷⁴ The vast preponderance of private placements involve the sale of debt to institutional investors.¹⁷⁵ To facilitate the institutional market in the resale of privately placed securities, the SEC in 1990 adopted

173. See *supra* note 55. This exemption now appears in § 4(2) of the Act. See Securities Act § 4(2), 15 U.S.C. § 77d(4) (1988). For discussion of the private placement exemption, see generally 3 LOSS & SELIGMAN, *supra* note 1, at 1350-1450.

174. A 1988 SEC release included the following table:

New Corporate Public and Private Financing
(Millions of Dollars)

	<u>Public</u>	<u>Percent Public</u>	<u>Private</u>	<u>Percent Private</u>	<u>Total New Financing</u>
1970	31,130	83	6,373	17	37,503
1975	46,828	78	13,515	22	60,343
1980	57,330	78	15,700	22	73,030
1981	56,085	75	18,400	25	74,485
1982	62,566	72	24,300	28	86,866
1983	97,103	73	35,600	27	133,703
1984	82,199	61	53,258	39	135,457
1985	138,288	65	73,093	35	211,380
1986	286,040	70	123,457	30	409,497
1987	271,477	66	139,355	34	410,832

Resale of Restricted Securities; Changes to Method of Determining Holding Periods of Restricted Securities Rules 144 and 145, Securities Act Release No. 33-6806, 42 SEC Docket (CCH) 76, 78 (Oct. 25, 1988).

175. 42 SEC Docket (CCH) at 77-84. Another table in the same release reported the following:

Rule 144A,¹⁷⁶ which permits qualified institutional buyers to purchase specified privately placed securities without registration under the Securities Act.¹⁷⁷

The combination of Form S-3, Rule 415, and the increased proportion of institutional private placements has substantially reduced the scope of the Securities Act of 1933. This, in effect, represents the most significant erosion of the federal securities laws' mandatory disclosure system since the New Deal period.

The integrated disclosure system — and implicitly the shelf registration and private placement concepts — are grounded in what the SEC terms "the principle of equivalency":

Integration, as a concept, involves a conclusion as to equivalency between transactional (Securities Act) and periodic (Exchange Act) reporting. If a subject matter is material information (other than a description of the transaction itself), then it will be material both in the distribution of securities and to the trading markets.

Moreover, requirements governing the description of such subject matters should be the same [for] both purposes. . . .

. . . [T]he concept of integration also proceeds from the observation that information is regularly being furnished to the market through periodic reports under the Exchange Act. This information is evaluated by professional analysts and other sophisticated users, is available to the financial press and is obtainable by any other person who seeks it for free or at nominal cost. To the extent that the market accordingly acts efficiently, and this information is adequately reflected in the price of a registrant's outstanding securities, there seems little need to reiterate this information in a prospectus in the context of a distribution.¹⁷⁸

Amount of Private Placements by Type of Security
(Millions of Dollars)

	Debt	Percent Debt	Equity	Percent Equity	Total
1965	9,562	97	258	3	9,820
1975	12,852	95	663	5	13,515
1980	13,800	88	1,900	12	15,700
1981	16,000	87	2,400	13	18,400
1982	20,700	85	3,600	15	24,300
1983	28,800	81	6,800	19	35,600
1984	43,600	82	9,700	18	53,300
1985	60,565	83	12,528	17	73,093
1986	110,524	90	12,933	10	123,457
1987	122,124	88	17,231	12	139,355

42 SEC Docket (CCH) at 79. See generally Symposium, *Exemptions for Institutional Investors or Concepts of Non-Public Offerings: A Comparative Study*, 13 U. PA. J. INTL. BUS. L. 473 (1993).

176. 17 C.F.R. § 230.144A (1994).

177. Securities Act Release No. 33-6862, 46 SEC Docket (CCH) 26 (Apr. 23, 1990); see Loss & SELIGMAN, *supra* note 1, at 384-404 (1994 Ann. Supp.).

178. Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 33-6235, 20 SEC Docket 1175, 1177 (Sept. 2, 1980).

The difficulty with the principle of equivalency is that the registrant's *preparation* of information under the 1933 and 1934 Acts is not equivalent. This remains true in the sense recognized by Milton H. Cohen that the pertinent civil liability provisions in the 1933 and 1934 Acts are different, with milder standards operative under the 1934 Act.¹⁷⁹ Although every underwriter who participates in a securities offering may be held liable under section 11 of the 1933 Act, there is no *statutory* provision ensuring that underwriters will perform a comparable role by way of monitoring the quality of 1934 Act reports.¹⁸⁰ This means, in effect, that in a substantial proportion of securities sales, underwriters will not be responsible for conducting a due diligence investigation.¹⁸¹

While this represents a real loss in terms of investor protection,¹⁸² both the significance of the reduced effective scope of the 1933 Act and the reduced role of underwriters in performing due diligence on registered offerings has been dwarfed by a counter-vailing development.

The past two decades have witnessed a significant expansion in what must be disclosed by all registrants in their 1934 Act Form 10-K annual reports and by new issuers when they register securities under the 1933 Act. This expansion, in effect, represents a "soft information revolution" in the mandatory disclosure system. Before 1972, the SEC generally only permitted registrants to file historical or "hard" information and generally prohibited projections of future or "soft" information. There were three somewhat

179. See Cohen, *supra* note 147, at 992-95; *supra* text accompanying note 153; see also David M. Green, Comment, *Due Diligence under Rule 415: Is the Insurance Worth the Premium?*, 38 EMORY L.J. 793 (1989); cf. Herb Frerichs, Jr., *Underwriter Due Diligence Within the Integrated Disclosure System — If It Isn't Broken, Don't Fix It*, 16 SEC. REG. L.J. 386 (1989).

180. To be sure, underwriters, in some circumstances, can be held liable for documents incorporated by reference into a registration statement. But the SEC has adopted Rule 176(h), 17 C.F.R. § 230.176(h) (1994), which as a practical matter may obviate the liability of an underwriter when it had no responsibility for the preparation of a document incorporated by reference.

181. Under § 11 of the Securities Act, underwriters can be held liable for material misrepresentations or omissions in a registration statement unless they carry the burden of proving that they conducted a reasonable investigation and had reasonable grounds to believe and did believe that the registration statement was true when it became effective. See Securities Act § 11, 15 U.S.C. § 77(k) (1988). See generally 9 LOSS & SELIGMAN, *supra* note 1, at 4246-78.

182. On the other hand, there are substantial advantages of the integrated disclosure system in terms of reduction of issuer document preparation costs, swifter SEC review of forms such as Form S-3, better registrant control over when to go to the capital markets, and improved quality of 1934 Act reports. Whether these advantages outweigh the likely deterioration in the preparation of some 1933 Act registration statements endures as a pivotal policy question concerning the integrated disclosure system.

overlapping bases for this exclusionary policy. First, the relevant constituency for SEC documents was assumed to be the unsophisticated investor. An Advisory Committee Report on disclosure explained: "The disclosure objective of providing meaningful information to the investment community has, in cases of perceived conflict, been subordinated to the objective of protecting unsophisticated investors from their own ignorance."¹⁸³ Thus, the exclusion of projections was justified as necessary to prevent them from being given undue credence by investors or being manipulated by managers. Second, projections were then viewed not as "facts" but as inherently unreliable. Third, paradoxically, investors were characterized as being just as competent as managers to make projections. The last two points were memorably articulated by Harry Heller, a senior SEC attorney, in a 1961 law review article:

As early as 1904 Veblen expressed the view that the value of an investment basically is a function of future earning power. . . .

. . . .

The question will be raised, if the determination of future earnings is the prime task confronting the investor, why not require or permit a direct prediction of such earnings? The answer to this is that the Securities Act, like the hero of "Dragnet" is interested exclusively in facts. Conjectures and speculations as to the future are left by the Act to the investor on the theory that he is as competent as anyone to predict the future from the given facts. Since an expert can speak with authority only as to subjects upon which he has professional knowledge and since no engineering course or other professional training has ever been known to qualify anyone as a clairvoyant, attempts by companies to predict future earnings on their own or on the authority of experts have almost invariably been held by the Commission to be misleading because they suggest to the investor a competence and authority which in fact does not exist.¹⁸⁴

On these bases, the SEC, in essence, took the view that projections were per se misleading and so stated in a note to one of its proxy rules.¹⁸⁵

By the early 1970s, the SEC's exclusionary policy was under severe criticism. One influential critic was Professor Homer Kripke. In a 1970 law review article, he dismissed the SEC's policy as "non-

183. REPORT OF THE ADVISORY COMM. ON CORP. DISCLOSURE TO THE SEC, HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 95th Cong., 1st Sess. 348 (Comm. Print 1977). See generally *id.* at 344-79, A-265 to A-329.

184. Harry Heller, *Disclosure Requirements under Federal Securities Regulation*, 16 BUS. LAW. 300, 304, 307 (1961) (footnotes omitted).

185. Rule 14a-9, 17 C.F.R. § 240.14a-9 note (1994) (proscribing predictions of specific future market values, earnings, or dividends); see also *Union Pac. R.R. v. Chicago & N.W. Ry.*, 226 F. Supp. 400, 408-10 (N.D. Ill. 1964). The Note was later withdrawn. See Securities Act Release No. 33-5699, 9 SEC Docket 472 (Apr. 23, 1976).

sense.”¹⁸⁶ Noting that “most sizeable corporations use projections of future sales and revenues and capital needs as the basis for making very important decisions as to borrowing, building new plants, establishing new branches, ordering materials, hiring and training labor, etc.,” Kripke urged, “The public is certainly not as able as the management of a corporation to understand the meaning, results and implications of the complex accounting events which have occurred in any dynamic company or of differential rates of improvement or decline in the sales volume and profitability of different product lines.”¹⁸⁷

Thus, a more realistic fear, argued Kripke, was that by prohibiting disclosure of earnings projections, the SEC had perpetuated a form of differential disclosure: “The professionals get management projections informally through press conferences, speeches to analysts’ societies or press releases, and these projections form the basis for professional judgments. Under its present system the SEC precludes the giving of this information equally to all investors through the documents filed with it”¹⁸⁸

By the late 1970s, the SEC reversed its position and adopted safe harbor rules to encourage disclosure of soft information.¹⁸⁹ More significantly, as part of its 1982 integrated disclosure system, the SEC adopted Item 303, which *mandates* management discussion and analysis of known trends or uncertainties concerning a registrant’s liquidity, capital resources, and income.¹⁹⁰ Item 303 is the key part of the evolution of the SEC’s approach to accounting from an emphasis on “hard fact” to its present emphasis on “soft” or predictive information. It is a comprehensive disclosure item. In effect, the SEC staff has employed the concepts of liquidity and capital resources to require managers to comment on material changes that may occur in a registrant’s balance sheet and the concept of results of operations to inspire similar disclosures concerning a registrant’s income statement.

186. See Homer Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1198 (1970).

187. *Id.* at 1197-98.

188. *Id.* at 1199.

189. Rule 175, 17 C.F.R. § 230.175 (1994) (under the 1933 Act); Rule 3b-6, 17 C.F.R. § 240.3b-6 (1994) (under the 1934 Act). See discussion and analysis in 2 LOSS & SELIGMAN, *supra* note 1, at 622-36.

190. Regulation S-K Item 303, 17 C.F.R. § 229.303 (1994); see 2 LOSS & SELIGMAN, *supra* note 1, at 668-72.

In 1989, the SEC published an interpretation release concerning Item 303.¹⁹¹ The release highlighted, among other topics, that the SEC now regarded disclosure of predictive or soft information as mandatory in a wide variety of circumstances.¹⁹² This mandate was still more recently given "teeth" by SEC enforcement actions specifically based on Item 303.¹⁹³

When the changes in the scope of the 1933 Act registration statement requirements and the "soft information" expansion of the disclosure requirements are considered simultaneously, predictions that the SEC's mandatory disclosure system will soon wither or die¹⁹⁴ appear to be premature. To be sure, foreign issuers have declined to be listed on U.S. securities markets because of our more

191. Management's Discussion and Analysis of Financial Condition and Results of Operations; Certain Investment Company Disclosures, Securities Act Release No. 33-6835, 43 SEC Docket (CCH) 1330 (May 18, 1989).

192. The SEC explained the "critical distinction" between mandatory and voluntary disclosure of soft information as follows:

The Project results confirm that the distinction between prospective information that is required to be discussed and voluntary forward-looking disclosure is an area requiring additional attention. This critical distinction is explained in the Concept Release:

Both required disclosure regarding the future impact of presently known trends, events or uncertainties and optional forward-looking information may involve some prediction or projection. The distinction between the two rests with the nature of the prediction required. Required disclosure is based on *currently known trends, events, and uncertainties that are reasonably expected to have material effects*, such as: A reduction in the registrant's product prices; erosion in the registrant's market share; changes in insurance coverage; or the likely non-renewal of a material contract. In contrast, optional forward-looking disclosure involves *anticipating a future trend or event or anticipating a less predictable impact of a known event, trend or uncertainty*.

43 SEC Docket (CCH) at 1333 (relying heavily on Concept Release on Management's Discussion and Analysis of Financial Condition and Operations, Securities Act Release 33-6711, 38 SEC Docket (CCH) 138, 140-41 (Apr. 17, 1987)).

193. In *In re Caterpillar, Inc.*, Securities Act Release No. 34-30,532, 51 SEC Docket (CCH) 147 (Mar. 31, 1992), the SEC issued a cease-and-desist order for Caterpillar's failure to disclose information about its Brazilian subsidiary, CBSA, which was responsible in 1989 for 23% of Caterpillar's net profits although its revenues represented only 5% of the parent company's revenues. The SEC, after explaining that Caterpillar was not required to prepare its consolidated financial statements showing CBSA as either an industry segment or a foreign operation, emphasized: "Since separate information about CBSA was neither required nor provided in Caterpillar's financial statements or the notes thereto, there was little, if any, information in the financial statements or accompanying notes that would inform a reader as to the importance of CBSA's earnings to Caterpillar's overall results of operations." 51 SEC Docket (CCH) at 152. This was required both because the CBSA earnings materially affected Caterpillar's reported income from continuing operations, and because there was a future uncertainty regarding CBSA's operations, as well as a concomitant possible risk of Caterpillar having materially lower earnings as a result of that risk. 51 SEC Docket (CCH) at 152-53.

In *In re Shared Med. Sys. Corp.*, Securities Act Release No. 33-33,632, 56 SEC Docket (CCH) 199 (Feb. 17, 1994), the Commission settled a cease-and-desist proceeding with an issuer that disclosed a known unfavorable trend in sales activity in a February 17, 1987 press release but failed to make the same disclosure in the Management Discussion and Analysis (MD&A) portion of its 1986 Form 10-K annual report or in its first quarter 1987 Form 10-Q.

194. Cf. Winter, *supra* note 19.

demanding disclosure requirements.¹⁹⁵ But the pressure to reduce U.S. disclosure requirements to secure foreign "listings" appears, at least momentarily, to have dissipated in 1993 when Daimler-Benz AG became the first German firm to register in the U.S. securities markets in recent years.¹⁹⁶

Over time, competitive pressure from foreign securities markets will ultimately lead to further changes in the mandatory disclosure system. But, it is as yet uncertain whether future changes will be of a fundamental nature, like the scope reductions represented by Form S-3 and Rule 415, or of a more tinkering nature, such as immaterial changes in U.S. generally accepted accounting principles applicable to foreign registrants.¹⁹⁷ To put this another way, it is no more certain for the foreseeable future that the United States will have to make further fundamental changes in its mandatory disclosure system to retain domestic or foreign securities sales than it is that foreign issuers will have to comply with U.S. standards in order to have access to the U.S. securities markets, currently the world's largest. What the experience with Form S-3 and Rule 415 has taught, however, is that concern that securities sales will be exported remains the most erosive potential element in federal securities regulation.

C. *Municipal Securities Regulation*

It also seems clear that in the foreseeable future there may well be further significant expansion of the SEC's role in one of its largest areas of exemption, municipal securities regulation.¹⁹⁸

195. See Joseph McLaughlin, *Listing Foreign Stocks on U.S. Exchanges: Time to Confront Reconciliation?*, 24 REV. SEC. & COMMODITIES REG. 91 (1991).

196. See Breeden Announces Daimler-Benz Will File to Trade Stock in U.S. Markets, 25 Sec. Reg. & L. Rep. (BNA) 477 (Apr. 2, 1993). Notably, Daimler-Benz agreed to provide financial information prepared in accordance with the United States' generally accepted accounting principles. *Id.* at 478.

In late 1991, the NYSE let it be known that it was drafting a proposal to relax foreign listing standards. Under this proposal, foreign issuers would not have to file financial statements prepared on the basis of accounting principles generally accepted in the United States. Chairman Breeden testified on July 25, 1991, that he opposed this type of "retreat" from U.S. accounting standards. *NYSE Drafting Plan to Boost Listings by Foreign Firms, Despite SEC Opposition*, 23 Sec. Reg. & L. Rep. (BNA) 1754 (Dec. 20, 1991).

197. Cf. Edward F. Greene et al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 BUS. LAW. (forthcoming Feb. 1995) (discussing possible changes in the mandatory disclosure system and advocating an approach giving greater deference to the disclosure systems of foreign countries).

198. See 3 LOSS & SELIGMAN, *supra* note 1, at 1159 ("In contemporary finance, the term *municipal securities* broadly refers to securities issued by states, their political subdivisions such as cities, towns, or counties, or their instrumentalities such as school districts or port authorities."); 3 *id.* at 1159-73; 1 *id.* at 285-307.

Municipal securities are usually categorized into two general types. First, there are general obligation securities that are backed by the taxing power or "full faith and credit" of the issuing governmental unit. Second, there are revenue securities backed solely by the revenues from a specific project such as a port, airport, bridge, or tunnel authority. In recent years, only twenty-five to thirty percent of all municipal securities have been "general obligations"; approximately seventy to seventy-five percent have been revenue bonds.¹⁹⁹ One form of revenue bond, the industrial development or conduit bond, has proved particularly controversial. Industrial development bonds are issued by a local government agency to buy or build a facility or to purchase equipment that a private business firm will then buy on installment or lease over periods that typically run from five to thirty years. The business firm will pay a rent that usually is equal to the amount necessary to pay principal and interest on the bonds. Because the only security for the bonds is the revenue from the lease payments paid by the business firm — or the facility leased by the firm — the SEC in 1978 took the position "that industrial development bonds . . . in substance are obligations of a business enterprise" and therefore "are sufficiently distinct from other municipal securities to warrant treatment under a separate regulatory framework."²⁰⁰

In 1993, the SEC Staff Report on the Municipal Securities Market, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,217 (Sept. 3, 1993) [hereinafter SEC Staff Report], stated: "The municipal securities market comprises approximately 50,000 state and local issuers with an outstanding principal amount of securities in excess of \$1.2 trillion. . . . Approximately 2,600 municipal securities dealers, banks, and brokers actively trade in municipal securities." *Id.* ¶ 84,334.

Later, the Commission added:

In 1993, a record level of over \$335 billion in municipal securities was sold, representing over 17,000 issues. This record financing was heavily influenced by refundings. Nevertheless, the level of long term new money financings, representing 49% of financings for the year, reflected continued growth. In 1993, there were \$142 billion of new money long term financings, compared to \$81 billion in 1988, a 75% increase.

Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 33-7049, 56 SEC Docket (CCH) 479, 480-81 (Mar. 9, 1994).

199. GENERAL ACCOUNTING OFFICE, TRENDS AND CHANGES IN THE MUNICIPAL BOND MARKET AS THEY RELATE TO FINANCING STATE AND LOCAL PUBLIC INFRASTRUCTURE 50 (1983).

200. Letter to Senator Harrison Williams from SEC Chairman Harold Williams, May 1, 1978, reprinted in 124 CONG. REC. 21,639 (July 19, 1978); see also Robert A. Fippinger, *Securities Law Disclosure Requirements for the Political Subdivision Threatened with Bankruptcy*, 10 FORDHAM URB. L.J. 541, 546-47 (1982); Eric M. Hellige, *Industrial Development Bonds: The Disclosure Dilemma*, 6 J. CORP. L. 291 (1981).

Nonetheless, section 3(a)(2) of the 1933 Act exempts virtually all municipal securities.²⁰¹ The near default of New York City securities between 1974 and 1975 and the subsequent default by the Washington Public Power Supply System (WPPSS) after expending \$2.25 billion to construct two nuclear power plants revived the debate as to whether issuers, particularly of industrial revenue bonds, should be subject to a mandatory disclosure system comparable to that for corporate issuers.²⁰²

As the full Commission explained after the 1988 staff report on WPPSS:

[T]he most disturbing aspect of the Supply System problems is that they arose after the New York City Report, after the subsequent voluntary improvements in municipal disclosure, and after most of the additional regulatory actions discussed [elsewhere]. Events such as the Supply System default inevitably focus attention on the adequacy of the current regulation of the municipal securities markets.²⁰³

Moreover, the SEC found that the New York City and WPPSS instances were not isolated:

In the period from 1972 to 1983, there were eleven defaults involving general obligation instruments, 25 defaults involving non-conduit rev-

201. Securities Act § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1988). Industrial development bonds are only exempt if they are tax exempt under § 103 of the Internal Revenue Code.

Over time, the SEC has used its rulemaking authority to tighten its regulation of industrial revenue bonds. Until January 1, 1969, it was the SEC's policy not to object if the issuer obtained an opinion of its own counsel to the effect that these bonds fell within the language of § 3(a)(2). Cf. Missouri Atty. Gen. Op., 1954-1971 Blue Sky L. Rep. (CCH) ¶ 70,322 (1956). But the Commission adopted a pair of definitional rules for bonds sold after that date — Rule 131 under the 1933 Act and Rule 3b-5 under the 1934 Act — in order to identify the interest in the obligation of the private company as a separate "security" issued by the company. See 17 C.F.R. §§ 230.131, 240.3b-5 (1994). Any part of an obligation evidenced by any bond, note, debenture, or other evidence of indebtedness issued by any governmental unit specified in § 3(a)(2) of the 1933 Act or § 3(a)(12) of the 1934 Act and "payable from payments to be made in respect of property or money which is or will be used, under a lease, sale, or loan arrangement, by or for industrial or commercial enterprise" is considered a separate "security" issued by the lessee or obligor. 17 C.F.R. § 230.131 (1994). Loan and sale as well as lease arrangements are covered in recognition of the fact that essentially the same kind of financing plan could be carried out by a governmental body's lending the proceeds of the bonds to private enterprise on a deferred payment basis.

202. 3 LOSS & SELIGMAN, *supra* note 1, at 1162-63. For a discussion of this debate in the period preceding the WPPSS debacle, see 3 LOSS & SELIGMAN, *supra* note 1, at 1163-70.

Regarding the near default in New York City, see SEC, SUBCOMM. ON ECON. STABILIZATION OF THE HOUSE COMM. ON BANKING, FIN. AND URBAN AFFAIRS, 95TH CONG., 1ST SESS., STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK (Comm. Print 1977), summarized in 3 LOSS & SELIGMAN, *supra* note 1, at 1162-63 n.56. Regarding the WPPSS, see Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities, *reprinted in part in* 1988-1989 Fed. Sec. L. Rep. (CCH) ¶ 84,327 (1988); LOSS & SELIGMAN, *supra* note 1, at 289-95 (Supp. 1994) (summarizing the staff report).

203. Report of the Securities and Exchange Commission on the Regulation of Municipal Securities, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶¶ 84,325, 89,436 (Sept. 22, 1988) [hereinafter Report on Regulation of Municipal Securities].

enue bonds, and at least 82 private purpose (conduit) bond defaults. . . . Moreover, the Bond Investors Association indicates that, from 1983 to the first quarter of 1988, over 300 municipal issuers defaulted on their obligations.²⁰⁴

In all, the municipal debt default rate of approximately 0.7% was nearly equal to the corporate debt default rate of 1.1%.²⁰⁵

The SEC and Congress have moved incrementally, but steadily, in the period after the New York City bond crisis and WPPSS default to expand federal securities regulation. First, in 1975 Congress enacted section 15B of the Securities Exchange Act to establish jurisdiction over municipal securities dealers, subject to a self-regulatory organization called the Municipal Securities Rulemaking Board (MSRB).²⁰⁶ Second, in 1990 the SEC approved a rule proposal made by the MSRB to require the mandatory filing of offering statements by municipal issuers.²⁰⁷ Third, the SEC adopted Rule 15c2-12, which makes it unlawful for any broker, dealer, or municipal securities dealer to act as underwriter in a primary municipal securities offering with an aggregate offering price of \$1 million or more unless (i) before bidding for or buying the securities it obtained and reviewed an official statement that was complete except for certain transaction-related data; (ii) it forwarded copies of the official statement to any potential customer on request; (iii) it obtained final copies of the official statement within seven business

204. *Id.* ¶ 89,436 n.57 (citation omitted).

205. PUBLIC SEC. ASSN., MUNICIPAL SECURITIES DISCLOSURE TASK FORCE REPORT: INITIAL ANALYSIS OF CURRENT DISCLOSURE PRACTICES IN THE MUNICIPAL SECURITIES MARKET (1988), cited in Report on Regulation of Municipal Securities, *supra* note 203, ¶ 89,437 n.58.

206. Securities Act Amendments of 1975, Pub. L. No. 94-29, § 15B(b)(1), 89 Stat. 97, 132. See generally 6 LOSS & SELIGMAN, *supra* note 1, at 3086-95.

207. Order Approving Proposed Rule Change Relating to the Delivery of Official Statements and Recordkeeping, Exchange Act Release No. 34-28081, 46 SEC Docket (CCH) 563 (June 1, 1990). The following year, the SEC approved a further rule change to permit the MSRB to establish and operate a central electronic facility, the Municipal Securities Information Library, through which information collected pursuant to MSRB Rule G-36 would be made available electronically to market participants and information vendors. Order Approving Proposed Rule Change of the MSRB Relating to the Proposed Operation of the Official Statement and Advance Refunding Document, Exchange Act Release No. 34-29298, 49 SEC Docket (CCH) 34, 34 (June 13, 1991). In 1991, Rule G-36 was amended also to require underwriters to deliver advance refunding documents to the MSRB. Order Approving Proposed Rule Change Relating to the Delivery of Advance Refunding Documents, Exchange Act Release No. 34-29299, 49 SEC Docket (CCH) 50 (June 13, 1991).

In April of 1992, the SEC approved a MSRB proposal to establish and operate the Continuing Disclosure Information Pilot System, which — functioning as part of the Library — will “accept and disseminate voluntary submissions of official *continuing disclosure* documents relating to outstanding issues of municipal securities.” Order Approving Proposed Rule Change of the MSRB Relating to the Proposed Operation of the Continuing Disclosure Information Pilot System, Exchange Act Release No. 34-30556, 51 SEC Docket (CCH) 231, 232 (Apr. 6, 1992) (emphasis added).

days after any final agreement to buy or sell the municipal securities; and (iv) it forwarded copies of the final official statement to any potential customer from the time the final official statement became available until the earlier of ninety days from the end of the underwriting period or the time when the official statement was available to any person from a nationally recognized municipal securities information repository, but in no case less than twenty-five days after the end of the underwriting period.²⁰⁸ Along with this rule, the SEC published interpretative commentary emphasizing the obligation of a municipal underwriter to have a reasonable basis for recommending any municipal securities and its responsibility in fulfilling that obligation to review in a professional manner the accuracy of offering statements with which it is associated.²⁰⁹ These are roughly the same due diligence requirements applicable to corporate issuers under section 11 of the 1933 Securities Act.²¹⁰

Fourth, in 1993, after a spate of allegations of illegal payoffs and influence peddling, Congressmen Dingell and Markey requested an SEC Statement regarding whether the "Tower Amendment" in sections 15Bd(1)-(2) of the 1934 Act²¹¹ — prohibiting 1933-Act type disclosure documents from being filed *before* a municipal issuance — should be repealed in whole or in part.²¹² An earlier SEC staff report appeared to sympathize with this proposal.²¹³ Subsequently, in 1994, the SEC published statements indicating an intent to

208. Municipal Securities Disclosure, Exchange Act Release No. 34-34961, 57 SEC Docket (CCH) 2994 (Nov. 17, 1994) (amendments to Rule 15c2-12); Municipal Securities Disclosure, Exchange Act Release No. 34-26985, 43 SEC Docket (CCH) 1880 (June 28, 1989) (adopted rule); Municipal Securities Disclosure, Exchange Act Release No. 34-26100, 41 SEC Docket (CCH) 1131 (Sept. 22, 1988) (proposed rule).

209. 43 SEC Docket (CCH) at 1898-900; *see also* 41 SEC Docket (CCH) at 1148-49.

210. Securities Act § 11, 15 U.S.C. § 77k (1988); *see supra* note 181 and accompanying text.

211. Securities Act Amendments of 1975, sec. 13, § 15B(d), 89 Stat. 97, 137 (codified at 15 U.S.C. § 78o-4(d) (1988)) (amending § 15 of the Exchange Act).

212. *Congressmen Ask SEC to Review Municipal Securities Regulation*, 25 Sec. Reg. & L. Rep. (BNA) 787 (June 4, 1993).

213. The SEC Staff Report on the Municipal Securities Market, [1993 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,217 (Sept. 15, 1993), while finding that "the municipal market generally functions in an effective manner," *id.* ¶ 84,333, nonetheless identified "significant areas where improvements can be made," *id.* With respect to municipal issuer disclosure, the report stated:

—Because of the voluntary nature of municipal issuer disclosure, there is a marked variance in the quality of disclosure, during both the primary offering stage and in the secondary market. The Staff believes that voluntary efforts to increase disclosure in the municipal securities market, while constructive, have not resulted in complete and comprehensive disclosure of the financial condition of issuers of municipal securities.

—In the Staff's view, comprehensive improvement of the existing system would require Congressional action. Congress could provide the Commission with specific statutory authority to set disclosure standards for municipal issuers, or even rescind the exempt status of municipal bonds under the Securities Act and the Exchange Act,

tighten municipal disclosure requirements further, either through legislation or through rulemaking.²¹⁴

Proposals of this type, if adopted, would go far toward applying a mandatory disclosure system to the municipal securities market. Underlying this evolution toward greater federal securities regulation has been a notable change in investors of municipal securities. As a 1993 SEC staff report explained:

The profile of the typical investor in municipal securities also has changed dramatically over this century. Historically, investors in municipal bonds were institutions and wealthy individuals wishing to take advantage of the tax-exempt status of fairly low-risk municipal securities. The interest received by holders of most municipal securities was exempt from federal income taxation, and in some cases, from state and local income taxation, and thus was very attractive to taxpayers in higher tax brackets. With the changing income tax rates, persons of more moderate means increasingly have invested in municipal securities. Today, households are the largest holders of municipal debt, followed by municipal bond mutual funds, property and casualty insurers, commercial banks, and money market funds.²¹⁵

thereby subjecting them to the registration and continuous reporting obligations applicable to corporate and foreign government bond issuers.

—If Congress chooses not to provide the Commission with full authority to create comprehensive and complete disclosure in this area, the Commission could explore ways to improve initial and secondary market disclosure, to the extent possible, under its existing authority.

—The Staff strongly believes, however, that any Commission action in this area could not fully address existing disclosure problems. Comprehensive improvements to the existing system would require legislation. At a minimum, the Staff supports across-the-board registration of corporate obligations underlying conduit bonds so as to assure equal regulatory treatment of corporate obligations whether or not such obligations nominally are issued through a municipal entity.

Id. ¶¶ 84,333-34.

214. In 1994, the SEC published a detailed Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 33-7049, 56 SEC Docket (CCH) 479 (Mar. 9, 1994). While praising voluntary disclosure guidelines issued by the Government Finance Officers Association and the National Federation of Municipal Analysts, *see id.* at 484, 491, 493-94, and noting that 46 states currently require, or are in the process of establishing a requirement, that state government financial statements be prepared in accordance with generally accepted accounting principles (GAAP), as determined by the Government Accounting Standards Board (GASB), *id.* at 486-87, the SEC found that "there continue to be concerns with the adequacy of municipal offering disclosure, particularly with respect to offerings of non-general obligation bonds and smaller issues," *id.* at 482. *See generally id.* at 482-83.

Accordingly, this interpretative release addressed four topics, including the following:

(2) The Commission is renewing its recommendation for legislation to repeal the exemption for corporate obligations underlying certain conduit securities from the registration and reporting requirements of the federal securities laws.

(3) Particularly because of their public nature, issuers in the municipal market routinely make public statements and issue reports that can affect the market for their securities; without a mechanism for providing ongoing disclosures to investors, these disclosures may cause the issuer to violate the antifraud provisions . . .

Id. at 480.

215. SEC Staff Report, *supra* note 198, ¶ 84,335 (footnotes omitted).

In essence, just as a growth in individual investor interest in corporate securities may have been the key dynamic in prompting and sustaining interest in a mandatory disclosure system, similar interest in tax-exempt municipal securities appears to have fueled a more recent enthusiasm for greater federal mandatory municipal securities regulation disclosure.

III. CONCLUSION

Ultimately, the resolution of the boundaries of federal securities regulation will involve a complex interplay of contextual and political factors. What is clear is that no single dynamic will be decisive in all applications. The enormous expansion of individual investor interest in corporate and, more recently, municipal securities may long check the countervailing preserves for erosion of mandatory standards associated with institutional investor interest and competitive foreign securities markets. Erosion of standards in one area — such as the 1933 Act — may well be concomitant with expansion or cognate standards — such as the periodic mandatory disclosure requirements under the 1934 Act. What does seem probable is that for the foreseeable future, while change may occur at the margins of federal securities regulation, the enduring need to remediate information asymmetries will keep core areas of this regulation intact.