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MATERIALITY, LAW REFORM, AND REGULATION BY PROSECUTION†

Michael Rosenzweig*

REGULATION BY PROSECUTION: THE SECURITIES & EXCHANGE COMMISSION VERSUS CORPORATE AMERICA. By *Roberta S. Karmel*. New York: Simon and Schuster. 1982. Pp. 400. \$20.75.

There has never been a paucity of criticism of the Securities and Exchange Commission or the laws it administers. Given the Commission's crucial role in ensuring the proper functioning of our securities markets, this is as it should be. Indeed, Congress and the Commission have both recognized the value of such criticism, frequently responding with appropriate amendments to the federal securities laws or important changes in enforcement or regulatory policy.

In light of this tradition of legislative and administrative responsiveness to thoughtful criticism, students of securities regulation are likely to approach with particular interest a book like *Regulation by Prosecution*. Written by Roberta S. Karmel, who gained a reputation for eloquence and resolve in a series of dissents to Commission actions during her tenure as a Commissioner,¹ the book holds promise as an important critique of the SEC, an insider's considered view of the appropriate direction for review and reform of Commission policies.

Unfortunately, that promise is never fulfilled. *Regulation by Prosecution* is a badly conceived, poorly structured and ultimately confusing work. Karmel's focus is fuzzy and shifting, leaving the reader uncertain of her thesis for most of the book. Moreover, when Karmel does finally reveal the crux of her argument, it is apparent that she has failed to make her case. In the end, this is a profoundly disappointing book, unworthy of a lawyer of Karmel's considerable talents.

† I wish to thank Lee Bollinger, Alfred Conard, Douglas Kahn, Cyril Moscow, Terrance Sandalow, Frederick Schauer, and Christina Whitman for their thoughtful comments on an earlier draft. I also benefited from conversations with Dennis Ross and Philip Soper.

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1. Commissioner Karmel served from 1977 to 1980. Her eighteen published dissents are listed in Appendix "C" of the book, at pages 347-48.

I

In her opening chapter, "The Crisis of Liberal Values," Karmel sets out what appears to be the thesis of her book: "[O]ver the past few decades the Commission has permitted its prosecutorial function to upset its balance as a regulator, and to impair its ability to reformulate its mandate for the politics and economy of the 1980s" (p. 17). Readers familiar with Karmel's dissenting opinions as a Commissioner, particularly in section 21(a)² and rule 2(e)³ proceedings, will immediately recognize this theme. Indeed, such readers likely will have been attracted to the book by the prospect, fortified by its title, that Karmel intends to extend and broaden the provocative criticisms of the Commission that she first advanced in those opinions. This, in short, is to be the author's "brief against the SEC's prosecutorial orientation" (p. 16), an argument that the Commission's adversarial approach to securities regulation has led to the sort of confusion and uncertainty one expects when an administrative agency "formulat[es] regulatory policy through the prosecution of enforcement cases" (p. 95).

Had Karmel succeeded in presenting a coherent exposition of this theme, the book would have been valuable to scholars as well as practitioners of securities law. There is much to her claim that "regulation by prosecution" is unfair and misguided, and a careful development of that argument would have been welcome. Regrettably, Karmel's treatment of this theme is far from careful; moreover, it later becomes apparent that Karmel actually writes to chide Congress, not the Commission, for failing to adopt a "more promotional

2. SEC Release No. 34-15664, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,014 (Mar. 21, 1979); SEC Release No. 34-15665, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,015 (Mar. 21, 1979); SEC Release No. 34-15719, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,049 (Apr. 11, 1979); SEC Release No. 34-15746, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,058 (Apr. 18, 1979); SEC Release No. 34-16321, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,341 (Nov. 5, 1979); SEC Release No. 34-16343, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,352 (Nov. 15, 1979).

Section 21(a) of the 1934 Act, 15 U.S.C. § 78u(a) (1982), authorizes the Commission to investigate possible violations of the 1934 Act, rules or regulations thereunder, and certain rules of securities exchanges, registered securities associations, registered clearing agencies and the Municipal Securities Rulemaking Board, and to publish information concerning such violations.

3. SEC Release No. 34-15982, [1979 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,124 (July 2, 1979); SEC Release No. 33-6105 (Aug. 15, 1979), 18 SEC DOCKET 64 (1979); SEC Release No. 34-16225, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,334 (Sept. 27, 1979); SEC Release No. 34-16448 (Dec. 21, 1979), 19 SEC DOCKET 12 (1980); SEC Release No. 34-16479, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,446 (Jan. 10, 1980).

Under Rule 2(e) of the SEC's Rules of Practice, 17 C.F.R. § 201.2(e) (1983), the Commission may implement administrative proceedings to deny lawyers or accountants the ability to practice before the SEC because of (1) failure to possess the "requisite qualifications to represent others," (2) failure to maintain a proper level of "character or integrity," (3) involvement in "unethical or improper professional conduct," or (4) willful violation (or willful aiding and abetting of a violation) of any provision of the federal securities laws or the rules and regulations thereunder. 17 C.F.R. § 201.2(e)(1)(i), (ii), (iii) (1983).

regulatory attitude" that would equate "investor protection . . . with capital formation" (p. 297). After castigating the Commission for most of the book, Karmel's unexpected turn blunts her earlier criticism, and leaves the reader wondering about her true objectives. The result is less than satisfactory; we know that Karmel is irate, but it is not clear why, nor can we be certain that her indignation is justified.

Before considering Karmel's shifting focus, let us examine her "brief" against the Commission, which occupies nearly two-thirds of the book.⁴ Karmel cites four examples of so-called "misguided prosecutorial regulation" (p. 99) by the Commission: (1) its promotion of a "national market system";⁵ (2) its role in the "corporate governance" movement;⁶ (3) its enthusiasm for "jurisdictional expansionism";⁷ and (4) its responsibility for the "erosion" of materiality as a disclosure standard.⁸ None of these is a compelling illustration of undue prosecutorial orientation.

Consider, for example, the Commission's efforts to foster a national market system. In the Securities Acts Amendments of 1975,⁹ Congress delegated to the Commission responsibility for facilitating "a nationwide interactive market system"¹⁰ for the trading of securities. As Karmel acknowledges, the Commission has not attempted to design and implement a national market system, choosing instead to rely on "self-regulation and evolutionary change as a way to permit marketplace forces to determine [the system's] important contours" (p. 111).¹¹ Karmel criticizes this approach as an example of "prosecutorial regulation" (p. 99), but never reveals precisely how

4. Roughly speaking, I refer here to chapters three through seven, pages 77 through 247.

5. Chapter four, pp. 101-38.

6. Chapter five, pp. 139-86.

7. Chapter six, pp. 187-229. In this chapter, Karmel criticizes the Commission for "prosecuting cases in which its jurisdiction is questionable," p. 189, addressing the growth of implied remedies, the relationship between federal and state securities regulation, the extraterritorial application of the federal securities laws, the SEC's use of consent injunctions, and practice regarding so-called Wells submissions (submissions to the Commission staff by prospective defendants or respondents in an effort to dissuade the staff from prosecuting). I do not deal separately with this discussion, principally because it may be criticized on essentially the same grounds as Karmel's treatment of the other three examples she cites. Her argument that this is "regulation by prosecution" is unconvincing, and much of her analysis is simply careless.

8. Chapter seven, pp. 230-47.

9. Securities Exchange Act of 1934, § 11A(a)(2), 15 U.S.C. § 78k-1(a)(2) (1982). See generally R. JENNINGS & H. MARSH, *SECURITIES REGULATION* 8-11, 492-97 (5th ed. 1982); Poser, *Restructuring the Stock Markets: A Critical Look at the SEC's National Market System*, 56 N.Y.U. L. REV. 883 (1981).

10. SEC Release No. 34-13662 (June 23, 1977), 12 SEC DOCKET 947, 952 (1979).

11. Congress also avoided precise definition of the national market system. Thus, section 11A(a)(2) merely requires the Commission to promote a trading system in furtherance of certain enumerated objectives:

- (i) economically efficient execution of securities transactions;
- (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets;

"the Commission has tended to look and think like a prosecutor" (p. 106) in promoting a national market system.¹² In short, her criticisms of the Commission's efforts to create a national market system are simply irrelevant to her thesis. She is unlikely to move the reader with her unsupported conclusion that the SEC's "prosecutorial orientation . . . has merely served to obfuscate the regulatory character of the national market system that is promotional" (p. 112).¹³

Karmel's discussion of the SEC's role in the "corporate governance" movement (chapter 5) is similarly flawed. Karmel focuses on the Commission's position with respect to management fraud and "sensitive" payments (tracing the enactment of the Foreign Corrupt Practices Act of 1977)¹⁴, its well-publicized corporate governance hearings and the rule-making initiatives that grew out of those hearings, and its view of the proper role of corporate counsel.¹⁵ In each instance, except perhaps the last,¹⁶ Karmel fails to persuade the

(iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities;

(iv) the practicability of brokers executing investors' orders in the best market; and

(v) an opportunity . . . for investors' orders to be executed without the participation of a dealer.

Securities Exchange Act of 1934 § 11A(a)(1)(C), 15 U.S.C. § 78k-1(a)(1)(C) (1982).

12. Indeed, Karmel concedes that her "real quarrel is not with the Commission or its staff, but with the Congress, which passed the Securities Acts Amendments of 1975." P. 102. But the reader is left to speculate about the nature of her "real quarrel." One might imagine Karmel disparaging Congress for affording so central a role to a law enforcement agency with an "historical prosecutorial orientation," p. 103, but she evidently recognizes that "government agencies with primarily prosecutorial functions seem better able to maintain the public's confidence than agencies that are promotional." P. 109. Nor does she offer any examples of the "vigorous prosecutorial response," p. 109, that she attributes to the Commission in its discharge of Congress' mandate.

13. As this passage indicates, Karmel's claims are also somewhat difficult to fathom at times. Additional examples abound. For instance, she argues that the "specifications of [a national market system] essentially are operational design matters [that] should not be decided by a lawyer dominated government agency," pp. 109-10, yet fails to recognize that her own observations about the Commission's reliance on "self-regulation and evolutionary change," p. 110, largely belie this criticism.

In fact, so confused is Karmel that one is unsure whether her final observations in this section of the book are critical or laudatory:

[W]hile I believe that the SEC should become more understanding and more cooperative in its relations with the securities industry, I also believe that the Commission has neither the resources nor the expertise to engage in classical promotional regulation of the economic structure and development of the securities markets. Further, I believe that the Commission's search for new programs and precedents in such controversial areas as corporate governance is due partly to a transformation of the SEC's role as a policeman of the securities industry to a role that is more promotional.

P. 138. Throughout most of the rest of the book, Karmel argues in *favor* of the "transformation" she appears to decry here. Is the Commission to be praised or disparaged for its attempts to become "more promotional"?

14. Pub. L. 95-213, 91 Stat. 1494 (1978) (codified at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78ff (1982)).

15. It is with respect to the last question that Karmel is perhaps best known, mainly for her dissents to Rule 2(e) proceedings by the Commission. See note 3 *supra*.

16. Karmel attacks the Commission's use of civil litigation and especially administrative

reader that the Commission's orientation was unduly "prosecutorial." Moreover, her criticisms of the Commission on other grounds are superficial at best.

Karmel's objections to the Commission's corporate governance program derive essentially from her claim that the Commission has ignored the basic tenet that the securities laws are "disclosure rather than standard-setting provisions" (p. 140). Thus, she argues that the Commission's decision in the late 1960's and early 1970's to require disclosure of "questionable payments and management fraud" represented an attempt to curb particular behavior by corporations and their agents rather than an effort to provide shareholders and investors with useful information. She asserts that "the obfuscation of [the] conflict between economic and social values has caused corporate governance reform proposals to be premised on the erroneous assumption that the interests of management and shareholders are antagonistic" (p. 143),¹⁷ and upbraids the Commission for its belief that "economic and social values" do not necessarily conflict. In other words, she apparently rejects the notion that, *long-run* profit

proceedings under Rule 2(e) of its Rules of Practice, 17 C.F.R. § 201.2(e) (1983), to promote greater lawyer responsibility. Pp. 173-83. This discussion, summarizing arguments she made in an earlier article, Daley & Karmel, *Attorneys' Responsibilities: Adversaries at the Bar of the SEC*, 24 EMORY L.J. 747 (1975), and as a Commissioner in a series of dissents to Rule 2(e) proceedings, *see* note 3 *supra*, is forceful and persuasive. Thus, she convincingly questions Commission authority to set standards of professional conduct for lawyers, and notes the dangers of the Commission's program: SEC discipline of lawyers threatens "government conscription of corporate counsel as a 'civil policeman' to disclose confidences and enforce the law," p. 183, and undermines the lawyer-client relationship and the goal of disclosing *material* information by encouraging lawyers to resolve all doubtful cases in favor of disclosure.

The SEC's Division of Enforcement has dramatically curtailed actions against lawyers since 1981. Whether in response to the increasingly vocal criticisms its policies provoked, *see, e.g.*, Downing & Miller, *The Distortion and Misuse of Rule 2(e)*, 54 NOTRE DAME LAW. 774 (1979); Klein, *The SEC and the Legal Profession: Material Adverse Developments*, 11 INST. ON SEC. REG. 597 (Practising Law Institute) (1979); Marsh, *Rule 2(e) Proceedings*, 35 BUS. LAW. 987, 991, 996 (1980); Note, *SEC Disciplinary Proceedings Against Attorneys Under Rule 2(e)*, 79 MICH. L. REV. 1270 (1981), or for other reasons, *see* note 35 *infra*, this development marks a sensible change in enforcement policy.

17. Karmel relies on Werner, *Management, Stock Market and Corporate Reform: Berle and Means Reconsidered*, 77 COLUM. L. REV. 388, 414 (1977). Professor Werner argues that management and shareholders have an identity of interest in corporate profit maximization, owing partly to the constraints imposed on management by markets such as the market for corporate control. He implies that this identity of interest helps foster investor confidence in the capital markets, which might diminish were management required to pursue goals that could conflict with profit maximization, such as corporate social responsibility. He asserts, in other words, that the market constraints that help "keep management in line" would less effectively enhance investor confidence were management obliged to follow a course adverse to profit maximization.

Karmel apparently believes that requiring disclosure of economically immaterial information similarly threatens the capital markets, but fails to recognize the irrelevance to her argument of the market constraints that are so central to Professor Werner's point. That is, even if one agrees with Professor Werner that those market constraints are ineffective in promoting management pursuit of goals other than profit maximization (a question beyond the scope of this review), it does not follow that mandating disclosure of economically insignificant information is inappropriate. *See* notes 29-54 *infra* and accompanying text.

being the ultimate goal of the corporation, there is no necessary clash between corporate profitability and corporate social responsibility:¹⁸

[T]he SEC should be thinking about corporate governance in terms of the needs of corporate America to raise capital in order to increase productivity to more effectively deliver jobs, goods and services in the increasingly competitive international marketplace. The Commission should stop worrying about how to improve corporate morality and social responsibility and start worrying about how to encourage the public to put dollars into savings and investment instead of consumption. [P. 145].

Although Karmel recognizes that “a component of investor confidence is faith in the honesty and integrity of business” (p. 146, emphasis added), she reveals a rather limited understanding of the obvious relationship between “improv[ing] corporate morality and social responsibility” and “encourag[ing] the public to put dollars into savings and investment” (p. 145). Thus, she evidently believes that the mere absence of outright fraud by corporate management suffices to foster investor confidence, leading her to criticize the Commission too harshly for its enforcement activity against behavior which is less than fraudulent:

[T]he reason why the SEC’s initiatives regarding corporate governance have been at best confused, and often misguided, is that the Commission’s management fraud program of the 1970s lost sight of the economic orientation of investors and became a political adventure. This occurred when the SEC made a transition from management fraud cases involving self-dealing to management integrity cases based on poor corporate citizenship. [P. 146].

This view ultimately derives from Karmel’s position regarding the linchpin concept of “materiality” in the disclosure system that has evolved under the federal securities laws.¹⁹ Indeed, her criticisms

18. See, e.g., J. GALBRAITH, *THE NEW INDUSTRIAL STATE* 167-73 (3d ed. 1978); J. SEARS, *THE NEW PLACE OF THE STOCKHOLDER* 209 (1929); *SEC Chairman Williams Warns Business: Clean Up Your Act*, *NATION’S BUSINESS*, Sept. 1980, at 57, 58.

Of course, scholars have argued about this question since at least the early 1930’s, when Professors Dodd and Berle debated the point in their famous *Harvard Law Review* exchange. See Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932). See also A. BERLE, *THE 20TH CENTURY CAPITALIST REVOLUTION* 169 (1954); Weiner, *The Berle-Dodd Dialogue on the Concept of the Corporation*, 64 COLUM. L. REV. 1458 (1964); *PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS* § 2.01 (Tent. Draft No. 1, 1982).

19. See notes 20-26 *infra* and accompanying text.

By focusing on disclosure policy, Karmel ignores the larger issues of “corporate social responsibility” that she herself mentions (*Is there a conflict between economic and social values? Is corporate social responsibility consistent with corporate profitability?*), and confusingly implies that the Commission’s disclosure philosophy and recent “corporate governance reform proposals” raise similar questions. See note 17 *supra* and accompanying text. Moreover, as I suggest below, her criticisms of SEC disclosure policy are themselves misguided, mainly because they rest on an overly narrow view of the “materiality” concept. That is, Karmel assumes without much discussion that investors have no legitimate interest in non-economic matters. Because she never seriously defends the validity of that assumption, her analysis begs

of the Commission's use of disclosure rules to promote corporate governance reform are essentially repeated, with somewhat greater amplitude, in a later chapter in which she describes "the erosion of materiality" (p. 230) as a separate example of "regulation by prosecution." Because Karmel's views regarding materiality therefore produce two of her four illustrative cases of "misguided prosecutorial regulation," it is appropriate that they be examined in some detail.

II

The federal securities laws, of course, require the disclosure of certain specified information, as well as other information that is "material" to investment and voting decisions.²⁰ Obviously, the key question in determining whether a disclosure obligation has been breached, assuming that disclosure of the item in question is not specifically required by statute, rule or form,²¹ is therefore the question of materiality.

one of the central questions in the ongoing debate regarding materiality. See notes 29-63 *infra* and accompanying text. One wonders whether a willingness to address the important issues she avoids would have led Karmel to a different understanding of SEC disclosure policy. Compare Werner, *supra* note 17.

20. See Securities Act of 1933 § 5, 15 U.S.C. § 77e (1982) (registration and prospectus requirements in connection with public offerings of securities); § 17(a), 15 U.S.C. § 77q(a) (1982) (prohibiting fraud in offer or sale of securities); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b) (1982) (prohibiting manipulative or deceptive practices in purchase or sale of securities); § 13(a), 15 U.S.C. § 78m(a) (1982) (annual and periodic reporting requirements); § 13(e), 15 U.S.C. § 78m(e) (1982) (requirements for issuer tender offers); § 14(a), 15 U.S.C. § 78n(a) (1982) (requirements for proxy solicitations); § 14(d), 15 U.S.C. § 78n(d) (1982) (requirements for tender offers by other than issuer); § 14(e), 15 U.S.C. § 78n(e) (1982) (prohibiting fraud in tender offers); see also SEC Rules 10b-5, 17 C.F.R. § 240.10b-5 (1983); 14a-9, 17 C.F.R. § 240.14a-9 (1983).

21. Through its authority to promulgate rules and forms, the Commission imposes specific affirmative disclosure requirements that apply in a variety of settings. These, of course, are the disclosures routinely required in 1933 Act registration statements, tender offer materials, and the like. See, e.g., Securities Act of 1933 § 7, 15 U.S.C. § 77g (1982) (SEC authority to promulgate rules or regulations regarding content of registration statement); Securities Exchange Act of 1934 § 12(b)(1), 15 U.S.C. § 78l(b)(1) (1982) (SEC authority to require issuers having securities traded on a national securities exchange to file registration containing such information as may be necessary or appropriate in the public interest or for the protection of investors); § 12(g)(1), 15 U.S.C. § 78l(g)(1) (1982) (same regarding issuers having total assets exceeding \$1,000,000 and a class of equity securities held by five hundred or more persons) (By rule, § 12(g)(1) now applies only to issuers having total assets exceeding \$3,000,000. See SEC Rule 12g-1, 17 C.F.R. § 240.12g-1 (1983).); § 13(a), 15 U.S.C. § 78m(a) (1982) (SEC authority to prescribe information required to be disclosed in annual and periodic reports by issuers of securities registered under section 12); § 13(d)(1), 15 U.S.C. § 78m(d)(1) (1982) (SEC authority to prescribe information required to be disclosed by persons owning more than five percent of any equity security registered under section 12); § 13(e)(1), 15 U.S.C. § 78m(e)(1) (1982) (SEC authority to prescribe information required to be disclosed in connection with issuer tender offers); § 14(a), 15 U.S.C. § 78n(a) (1982) (SEC authority to promulgate rules and regulations regarding the solicitation of proxies in respect of securities registered under § 12, as necessary or appropriate in the public interest or for the protection of investors); § 14(d)(1), 15 U.S.C. § 78n(d)(1) (1982) (SEC authority to prescribe information required to be disclosed by tender offerors).

There is little dispute regarding the articulated test of materiality under the federal securities laws. SEC Rule 405,²² promulgated under the 1933 Act, defines as material "those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered." In the context of a proxy solicitation, the Supreme Court has held that a fact is material if

there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. . . . Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.²³

Materiality is often easy to discern and uncontroversial. Thus, information of financial significance because of its impact on such items as a company's earnings, assets or liabilities generally must be disclosed under traditional quantitative notions of materiality.²⁴ In enacting the federal securities laws, Congress plainly intended to require the disclosure of information having economic significance for investors and shareholders.²⁵ Indeed, there has never been any serious doubt that Congress perceived "the primary interest of investors [to be] economic."²⁶ Accordingly, no one has ever questioned the obligation to disclose *economically material* information; that obligation is at the very core of the securities laws.

Karmel argues, however, that the Commission has "eroded" the materiality concept, revealing the agency's lamentable inclination to "formulat[e] regulatory policy through the prosecution of enforcement cases" (p. 95). She relies on three illustrations to support this claim: (1) the Commission's insistence on standards of "qualitative," as distinguished from merely "quantitative" materiality (p. 233); (2) the Commission's related tendency to require disclosure of regula-

22. 17 C.F.R. § 230.405 (1983). See also SEC Rule 12b-2, 17 C.F.R. § 240.12b-2 (1983) (substantially identical definition of materiality under 1934 Act).

23. *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (footnote omitted). The courts have also applied this standard in non-proxy settings. See, e.g., *Santa Fe Indus. v. Green*, 430 U.S. 462, 474 n.14 (1977); *Kidwell ex rel. Penfold v. Meikle*, 597 F.2d 1273, 1293 n.9 (9th Cir. 1979); *Goldberg v. Meridor*, 567 F.2d 209, 218-19 (2d Cir. 1977), *cert. denied*, 434 U.S. 1069 (1978).

24. See, e.g., SEC Release No. 33-5627, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,310 (Oct. 14, 1975); SEC Release No. 33-5704, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,495 (May 6, 1976).

25. H.R. REP. NO. 85, 73d Cong., 1st Sess. 4 (1933) (House Report accompanying 1933 Act); S. REP. NO. 792, 73d Cong., 2d Sess. 10 (1934) (Senate Report accompanying 1934 Act).

26. SEC Release No. 33-5627, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,310, at 85,721 (Oct. 14, 1975):

After all, the principal, if not the only reason why people invest their money in securities is to obtain a return. A variety of other motives are [sic] probably present in the investment decisions of numerous investors but the only common thread is the hope for a satisfactory return, and it is to this that a disclosure scheme intended to be useful to all must be primarily addressed.

tory violations by issuers;²⁷ and (3) the Commission's promotion of shareholder proposals and the inclusion of those proposals in issuer proxy statements.²⁸

On the subjects of qualitative and quantitative materiality and the SEC's position regarding disclosure of regulatory violations,²⁹ Karmel argues that the Commission has erred by "too frequently permitt[ing] materiality concepts to be developed through the prosecution of enforcement cases dealing with management integrity and regulatory violations, without any conceptual linkage of such concepts to a materiality standard usable in financial reporting" (p. 231). She also faults the Commission for "substitut[ing] moral for economic or legal materiality" (p. 234), which she apparently believes followed the agency's refusal to recognize that the "investor is an economic, rather than a political or philosophical creature. . . . Investors are concerned about a good return on their investment" (p. 235).

But these claims beg the question. Karmel assumes without analysis that qualitatively significant information is not important to investors, and proceeds to criticize the Commission for mistakenly asserting securities law violations for failure to disclose such information. The question worth addressing, of course, is the one Karmel ignores: *Should* information having no immediate quantitative or economic impact on a company's financial position nonetheless be deemed material in certain circumstances? That is, are there

27. Karmel's disapproval of these requirements is apparent from her consequent characterization of the Commission as "the policeman for Washington . . . more concerned about improving business morality and imposing liability on public corporations than it is concerned about investor preferences and the capital formation process." P. 238.

28. Karmel criticizes the Commission for assuming the role of "political activist," arguing that "[i]n its decision to permit shareholder proposals to be included in issuer proxy soliciting materials, the Commission has made no effort to enforce a materiality standard." P. 245. *See* note 63 *infra*.

29. The Commission's position with respect to these matters is changing. In remarks made recently before an American Bar Association group, John M. Fedders, Director of the SEC's Division of Enforcement, observed that "the Commission generally should not utilize the antifraud provisions of the securities laws for law enforcement where there is a failure to disclose conduct which may be considered qualitatively material. . . . If unlawful conduct could not have a material economic effect on a corporation, it is not likely to be considered important by a reasonable investor contemplating an investment or voting decision." Speech by John M. Fedders on Failure to Disclose Illegal Conduct, 14 SEC. REG. L. REP. (BNA) 2057, 2057-58 (1982) [hereinafter cited as Fedders Speech]. Fedders' comments, coming soon after the Commission's well-publicized decision not to bring enforcement proceedings against Citicorp for its alleged violations of foreign banking and tax laws, *see* Freeman, *The SEC and the Citicorp Case: The Legal Issue of Materiality*, NATL. L.J., Nov. 15, 1982, at 20; Gerth, *SEC Overruled Staff on Finding that Citicorp Hid Foreign Profits*, N.Y. Times, Feb. 18, 1982, at A1, evidently repudiate the notion that information bearing on management's integrity or other qualitatively significant matters may be material to investors without regard to such information's quantitative impact on a company's financial position. *See also* Schneider, *Qualitative and Other Soft Information Disclosures*, 15 INST. ON SEC. REG. 35, 50-55 (Practising Law Institute) (1983); Tyler, *Ambiguous Rules Prevented Mobil Disclosure, Ex-Aide at SEC Says*, Wash. Post, Feb. 9, 1982, at A6. Karmel's view of disclosure is not significantly different.

circumstances in which such information is likely to be important to the reasonable investor or shareholder?³⁰ It is that question — what information is important to investors? — that lies at the core of the materiality debate, and Karmel's critique of Commission enforcement activity is sound only to the extent one accepts her underlying characterization of investors and her corresponding view that quantitatively irrelevant information is not material. In other words, her criticisms bear less on enforcement practices than on the materiality standard itself. Accordingly, in the remainder of this section, I will address Karmel's implicit view of materiality rather than dwell further on her claims regarding "regulation by prosecution."

Karmel's failure to reflect thoughtfully on the investor's informational needs presents a view of materiality that is misguided in at least two respects. First, she assumes that those informational needs, however defined, are identical in all contexts; an investor deciding whether to buy, hold or sell, she claims, requires precisely the same information as a shareholder deciding how to vote in an election of directors.³¹ This is overly simplistic, and happens incidentally to ignore a body of case law and scholarly literature to the contrary.³² That case law and scholarly literature suggest, sensibly, that an investor's informational needs vary with the setting and decision confronting the investor. For example, it is not obvious, despite Karmel's assumption to the contrary, that shareholders voting in an election of directors have no interest in information bearing on the honesty of director candidates, *even if* that information is both quantitatively insignificant and unimportant to an investor's trading strat-

30. See note 22 *supra* and accompanying text.

31. Here, as elsewhere, Karmel offers little more than *ipse dixit*:

[T]he distinction between information that is material to a purchaser or seller of securities, and information that is material to a stockholder voting a proxy, is essentially fallacious. . . . Accordingly, the distinction between materiality for the trading markets and materiality for proxy solicitation, even if legally or theoretically justifiable, should be discarded.

P. 235.

I suggest below that the monolithic materiality standard Karmel favors might improperly constrict the class of information that must be disclosed to investors. Ironically, however, Karmel's approach may also lead her to a view of materiality that is at times *over-inclusive*. Thus, Karmel agrees that certain information bearing on management's integrity — namely information about management conflicts of interest — is "an appropriate subject for SEC mandated disclosure," p. 147, but overlooks the argument that such information may be relatively less important to an investor deciding on trading strategy than to a shareholder deciding whether to vote for management's slate of directors.

32. See, e.g., authorities cited at note 23 *supra*; Ferrera, 2 L. LOSS, SECURITIES REGULATION 918 (1961); Starr & Steinberg, *Disclosure of Information Bearing on Management Integrity and Competency*, 76 NW. U. L. REV. 555, 559-60 (1981); see also M. STEINBERG, CORPORATE INTERNAL AFFAIRS 77 (1983); Longstreth, *SEC Disclosure Policy Regarding Management Integrity*, 38 BUS. LAW. 1413 (1983); Roiter, *Illegal Corporate Practices and the Disclosure Requirements of the Federal Securities Laws*, 50 FORDHAM L. REV. 781, 798-99 (1982). Again, one is troubled as much by Karmel's approach as by her conclusions. This, quite simply, is not careful work.

egy. Perhaps a respectable argument supporting that proposition can be made,³³ but Karmel offers none.

Beyond nice questions of context, however, Karmel's underlying view of materiality — that investors care only about "a good return on their investment" (p. 235)³⁴ — is more deeply disturbing.³⁵ Her central point is that a sensible materiality standard requires certainty and predictability; an exclusively quantitative standard, she argues, would provide such certainty and predictability while, not incidentally, comporting with the informational needs of investors and the intent of Congress. What she overlooks, however, is the *inherent uncertainty* of the materiality concept. In order to accomplish what is surely a desirable goal — clear-cut, unambiguous and certain disclosure standards — she would define materiality quite inflexibly, introducing an artificiality that the concept cannot (and should not) bear. Only by affording the Commission a degree of discretion in fashioning its disclosure policy can we preserve the sort of sensitivity we require of sound law enforcement.³⁶ Novel and difficult disclosure

33. See, e.g., Branch & Rubright, *Integrity of Management Disclosures Under the Federal Securities Laws*, 37 BUS. LAW. 1447, 1466-76 (1982).

34. Although she is by no means clear, Karmel may in fact be making two distinct, albeit related, claims. First, and most obviously, she seems to assert that investors simply do not need or desire information which is not quantitatively or economically significant. Second, she also appears to argue, much less perceptibly, that Congress never intended that the securities laws embrace a theory of qualitative materiality. The second argument, of course, is the more powerful, for it supports a narrower view of materiality even if one believes that investors do attach importance to qualitatively significant information. Thus, insofar as the materiality question is one of congressional intent, it is in a sense irrelevant that investors may legitimately care whether their managers are making bribes or evading the tax laws; what matters is whether Congress, in enacting securities laws which based disclosure obligations on the "materiality" of information, thought that investors cared or should care about such matters.

Despite Karmel's imprecision, one cannot analyze her view of materiality without addressing both of these claims. I argue below that neither claim supports her position.

35. For the present, at least, the Commission's Division of Enforcement appears to agree with Karmel. See note 29 *supra*. Of course, the Division's position, like Karmel's, is sound only insofar as its assumptions regarding investors' informational concerns (and perhaps Congress' intent, see note 34 *supra*) withstand challenge. In a real sense, therefore, my views also represent a critique of the Commission's current disclosure policy, as well as a defense of its earlier philosophy. This reveals not only the practical significance of arguments regarding disclosure theory, but also the political context in which administrative agencies function. That is, the political temperament of the Director of the Division of Enforcement (as well as that of the President and SEC Chairman responsible for the Director's appointment) probably explains the Commission's disclosure philosophy as usefully as the sometimes illuminating debates undertaken by students of securities regulation. One can only hope that concededly political enforcement positions, at some level, rest upon consistent and sensible legal theories.

36. One should distinguish, however, between a desire for precision and certainty, on the one hand, and a desire to eliminate non-quantitative factors for substantive reasons, on the other. Although Karmel fails to make this distinction, one could eliminate moral and other non-economic factors yet have a relatively subjective materiality standard, and one could include those factors yet have a precise and certain standard, such as by listing the types of information that must be disclosed. Karmel appears to believe that precision is desirable for its own sake *and* that qualitative information — such as facts bearing on management's integrity — should be deemed immaterial so as to preclude the Commission from using putative disclosure violations to regulate corporate conduct, which she views as unauthorized and dan-

questions do not disappear simply because they are defined away in an effort to draw a bright line; to achieve certainty at the expense of a *realistic* standard of materiality would be an empty accomplishment indeed.

Courts and commentators have long recognized the materiality of qualitatively significant information, including information regarding illegal conduct by a company or its management,³⁷ socially significant information,³⁸ and, most notably, information generally relevant to an assessment of management's character, integrity, or competence.³⁹ Plainly, however, some types of qualitative information⁴⁰ are more material than others: shareholders and investors care more about management's honesty and competence than its policies concerning employment discrimination or environmental pollution.⁴¹ But Karmel fails to distinguish among these different

gerous. I address these points separately below, arguing that (1) precision may not be attainable in every circumstance, *see* notes 56-62 *infra* and accompanying text, and (2) the test of materiality should be the significance of information to investors, even if that produces disclosure requirements which incidentally affect corporate conduct, *see* notes 49 & 50 *infra* and accompanying text.

My argument would yield a more flexible approach to disclosure regulation, although I recognize that even a flexible approach has its limits. *See* note 41 *infra*. *See also* notes 52-54 *infra* and accompanying text. To recognize such limitations, however, is not to reject entirely the materiality of qualitatively significant information; it is only to suggest certain concerns to which the Commission should be sensitive.

37. *See, e.g.*, SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978).

38. *See, e.g.*, Natural Resources Defense Council v. SEC, 389 F. Supp. 689 (D.D.C. 1974). *But see* Natural Resources Defense Council v. SEC, 432 F. Supp. 1190 (D.D.C. 1977), *rev'd*, 606 F.2d 1031 (D.C. Cir. 1979); Amalgamated Clothing and Textile Workers Union v. J.P. Stevens & Co., 475 F. Supp. 328 (S.D.N.Y. 1979), *vacated as moot*, 638 F.2d 7 (2d Cir. 1980); SEC v. Chicago Helicopter Indus., No. 79-C-0469 slip op. (N.D. Ill. Jan. 18, 1980), *vacated*, No. 79-C-0469 slip op. (N.D. Ill. Mar. 7, 1980); note 41 *infra* and accompanying text.

39. *See, e.g.*, SEC v. Carriba Air, Inc., FED. SEC. L. REP. (CCH) ¶ 98,766 (11th Cir. 1983); SEC v. Washington County Util. Dist., 676 F.2d 218 (6th Cir. 1982); Zell v. Intercapital Income Sec., 675 F.2d 1041 (9th Cir. 1982); Weisberg v. Coastal States Gas Corp., 609 F.2d 650 (2d Cir. 1979), *cert. denied*, 445 U.S. 951 (1980); GAF Corp. v. Heyman, [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,237 (S.D.N.Y. 1983); Bank and Trust of Old York Road Co. v. Hankin, [1982-83 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 99,070 (E.D.Pa. 1982); Pabst Brewing Co. v. Kalmanovitz, [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,873 (D. Del. 1982); General Steel Indus. v. Walco Natl. Corp., [1981-82 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 98,402 (E.D. Mo. 1981); Bertoglio v. Texas Intl. Co., [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,342 (D. Del. 1980); Berman v. Gerber Prod. Co., 454 F. Supp. 1310 (W.D. Mich. 1978); SEC v. Kalvex, Inc., 425 F. Supp. 310 (S.D.N.Y. 1975); Cooke v. Teleprompter Corp., 334 F. Supp. 467 (S.D.N.Y. 1971); *see also In re Franchard Corp.*, 42 S.E.C. 163 (1964); M. STEINBERG, *supra* note 32, at 73-131; Ferrara, Starr & Steinberg, *supra* note 32; Longstreth, *supra* note 32; Roiter, *supra* note 32.

40. I exclude from this discussion qualitative information that is independently material on economic or quantitative grounds. For example, a pattern of illegal management conduct which jeopardizes a significant amount of a company's earnings or assets would be disclosable even under traditional notions of economic materiality. *See, e.g.*, Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 118 (2d Cir. 1982) (failure to disclose that sales growth resulted from illegal payments may be material if payments or business thereby secured are significant in amount); SEC v. Jos. Schlitz Brewing Co., 452 F. Supp. 824 (E.D. Wis. 1978) (kickback scheme that threatens suspension of important licenses may be economically material).

41. The Commission itself has found that "investors who consider social information [such

types of qualitative information.

Thus, despite convincing arguments and data to the contrary,⁴² she claims that investors view environmental, equal employment opportunity and similar socially significant information as indistinguishable from all other qualitative information, including information bearing on management's integrity (p. 242), and therefore infers from investors' uninterest in the former that no qualitative information is material. But investors' unconcern with socially significant information suggests only that *that information* is not material. Arguably, investors have a genuine interest in at least certain management integrity information — *e.g.*, facts revealing self-dealing or adjudicated violations of law — which is therefore often material. Where the shareholder is being asked to vote for management, or candidates closely allied with management, the relevance of such information is plain.⁴³ But even investors not being solicited for proxies would find such information important in judging the stewardship of the company whose stock they are holding,⁴⁴ buying or selling. As the Commission noted in its famous opinion in *In re Franchard Corp.*: "Of cardinal importance in any business is the quality of its management. . . . Evaluation of the quality of management — to whatever extent it is possible — is an essential ingredient of informed investment decision."⁴⁵

as the effect of corporate activities on the environment and statistics about equal employment practices] important. . . . constitute . . . an insignificant percentage of . . . U.S. shareholders." SEC Release No. 33-5627, [1975-76 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,310, at 85,719 (Oct. 14, 1975). Hence, even before its recent change in enforcement policy, *see* note 29 *supra*, the SEC rarely viewed socially significant information as material apart from its economic relevance. (For a time, the Commission required disclosure of *all* environmental administrative proceedings, whether initiated by the issuer or by a governmental authority, and regardless of the amount of money involved. *See, e.g., In re United States Steel Corp.*, SEC Release No. 34-16223, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,319, at 82,383-84 (Sept. 27, 1979). However, the Commission adopted this position in light of the national policy expressed in the National Environmental Policy Act of 1969, and, in any event, subsequently revised its rules to require disclosure of only *economically significant* proceedings. *See* Regulation S-K, Item 103, Instruction 5, 17 C.F.R. § 229.103, (1983).) Apparently, only one court has ruled otherwise, *see* Natural Resources Defense Council v. SEC, 389 F. Supp. 689 (D.D.C. 1974); Natural Resources Defense Council v. SEC, 432 F. Supp. 1190 (D.D.C. 1977), and it was reversed on appeal. 606 F.2d 1031 (D.C. Cir. 1979).

42. *See* note 41 *supra*.

43. *See, e.g.,* Fedders Speech, *supra* note 29, at 2057; TWA v. Catalano, [1979-80 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 97,159 (S.D.N.Y. 1979); Cooke v. Teleprompter Corp., 334 F. Supp. 467 (S.D.N.Y. 1971).

44. I do not address the question whether, absent a purchase or sale of a security, a company ever has an affirmative duty to disclose. *See generally* Bauman, *Rule 10b-5 and the Corporation's Affirmative Duty to Disclose*, 67 GEO. L.J. 935 (1979).

45. 42 S.E.C. 163, 169-70 (1964). *See also* SEC v. Freeman, [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 96,361 (N.D. Ill. 1978). *But see* Branch & Rubright, *supra* note 33, at 1457-58; note 31 *supra* and accompanying text.

Note that SEC forms, *see* note 21 *supra*, sometimes specifically require disclosure of adjudicated violations of law. *See* Regulation S-K, Item 401(f), 17 C.F.R. § 229.401(f) (1983) (setting forth disclosure requirements applicable to (1) 1933 Act registration statements on Form

Therefore, despite the conceded centrality of economic materiality,⁴⁶ a sound disclosure policy should require the dissemination of certain kinds of information without regard to questions of financial significance. Although Congress clearly intended that Commission disclosure authority focus on quantitatively significant information,⁴⁷ the legislative history of the federal securities laws also reveals Congress' belief that investors often require information that may be economically immaterial.⁴⁸ Of course, requiring the disclosure of such information may affect substantive corporate conduct,⁴⁹ but that is no reason for adopting a materiality standard that would deprive investors of needed information. One can legitimately criticize the SEC for using its disclosure authority artfully to regulate substantive conduct where the Commission requires the disclosure of information in which investors have no interest;⁵⁰ but if investors believe that certain information is pertinent to investment or voting decisions, the Commission should require its production despite the impact that policy may have on corporate conduct. This is merely to restate the obvious: what matters most in fashioning a materiality standard is the significance of particular information to investors.

To so recognize, of course, does not solve the problems that beset

S-1, FED. SEC. L. REP. (CCH) ¶ 8,251 (1983) (Item 11); (2) 1934 Act Annual Report on Form 10-K, FED. SEC. L. REP. (CCH) ¶ 31,105 (1983) (Item 10); and (3) Schedule 14A, pertaining to proxy statements, 17 C.F.R. § 240.14a-101 (1983) (Item 6(a)).

46. See notes 24-26 *supra* and accompanying text.

47. See authorities cited in note 25 *supra*.

48. See, e.g., S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934) ("[I]t is essential that [the stockholder] be enlightened not only as to the financial condition of the corporation, but also as to the major questions of policy, which are decided at stockholders' meetings."); H.R. REP. NO. 1711, 90th Cong., 2d Sess. 3 (1968), *reprinted in* 1968 U.S. CODE CONG. & AD. NEWS 2811, 2812 (House Report accompanying the Williams Act) ("The competence and integrity of a company's management, and of the persons who seek management positions, are of vital importance to stockholders. Secrecy in this area is inconsistent with the expectations of the people who invest in the securities of publicly held corporations and impairs public confidence in securities as a medium of investment.").

49. This has long been recognized as an inevitable and frequently desirable consequence of disclosure requirements. See L. BRANDEIS, *OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT* 92 (1914) ("Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."); SECURITIES AND EXCHANGE COMMISSION, *THE WHEAT REPORT: DISCLOSURE TO INVESTORS — A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS* 50-51 (1969).

Where the conduct at issue constitutes a breach of fiduciary responsibility under state law, imposing a disclosure obligation raises interesting and difficult federalism issues. See *Santa Fe Indus. v. Green*, 430 U.S. 462, 479 (1977); *Cort v. Ash*, 422 U.S. 66, 84 (1975). While these issues are beyond the scope of this review, I find persuasive the suggestion that "[r]equiring adequate disclosure in appropriate circumstances . . . may be viewed as an acceptable jurisprudential accommodation between the federal interest in full disclosure and the state interest in redressing breaches of fiduciary duty." Ferrara, Starr & Steinberg, *supra* note 32, at 563 (footnote omitted).

50. For example, putting to one side the argument that the National Environmental Policy Act of 1969 makes environmental disclosure a special case, it would be inappropriate for the Commission, in the face of obvious investor uninterest, see note 41 *supra*, to require firms to reveal economically insignificant information about their environmental policies.

efforts to shape meaningful disclosure requirements for qualitatively significant information. There remain difficult and often subjective questions about disclosure theory, and countervailing considerations may dictate different results in other settings.⁵¹ For example, I have already noted my agreement with Karmel that the Commission ought not require disclosure of socially significant information;⁵² investors do not want such information, and to require its disclosure would dangerously involve the SEC in the making of social policy.

Similarly, even if one believes that investors might want information about *potential* violations of law, to require disclosure of such information would be to endow the Commission with authority effectively to administer and enforce laws far removed from that agency's presumed expertise. Quite apart from the danger of, in effect, requiring management "to accuse itself of illegal behavior,"⁵³ this would entangle the Commission in complex legal issues having nothing to do with securities regulation per se; it is doubtful that Congress envisioned the Commission determining violations of the banking and tax laws, nor does such a role make sense as a matter of policy.⁵⁴

51. Some would claim, for example, that "ethical investors" do attach importance to socially significant matters, such as a company's policies regarding equal employment opportunity or the environment. *See, e.g.,* Natural Resources Defense Council v. SEC, 389 F. Supp. 689, 700 (D.D.C. 1974); Stevenson, *The SEC and the New Disclosure*, 62 CORNELL L. REV. 50, 58-66 (1976). On the other hand, even assuming general agreement that information bearing on management's honesty and competence may be material, some such information is not terribly important to investors; distinguishing the significant from the insignificant management integrity information may require delicate judgment.

Nevertheless, framing the issue in terms of the importance of information to investors at least clarifies the materiality discussion and eliminates distracting polemical debate. Under this approach, there is less room for the incautious and unsupportable generalizations Karmel favors, of which the following is a rather typical example:

The disclosure of economically immaterial information . . . is confusing to investors and expensive for issuers. It is a regulatory cost that should not be borne for the sake of such a subjective and ephemeral concept as management integrity. . . . To permit the SEC to define materiality by its notions of management integrity is to give the government license to prosecute anyone of whom it disapproves.

P. 240.

52. *See* notes 41 & 50 *supra* and accompanying text.

53. Branch & Rubright, *supra* note 33, at 1472 n.100 (quoting from SEC v. Chicago Helicopter Indus., No. 79-C-0469 slip op. at n.2 (N.D. Ill. Jan. 18, 1980), *vacated*, No. 79-C-0469 slip op. (N.D. Ill. Mar. 7, 1980). *See also* Amalgamated Clothing & Textile Workers Union v. J.P. Stevens & Co., 475 F. Supp. 328, 332 (S.D.N.Y. 1979) ("No matter how the . . . rule is construed, indeed even if it explicitly stated such a duty, corporate management would not announce . . . an intention to violate laws. It is simply contrary to human nature. The rule, if it were construed to require this, would never succeed in its purpose of bringing such disclosure to the shareholders."), *vacated as moot*, 638 F.2d 7 (2d Cir. 1980).

54. Karmel also believes that mandated disclosure of unadjudicated violations is improper, but for a different reason: She argues that such disclosure unduly restricts management's freedom of action. P. 244. I am more troubled by the prospect of SEC enforcement officials investigating and, in effect, adjudicating violations of substantive laws and regulations about which they know very little. Why, for example, should the Commission staff be entrusted with authority effectively to enforce (albeit in the guise of disclosure policy) state liquor laws, federal banking laws, or foreign currency regulations?

Beyond all this, thinking about disclosure theory provokes more fundamental and abstract questions regarding the materiality concept. Nearly all discussions of corporate disclosure, including Karmel's, assume that materiality, *properly understood*, offers a meaningful standard for imposing disclosure obligations. Debates about materiality generally address the issue I consider above: How *should* the concept be "properly understood"? Should materiality, for example, at times embrace financially irrelevant information, or instead be limited to information that is plainly economically significant to investors? Karmel, of course, writes in this tradition, confining her critique to the assertion that the Commission has improperly construed the meaning of materiality.

Thus far, I have suggested merely that Karmel's discussion of materiality is unsatisfying, but have not broached the larger issue she and most others ignore: Is there reason to believe that, in the final analysis, materiality itself may be a meaningless criterion on which to predicate disclosure requirements? Is materiality, in short, a concept ultimately devoid of meaningful content?

On reflection, I believe that the concept of materiality may indeed offer little guidance for resolving the hardest disclosure cases. While this is not the place for a full exposition of my views, a brief discussion would, I think, be useful for considering Karmel's analysis from a somewhat broader perspective. At the same time, I may be able to demonstrate why I believe problems of disclosure theory are far more difficult and complex than Karmel suggests.⁵⁵

I have argued that Karmel errs in assuming investor uninterest in information bearing on management's integrity or competence but having no immediate economic significance. But why would investors have an interest in such information? Presumably, investors seek primarily, if not exclusively, to enhance their wealth.⁵⁶ It follows that information is relevant to investors to the extent that it relates to attainment of that goal. In other words, investors care about management's honesty and competence because, at least in the long run, those factors are likely to affect the company's performance and therefore shareholder wealth.

To so observe, of course, is to infer from Karmel's own analysis the incorrectness of her argument that only immediately economi-

55. I do not address the view that a disclosure policy aimed at providing the average investor with individual firm-oriented information is fundamentally misguided. See, e.g., H. KRIPKE, *THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE* 24-36 (1979); Kripke, *A Search for Meaningful Securities Disclosure Policy*, 31 BUS. LAW. 293, 305-17 (1975); Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U. L. REV. 1151, 1153 (1970). Rather, my comments here concern the meaningfulness of materiality as a disclosure standard. Compare Sargent, Book Review, 12 BAL. L. REV. 371, 381 (1983) (reviewing *REGULATION BY PROSECUTION*).

56. See notes 24-26 *supra* and accompanying text.

cally important information is material; her mistake is to exclude from the domain of materiality information that is in fact relevant to the investor's *economic* interests, which she concedes (and Congress and the Commission agree) ought to be the touchstone for fashioning disclosure requirements. The problem with Karmel's standard of materiality, then, is that it would define as immaterial information that is important to *economically motivated* investors.⁵⁷

But, as thus construed, what does the materiality standard really tell us about how and where to draw the line between disclosable information and that which need not be produced? The answer, I believe, is that it tells us very little. Indeed, my criticisms of Karmel's arguments regarding qualitative materiality themselves reveal the ultimate emptiness of the materiality concept for deciding the most confounding disclosure issues.

My central criticism of Karmel's discussion of qualitatively significant information is that she mistakenly strays from the proper test of materiality: Would the investor likely attach importance to the information in question?⁵⁸ But in a real sense that is a trivial point (even if a valid criticism of Karmel's analysis), for it merely restates the very question disclosure theory must answer.⁵⁹ That is to say, the search for a meaningful disclosure standard for management integrity information is scarcely advanced by the observation that such information should be deemed material where it is probably important to investors; the hardest question — precisely *which* management integrity information, in *which* circumstances, *is* important to investors? — remains unanswered.

My point may be made more generally. Materiality is an unhelpful guide for resolving the hardest cases because of the "essential indeterminacy"⁶⁰ of the concept itself. I have suggested that a sound disclosure theory must focus on the importance of information to investors. But only in the easiest cases (*i.e.*, where information is immediately quantitatively significant) is there general agreement on that issue. The problem, of course, in the harder cases involving qualitatively significant information, where such general agreement is lacking, is actually deciding whether information is important to investors. How can one determine whether shareholders attach significance to information having no immediate bearing on their com-

57. In another context, Philip Soper has described this as "the problem of collapse or congruence of result." Soper, *On The Relevance of Philosophy to Law: Reflections on Ackerman's Private Property and the Constitution*, 79 COLUM. L. REV. 44, 44 (1979): "Just when one believes he has isolated a strongly entrenched intuition, demonstrating the untenability of one theory or the other, defenders of the theory counter with a sophisticated proof that, as respects the critical intuition, both theories agree in result."

58. See notes 22 & 23 *supra* and accompanying text.

59. Cf. note 57 *supra*.

60. Soper, *supra* note 57, at 53.

pany's performance? The materiality standard, however precisely articulated, merely poses the question; the answer must lie elsewhere.

Perhaps ironically, these observations may inspire sympathy for Karmel's plea that materiality be construed as a narrow, quantitative standard. Our inability to resolve the harder cases objectively and predictably may suggest diverse or shifting societal values regarding the importance of qualitative information.⁶¹ Why not opt for the relative certainty of a quantitative measure, at least until we reach a more reliable consensus on the significance of qualitative information? This would also produce a disclosure standard that the Commission could administer easily and consistently, itself an estimable achievement.

Nevertheless, the suggestion that such a consensus is possible may be misleading, in which case recognizing the inherent indeterminacy of the materiality concept seems a wiser course than striving for a spurious precision.⁶² Moreover, the basic criticism of Karmel's *approach* to disclosure theory remains. If, as I argue, much of the information she would exclude as immaterial is, in some ultimate sense, *economically* relevant to investors, then the question she proffers as the key to understanding materiality is unhelpful. The very language of the discussion she joins is, finally, meaningless; on this view, what is most disappointing about her call for certainty is that it represents a missed opportunity for raising the level of the materiality debate.

On balance, therefore, it appears that materiality is an infinitely more complicated concept than Karmel allows. I have not attempted in this short space to solve all of the difficult problems that arise regarding materiality; rather, I have tried to show where Karmel's analysis falls short, and in so doing to refine the questions one must ask in sensibly discussing disclosure theory. While that process itself may yield some answers, others are less obvious. What is important here, I suppose, is to recognize that Karmel's approach is dangerously simplistic.⁶³

61. *Cf. Id.* at 64.

62. Professor Soper's citation of Aristotle is apt: "To look for more is to ignore the injunction of one of the first philosophers to seek 'precision in each class of things just as far as the nature of the subject admits.'" *Id.* at 64 (quoting ARISTOTLE, NICOMACHEAN ETHICS, I. iii. 1094b. 24-25 (W.D. Ross trans. 1925) (footnote omitted)).

63. I have not separately addressed Karmel's treatment of SEC policy regarding shareholder proposals. She claims, essentially, that the Commission should be more censorious with respect to the inclusion of such proposals in management proxy materials, excluding those proposals which are not economically material to investors. Pp. 245-47. Not only does she assume too readily that shareholders have no interest in economically immaterial matters, she virtually ignores the classic justifications for preserving and strengthening the shareholder proposal mechanism — that it enhances shareholder communications, often has a salutary (if indirect) impact on management and, if nothing else, provides "a healthy safety valve for the discussion of views critical of the corporation." P. 246. *See, e.g.*, B. LONGSTRETH & H. RO-

III

In the last two chapters of her book, Karmel reveals that the actual target of her attack is Congress. Thus, despite the invective against the Commission that fills the preceding chapters, Karmel's real thesis, it develops, is that the promotion of investment should replace narrower notions of investor protection as the focus of securities regulation. Congress, she argues, must amend the Commission's charter to make plain the paramount importance of capital formation. In short, her lengthy "brief against the SEC's prosecutorial orientation" (p. 16) has been merely introductory; her true goal is "sweeping reform" (p. 256) of the securities laws themselves.⁶⁴

Apart from the substance of her argument, Karmel's presentation is poorly organized and needlessly confusing. Although she earlier hints at her ultimate focus,⁶⁵ the reader is genuinely surprised by her sudden shift. The result is a book that appears disjointed and slapdash, confirming one's conviction that this is less than careful work.⁶⁶

More pointedly, however, Karmel's "brief" for law reform is it-

SENBLOOM, CORPORATE SOCIAL RESPONSIBILITY AND THE INSTITUTIONAL INVESTOR 19 (1973); Eisenberg, *Access to the Corporate Proxy Machinery*, 83 HARV. L. REV. 1489 (1970); Schwartz, *The Public-Interest Proxy Contest: Reflections on Campaign G.M.*, 69 MICH. L. REV. 421 (1971). Again, while there may be grounds for criticizing the Commission's approach, see, e.g., Manne, *Shareholder Social Proposals Viewed by an Opponent*, 24 STAN. L. REV. 481 (1972), Karmel's analysis is shrill and unhelpful. See also SEC Release No. 34-20091, FED. SEC. L. REP. (CCH) ¶ 83,417 (Aug. 16, 1983) (amending the shareholder proposal rule, SEC Rule 14a-8, 17 C.F.R. § 240.14a-8 (1983), but essentially preserving basic framework of the rule).

64. Karmel does observe that she is "not persuaded that the SEC's institutional survival as an independent commission is necessarily in the general public interest," suggesting that it be recast as an executive agency, subject "to some effective Presidential control." P. 91. But her suggestion rests on her claim that the Commission's significant impact on the economy calls for executive control "as to matters of policy that override a singular mandate such as investor protection." P. 91. In other words, her plea for reforming the Commission into a "meaningful instrument for carrying out national economic policy," p. 61, derives less from her allegations of prosecutorial orientation than from her proposal to substitute capital formation for investor protection as the Commission's primary concern. P. 294.

Karmel herself seems ambivalent about the value of preserving the Commission's independence. Thus, despite her view that "[t]he SEC's independence is, in part, an attitude of resistance to outside interference," p. 87, she concedes that "[o]ne worthwhile fact of the SEC's independence . . . is that the Commission has developed a highly competent staff with unusual *esprit de corps*." P. 90. Moreover, as I discuss below, her argument for changing the Commission's mandate is itself poorly developed and unconvincing. Compare PRESIDENT'S ADVISORY COUNCIL ON EXECUTIVE ORGANIZATION, A NEW REGULATORY FRAMEWORK 5-7, 99-106 (1971).

65. See, e.g., pp. 33, 61, 76.

66. It is not until page 294 (of a total of 339 pages of text) that Karmel explicitly states her principal point:

[T]he SEC's primary concern in the 1980s should be capital formation. The statutes and their implementation by the SEC should be tested against whether they encourage savings and the deployment of savings in investments that contribute to productivity in the American economy.

self thin and unconvincing, seeming almost an afterthought added hastily to the book. She begins by conceding that the Commission alone can accomplish very little,⁶⁷ which leads her to focus on Congress:

[T]he securities laws are not now drafted in such a way that capital formation is necessarily part of the public interest to which the Commission refers in taking action. . . .

. . . .

. . . [T]he Securities and Exchange Commission . . . has no direct statutory mandate to promote investment. . . .

. . . .

. . . To suggest to a staff with any integrity that they simply stop enforcing the law that exists is wrong. . . . The ideological energies of a productive staff need to be turned to the solution of new problems specifically identified by Congress. [Pp. 298, 299, 302].

She therefore proposes that the securities laws be amended to make capital formation the SEC's principal concern;⁶⁸ while she admits that investor protection fosters investor confidence, which surely enhances capital formation, she believes that where the two goals clash, investor protection must yield (p. 298). This prescription, she claims, will revitalize American industry, increase employment and productivity and improve the national welfare.

Karmel's argument is unpersuasive. First, her tangible suggestions for amending the securities laws are rather feeble. She recommends that the preambles to the 1933 and 1934 Acts be changed to include the purpose "to promote capital formation and business productivity" (p. 301), and proposes adding to both statutes "a carefully crafted regulatory analysis requirement" (p. 301) to ensure that the Commission examines the costs and competitive effects of disclosure rules. These modest amendments seem unlikely to accomplish the "sweeping reform" Karmel favors.

Second, she too readily sacrifices investor protection for goals that may not be accomplished by the reform she proposes. Nobody, including Karmel, has demonstrated that relaxing the protections afforded by the securities laws will help revitalize the American econ-

67. [T]here are severe limitations on the ability of an independent regulatory agency to undertake substantive regulatory reform on its own initiative. The political imagination and daring needed to move in new directions, to dismantle old and outdated programs and engage in new programs must take root outside the Commission. After all, the essence of an administrative agency is to administer the programs of the Legislative and Executive branches of government. . . .

. . . In the final analysis, changing the direction and methodology of government regulation will require law reform, not just regulatory reform.

P. 297. These observations, of course, make inapposite much of Karmel's earlier criticism of the Commission. One consequence of her extended but misdirected reproach is to divert attention from her chief concern, enhancing capital formation.

68. See note 66 *supra*.

omy.⁶⁹ Until that case has been made more convincingly, trading investor protection for capital formation, even if only where the two goals conflict, seems unwise.

Finally, pervading Karmel's discussion is the implicit claim that the Commission has viewed its role too narrowly, in a sense, by refusing actively to promote capital formation. While she recognizes that it rests with Congress ultimately to redefine the Commission's perspective, her argument raises fundamental questions about the effectiveness of administrative agencies. She assumes, apparently, that the SEC can be made more effective by broadening its charge, but that is a controversial assumption which demands close scrutiny. Had Karmel addressed this issue, she might have become convinced, with others, that "the effectiveness of the SEC over the years has been a product of the *narrow* scope of its jurisdiction"⁷⁰ It is by now clear, however, that Karmel's vision is decidedly different.

CONCLUSION

Bad books are always disappointing. They are especially disappointing when, owing to the author's talent and experience, one expects so much more. *Regulation by Prosecution* is an especially disappointing book, not the least because of Roberta Karmel's deserved reputation for intellect and conviction. In the end, that is what most rankles about this book.

69. As Norman Poser has suggested, Poser, *Regulation by Prosecution* (Book Review), 15 REV. SEC. REG. 876, 877 (1982), it is noteworthy that equity financing is relatively unimportant as a means of raising capital in this country. Since most financing is accomplished either internally or through borrowing, one doubts whether easier access to the markets would significantly enhance capital formation. One can argue, as Professor Poser notes, that the very reluctance of companies to resort to the equity markets supports Karmel's view, but diluting investor protection on the basis of such speculative evidence seems unreasonably hazardous.

70. Longstreth, *The SEC After Fifty Years: An Assessment of Its Past and Future* (Book Review), 83 COLUM. L. REV. 1593, 1594 (1983) (reviewing J. SELIGMAN, *THE TRANSFORMATION OF WALL STREET — A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE* (1982)) (emphasis added).