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Book Reviews: Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America; The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance

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BOOK REVIEWS

REGULATION BY PROSECUTION: THE SECURITIES AND EXCHANGE COMMISSION VS. CORPORATE AMERICA. By Roberta S. Karmel.† Simon and Schuster, New York, New York, 1982. Pp. 400; THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE. By Joel Seligman.†† Houghton Mifflin Company, Boston, Mass., 1982. Pp. 701. Reviewed by Mark A. Sargent.†††

The Securities and Exchange Commission (SEC) today resembles a bureaucratic version of St. Sebastian, pierced with arrows flung from every direction. The Burger court, for example, has persistently refused to follow the SEC's suggestions on a broad variety of questions ranging from the definition of "security,"[1] to the establishment of a scienter standard in rule 10b-5 enforcement actions,[2] to the preemption of state takeover regulation.[3] Homer Kripke, a former SEC staff member and well-known scholar and lawyer, has argued forcefully that the economic and psychological premises of the SEC's system of corporate disclosure are nonsense.[4] The members of Stanley Sporkin's once-proud SEC Enforcement Division were scattered to the winds during the last days of the Carter administration and the early days of the present regime,[5] and Sporkin himself has moved on to become General Counsel of the Central Intelligence Agency, thus abandoning the world of full disclosure for the world of nondisclosure. Most ominous, however, is the rapidly gathering revolution in financial institutions. This revolution will obliterate the traditional boundaries between the various sectors of the financial world, and may also obliterate the SEC's traditional niche in that world.[6]

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1. International Brotherhood of Teamsters v. Daniel, 439 U.S. 551 (1979).
2. Aaron v. Securities and Exchange Commission, 446 U.S. 680 (1980).
3. Edgar v. MITE Corp., 102 S.Ct. 2620 (1982). The SEC, arguing as amicus curiae, urged the Court to hold that the Illinois Business Take-Over Act was preempted by the Williams Act. The Court ultimately found the Illinois statute unconstitutional on commerce clause grounds, but Justice White, who wrote the majority opinion, was unable to command a majority on the preemption question. The SEC was also unable to convince the Court to find preemption of the Idaho Takeover Statute in Leroy v. Great Western United Corp., 443 U.S. 173 (1979). In that case the Court reversed the Fifth Circuit's finding of preemption on procedural grounds.
4. H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE (1979).
5. *See* Bruck, *Waning Days for the Zealot of the SEC,* THE AM. LAW. 14 (Oct. 1980); *Washington Lawyer John Fedders Picked as Head of SEC's Enforcement Division,* Wall St. J., June 29, 1981, at 10, col. 2.
6. For recent surveys of these developments, see NATIONAL ASSOCIATION OF SECUR-

Roberta S. Karmel has joined in the barrage. The arrows hurled in her portentously-titled book, *Regulation by Prosecution: The Securities and Exchange Commission vs. Corporate America,*[7] may also carry a special sting, because she was a true SEC "insider." Not only did she work as a member of the SEC staff from 1962-68,[8] but she also served as a commissioner from September 20, 1977 to February 1, 1980.[9] In addition, she is not an ideological conservative, but rather a self-proclaimed "liberal,"[10] with no delusions about the need to restore the "free" market. Her criticisms, therefore, will sting because they come from one of the SEC's own, not from one of its traditional enemies in the business world. They will also smart because Karmel is exceptionally well-informed, as exemplified by her mastery of terminology and concepts such as "hard-clobbers,"[11] "disintermediation,"[12] the "Papilsky rule,"[13] "Wells submissions,"[14] the "passkey theory,"[15] and "sunset

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ITIES DEALERS, INC., THE FINANCIAL SERVICES INDUSTRY OF TOMORROW (1982); American Bar Association Ad Hoc Committee on Developments in Investment Services, *Homogenization of Financial Institutions: The Legislative and Regulatory Response,* 38 BUS. LAW. 241 (1982).

7. The book is hereinafter cited as REGULATION BY PROSECUTION.
8. REGULATION BY PROSECUTION 18.
9. *Id.* at 17.
10. *Id.* at 20-31.
11. *See id.* at 110. "CLOB" is an acronym for "consolidated limited order book," a device which would automatically execute securities orders, and which would thus function as part of an automated national market system. "Hard CLOB" refers to the Peake-Mendelson-Williams "National Book System" proposal whereby all bids and offers would be entered into a computer which would project those bids and offers onto a screen located at each broker's desk. This system would allow a broker to directly execute orders and make offers by pressing the keys on his computer console. Proponents of the "hard-CLOB" scheme are sometimes called "hard clobbers"; *see also* J. SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 520-23 (1982).
12. REGULATION BY PROSECUTION 207. Karmel uses the term "disintermediation" to describe the way money market funds permit small investors to pool their funds for investment in large money market instruments. Prior to the development of money market funds, only institutional investors such as banks, insurance companies, and pension funds could invest in such instruments. Since money market funds permit an individual relatively direct access to these instruments, they have reduced an individual investor's dependence on banks, insurers, or pension funds as investment intermediaries.
13. *Id.* at 131-35. The "Papilsky Rule" emerged as a reaction to a judicial decision defining the obligation of an investment adviser to a mutual fund to engage in "underwriter recapture." Underwriter recapture is an arrangement by which the mutual fund investment adviser would also act as a member of a selling group in the distribution of securities, thereby obtaining a price concession from the underwriter, which could then be credited against the advisory fee charged to the mutual fund. In Papilsky v. Berndt, [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 95,627 (S.D.N.Y., June 24, 1976), the court ruled that the savings realized through such a price concession should be passed on to the mutual fund through a reduction in the advisory fee. In reaction to this case, the SEC adopted a rule which, in effect, prohibited passing price concessions along to the institutional investor through "underwriter recapture." For a full discussion of these

review."[16] In addition, her book will receive more attention than it deserves because her arguments fit nicely with the current conventional wisdom.

Karmel's critique is not easy to summarize because her book is rambling and repititious,[17] and she often seems more concerned with vindication of the controversial role she played as a commissioner than with careful, step-by-step articulation of a policy argument.[18] She does seem to be saying, however, that the SEC of the 1970's was the prisoner of Stanley Sporkin's Enforcement Division. According to Karmel, Sporkin and the members of his division were ideologues obsessed with investor protection and corporate governance at the expense of the legitimate needs of business.[19] Their chosen mode of regulation was fer-

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issues, see Brunelle, *The Papilsky Rule and the Emerging Antitrust Dimensions of the Securities Exchange Act,* 9 SEC. REG. L.J. 50 (1981).

14. REGULATION BY PROSECUTION 222-26. In 1972, an SEC Advisory Committee on Enforcement Policies and Practices, chaired by private attorney John A. Wells, recommended that the Commission give parties against whom the SEC staff recommended proceedings an opportunity to present their own version of the facts to the Commission. This procedure, subsequently adopted by the SEC to a limited extent, gives the potential defendant an opportunity to state his case to the Commission *before* the Commission approves the initiation of administrative proceedings or a court action. These presentations have become known colloquially as "Wells submissions." *Id.* at 223.
15. *Id.* at 174. According to Karmel, the SEC justified its controversial disciplinary program for securities lawyers on the theory that issuers and securities professionals "often depend on the advice . . . of a lawyer before securities can be sold generally to the public. Investors therefore rely directly or indirectly on the work and opinions of lawyers, who provide access to or who hold the passkey to the marketplace." *Id.*
16. *Id.* at 85-86, 255. Generally speaking, "sunset review" is the process whereby a legislature will mandate review of existing administrative programs in order to determine whether they should be continued. *Id.*
17. For example, much of the discussion in Chapter Three, "Functional Weaknesses in the Administrative Process," is substantially restated in Chapter Nine, "Law Reform to Promote Capital Formation." In addition, Part One, "A Political Analysis" could have been stripped of repeated protestations of Karmel's affection for the SEC and of her identity as a "liberal." Furthermore, Karmel's stab at writing a capsule history of the SEC would have been more successful without detours into personal reminiscence, *see, e.g., id.* at 73-74, or name calling. *See, e.g., id.* at 66.
18. An author who begins a book with the words "I have been called a maverick" is a person who takes herself very seriously indeed. *Id.* at 15. Another reviewer of this book has suggested that the argumentative, conclusory tone of Karmel's book suggests why she has been called a maverick:

    > [The book's] abrasive tone in discussing positions and individuals with whom she disagreed and its conclusory rather than analytical approach in dealing with complex issues gives insight into why Commissioner Karmel earned the reputation of being a maverick dissenter rather than an effective advocate capable of convincing her fellow commissioners to accept her point of view.

    Mann, Book Review, 10 SEC. REG. L.J. 283, 283 (1982). For further discussion of Karmel's stormy tenure on the Commission, see *Departing Karmel: Caution Will Prevail,* Legal Times of Wash., Jan. 28, 1980, at 2, col. 2.
19. REGULATION BY PROSECUTION 30-31, 70, 147. Despite her disclaimers, Karmel's

vent prosecution of apparent violations, rather than careful rule-making or reliance on the self-regulatory organizations. Because the commissioners were largely former staff members, because loyalty to the SEC as an institution clouded individual judgment, and because actions brought by the Enforcement Division were typically resolved by consent injunctions subject to the control of the Division, there was no effective check on the SEC's abuse of its statutory mandate.[20] Karmel concludes that this exaggerated emphasis on investor protection and corporate governance (each to be achieved primarily through prosecution of individual offenders) diverted the SEC from its other major task, the encouragement of capital formation.[21]

Karmel expounds this general critique through case studies of the SEC's role in the corporate governance movement, its approach to the evolving national market system, its jurisdictional expansionism, and its tendency to erode materiality as a prerequisite to mandatory disclosure. Although a full summary of each of these case studies is beyond the scope of this review, some of her specific criticisms deserve attention.

For example, Karmel's analysis of how the SEC used its control over the proxy rules to promote reforms in corporate governance, in overseas selling practices, and, generally, in the corporate sense of social responsibility, points clearly to one unresolved contradiction in the agency's conduct. Specifically, the SEC would bring or threaten to bring enforcement actions against corporations which had paid foreign officials to secure contracts from their governments on the ground that such payments had not been adequately disclosed to the stockholders in a proxy statement or annual report.[22] The corporation would ordinarily agree to a consent injunction through which the SEC would cause a restructuring of the board of directors or would apply other, ever more novel, forms of ancillary relief.[23] The SEC would bring all of this about in the name of investor protection. The contradiction, however, is that most shareholders of those companies were not concerned with the illegality or immorality of foreign payments. Rather, those shareholders, like most shareholders, were primarily investors interested in tapping the corporation's income stream, thereby receiving a return on their investment. Thus, the relatively small amounts paid by management to receive lucrative foreign contracts were not matters of information material to the shareholders and, Karmel concludes, should not have been a basis for SEC action. In other words, the SEC's sensitive payments program of the mid-1970's may have served some

analysis of the role of the Enforcement Division of the 1970's comes very close to an *ad hominem* attack on Stanley Sporkin.

20. *See generally id.* at 219-22.

21. *Id.* at 145, 185.

22. *See generally id.* at 148-59.

23. *Id.* at 148, 220.

public purpose, but it was not that of investor protection.[24]

Karmel generalizes this critique of the sensitive payments program to encompass the SEC's entire effort to use the proxy rules to reform corporate governance in order to institutionalize a sense of corporate social responsibility.[25] In Karmel's view, the SEC's goal was to restructure public corporations so that they would meet social needs as well as economic goals. Karmel concedes that such reform may be desirable, but insists that it cannot be achieved in the name of the *investor,* because the investor's objectives are, with rare exception, primarily economic.[26] Karmel, therefore, concludes that the SEC's mandate of investor protection provided no basis for the agency's attempt to reform corporate governance. While one may argue about the implications of all of this, it is hard to dispute her basic point about the limited nature of the SEC's authority in this area.

Even more compelling is Karmel's indictment of the SEC's record in the regulation of tender offers, a record recently marred by the agency's assault on state tender offer laws.[27] The SEC's attempt to force preemption of state tender offer statutes would perhaps be more defensible if it had been the result of a careful, thorough, and open analysis of the regulatory alternatives, and not, as Karmel emphasizes, *ad hoc* litigation.[28] The SEC's behavior in this episode appears even more reprehensible once it is realized that the tender offer statute administered by the SEC (the Williams Act) was not the product of careful study and policy formulation by the agency, but was an expedient political compromise.[29] The SEC's preemptive strike on state takeover regulation thus seems more and more like institutional self-aggrandizement coupled with utter disregard for the effects of its actions on the traditions of federalism.

Karmel suggests that the SEC's disregard for the broader consequences of its actions undermined the credibility of other agency efforts in the 1970's. As an example, Karmel cites *International Brotherhood of Teamsters v. Daniel,*[30] where the Supreme Court rejected the SEC's assertion, as amicus curiae, that a noncontributory, compulsory pension

24. *Id.* at 148-51.

25. *Id.* at 140.

26. *Id.* at 160-61, 186.

27. *See generally id.* at 207-11. For a discussion of how the SEC attempted to preempt the state takeover laws first through litigation and then through a directly preemptive rule, see Sargent, *On the Validity of State Takeover Regulation: State Responses to MITE and Kidwell,* 42 OHIO ST. L.J. 689, 692-702 (1981); Note, *State Regulation of Takeovers*, 7 J. CORP. L. 603, 612-20 (1982).

28. REGULATION BY PROSECUTION 211.

29. For a detailed examination of how the Williams Act represents one of the SEC's failures to play a positive role in policy formulation, see J. SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 432.

30. 439 U.S. 551 (1979).

plan constituted a "security."[31] The SEC's action in *Daniel* was, according to Karmel, typical of the SEC's tendency to take adversarial positions without fully analyzing the policy implications of its actions.[32]

An even more glaring example of the SEC's myopia was its argument in *Schoenbaum v. Firstbrook*[33] that "there are no so-called territorial limitations" on the Securities Exchange Act of 1934, since the Act "is generally applicable whenever such application is necessary and appropriate for the protection of American investors and markets."[34] Although the *Schoenbaum* court rejected that argument, the SEC has continued to urge that the securities laws be given the broadest possible extraterritorial effect.[35] Karmel's criticism of this position is persuasive:

> [T]he Commission looked at the [foreign] issuers from the standpoint of a mythical public investor, entitled to the same disclosure from foreign as from U.S. issuers. For better or worse, the national interest is much more complex than this single-minded focus. A regulatory policy that may have an important impact on foreign policy, capital allocation and the balance of payments should not be made by an independent agency in the process of maintaining and expanding its jurisdiction through the prosecution of cases.[36]

While the SEC's record in the tender offer, pension plan, and foreign issuer contexts is marked by a disregard for the broader consequences of its prosecutorial actions, its record in two other areas is marked by what Karmel would characterize as simple disregard for the law. While this may be an overstatement, Karmel has accurately defined some of the unresolved tensions in the agency's rule 2(e)[37] professional responsibility program[38] and its use of section 21(a)[39] reports to publicize cases that involved questionable conduct which did not seem

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31. *Id.* at 563-69.

32. *See* REGULATION BY PROSECUTION 191, where Karmel notes:

> [T]he Commission refused to come out with a clear interpretation of the type of employee-benefit plan that would be considered 'securities,' and how the securities laws applied to different types of plans that were 'securities' until after the *Daniel* decision. Billions of dollars of pension plan interests were affected by this interpretation. It should not have been deferred for the sake of "winning" a single case.

Id. (citations omitted).

33. 405 F.2d 200 (2d Cir. 1968), *cert. denied sub nom.* Manley v. Schoenbaum, 395 U.S. 906 (1969).

34. Brief of the SEC as Amicus Curiae on Rehearing at 11, 16, Schoenbaum v. Firstbrook, 405 F.2d 200 (2d Cir. 1968), *quoted in* REGULATION BY PROSECUTION 217, *cert. denied sub nom.* Manley v. Schoenbaum, 395 U.S. 906 (1969).

35. *See, e.g.,* IIT v. Cornfeld, 619 F.2d 909 (2d Cir. 1980); SEC v. Kasser, 548 F.2d 109 (3d Cir.), *cert. denied,* 431 U.S. 938 (1977).

36. REGULATION BY PROSECUTION 219.

37. 17 C.F.R. § 201.2(e) (1982).

38. *See generally* REGULATION BY PROSECUTION 173-83.

39. 15 U.S.C. § 780(a) (1976 & Supp. V 1981).

to constitute clear violations of the federal securities laws.[40]

Rule 2(e) permits the SEC to discipline any person practicing before the agency who fails to meet certain generally specified standards of integrity and competence. In the early 1970's the SEC began using the rule routinely in order to suspend or bar attorneys from practice before it. Since the SEC construes "practice before the Commission" to include the furnishing of any opinion or advice in connection with a securities transaction, application of this rule could have a devastating effect. The rule 2(e) professional responsibility program drew much of Karmel's fire while she was a Commissioner, and she restates in her book two basic objections:

> First, as a matter of statutory construction, I did not believe the Commission had the authority to promulgate rule 2(e). That is, I did not believe that the general power to make such rules and regulations as may be necessary or appropriate to implement the provisions of the securities laws was a sufficient predicate for a program to discipline professionals, particularly attorneys. Second, I was convinced that the SEC's utilization of [r]ule 2(e) to promote the agency's regulatory policies was an unwarranted interference with the right to the effective assistance of counsel of persons regulated by the Commission.[41]

While these objections are answerable,[42] they do compel the conclusion that the SEC should have been more tentative about developing disciplinary cases against the very same attorneys who were representing persons under investigation or who were subject to prosecution by the agency.

The SEC's expansive use of rule 2(e) is matched by its use of section 21(a) of the Securities Exchange Act of 1934, which authorizes the agency to publish reports of its investigations. According to Karmel, the SEC has frequently used the threat of section 21(a) publicity to compel changes in corporate governance in cases which the agency could not have established a violation of the securities laws and obtained an injunction.[43] Karmel argues persuasively that the SEC's use of publicity as an implied enforcement procedure is highly improper.

From these critiques Karmel derives some sensible recommendations. Her principal recommendation urges the SEC to shift from regulation by prosecution to a regulatory mode that emphasizes rule-making, consensus building, and government business and inter-agency cooperation.[44] Equally sensible is Karmel's insistence that the

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40. *See generally* REGULATION BY PROSECUTION 196-98.
41. *Id.* at 177.
42. See, for example, Karmel's summary of the SEC's responses to her arguments in *id.* at 179.
43. *Id.* at 197-98.
44. *Id.* at 95, 98, 109, 145, 185, 336. While the regulatory mode proposed by Karmel

SEC abandon its institutional parochialism and defensiveness in order to respond to the ongoing reorganization of the financial world.[45] The validity of some of Karmel's criticisms, and the value of some of her recommendations, however, are undercut by some serious flaws in her general approach.

First, her faith in the ability of the securities industry to regulate itself seems largely unjustifiable. As Joel Seligman demonstrates in *The Transformation of Wall Street: A History of the Securities and Exchange Commission and Modern Corporate Finance,*[46] the SEC's reliance on the self-regulatory organizations has worked effectively only when the SEC has demonstrated its willingness to use what William O. Douglas, the agency's third Chairman, might have called the "shotgun in the closet."[47] For example, Seligman shows in detail how the SEC's deferral to self-regulation by the New York Stock Exchange exacerbated the "back-office" crisis of the late 1960's[48] and prolonged the life of the Exchange's outmoded and anti-competitive fixed commission rate

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seems desirable in the abstract, and while the phrase "regulation by prosecution" carries highly negative connotations, some doubts about the effectiveness of her proposed mode should be expressed. Regulation through an agency's enforcement division has the virtue of precision, since the regulatory weight falls primarily on a narrow segment of the regulated industry. Regulation through broadly-focused rule-making tends to effect all segments of the industry, thus generating greater compliance costs as a whole, and increasing the total "amount" of regulation. Karmel does not seem to recognize this phenomenon, and emphasizes only the negative aspects of the prosecutorial mode of regulation.

45. *Id.* at 307.

46. The book is hereinafter cited as THE TRANSFORMATION OF WALL STREET.

47. The term "shotgun in the closet" is a paraphrase of how Douglas once described the responsibility of the SEC to monitor the performance of the self-regulatory organizations. "Government would keep the shotgun, so to speak, behind the door, loaded, well-oiled, cleaned, ready for use but with the hope it would never have to be used." W. DOUGLAS, DEMOCRACY AND FINANCE 82 (1940). This volume collects the addresses and public statements of Douglas as a member and chairman of the SEC. One of the major achievements of THE TRANSFORMATION OF WALL STREET is its reexamination of Douglas' important role in the SEC's early successes. THE TRANSFORMATION OF WALL STREET 156-212. This reexamination is long overdue. Since Douglas' accomplishments as a Supreme Court Justice overshadowed his accomplishments as an SEC commissioner, relatively little scholarly attention has been paid to that part of his career. The most detailed study prior to Seligman's book was Jennings, *Mr. Justice Douglas: His Influence on Corporate and Securities Regulation,* 73 YALE L.J. 920 (1964). Douglas himself has also described his experiences at the agency in his memoirs. W. DOUGLAS, GO EAST, YOUNG MAN 257-315 (1974).

48. The "back-office" crisis of 1967-70 was the result of an inability of many brokerage firms, both large and small, to handle the increased flow of business generated by a sharp and prolonged increase in trading volume on the New York Stock Exchange. The inability of the industry's self-regulatory organization to cope with this crisis helped set in motion the greatest rash of brokerage firm collapses in Wall Street's history. *See generally* THE TRANSFORMATION OF WALL STREET 450. Seligman argues convincingly that the SEC deferred to the Exchange's regulation of its member firms for too long a time, and that it must therefore bear some of the blame for the wave of firm failures in 1969-70. *Id.* at 464.

structure.[49] Similarly, Seligman shows how the SEC contributed to the near breakdown of the American Stock Exchange during the early 1960's by assuming that the Exchange was aware of its responsibilities and was capable of meeting them.[50] The agency's failure to pull the shotgun out of the closet during the Truman and Eisenhower administrations also allowed the National Association of Securities Dealers (NASD), which regulates over-the-counter broker-dealers, to relax its disciplinary standards. This lack of disciplinary rigor on the part of the SEC and NASD was, according to Seligman, at least partially responsible for the discernible increase in securities fraud during the 1950's.[51] An objective appraisal of this record should be enough to cast doubt on Karmel's assertion that advances in commercial technology render the current marketplace more capable of self-policing than was formerly the case.[52]

Karmel's rosy view of the securities industry has also colored her perception of the ongoing battle over the national market system.[53] Not only does she describe the SEC's behavior in the process of developing this system as overly strident and even vituperative, but she also accuses the SEC of attempting "to indict the entire securities industry for failing to accomodate itself . . . to a rapidly changing economy and marketplace."[54] While Karmel's description is not without merit, it appears insubstantial when compared to Seligman's incisive analysis concerning the SEC's efforts to avoid disruptions in securities trading while developing a central market system.[55] Seligman's analysis, in fact, leads him to the opposite conclusion. Seligman argues that the various sectors of the securities industry are responsible for the delay in the development of a technologically efficient system which would maximize competition among market-makers, and suggests that the SEC has been unduly concerned with preserving existing institutions and jobs at the expense of long-term economic rationality.[56]

Second, Karmel's insistence that the SEC has neglected its responsibility to assist capital formation is misconceived. The nature of her misconception is demonstrated most vividly by her sole positive recommendation with respect to how the SEC could play a greater role in capital formation. Karmel recommends that Congress insert language into the preambles of the securities statutes requiring the SEC, when implementing those statutes, to encourage capital formation.[57] Why is

49. *See generally id.* at 382-416.
50. *Id.* at 281-89.
51. *Id.* at 299-300.
52. REGULATION BY PROSECUTION 339.
53. *See generally id.* at 486-534.
54. *Id.* at 109.
55. *See generally* THE TRANSFORMATION OF WALL STREET 486-534.
56. *Id.* at 533-34.
57. REGULATION BY PROSECUTION 300-01. A current SEC commissioner, Bevis Longstreth, has also recognized that the existing federal securities statutes do not

Karmel's only positive recommendation so tentative, so aspirational, so devoid of substantive content? Why did she have so much trouble producing a more substantial redefinition of the SEC's role in the capital formation process? The answer is simple: the SEC's role in that process can only be very limited.

The SEC can encourage capital formation by meeting its traditional responsibility of sustaining investor confidence through investor protection. As Seligman shows at length, and as Karmel would probably concede, the agency has generally met that responsibility. The SEC can also encourage capital formation by removing or reducing the costs of regulatory compliance when those costs are disproportionate to the social and economic benefits generated by compliance. Accordingly, the agency has been gradually redesigning its scheme of transactional exemptions in order to allow small businesses to raise capital without incurring the costs of full-scale registration of securities.[58] Since the costs of full-scale registration are prohibitively high for small businesses, these reforms may remove some obstacles to small business capital formation.

Simply stated, there is not much the SEC can do to foster capital formation beyond meeting its traditional goals of maintaining the stability of capital markets, sustaining investor confidence, and removing unnecessary impediments to capital formation. Our nation's current difficulty in generating capital has much more to do with the decline in American productivity than with what the SEC has or has not done. The causes of this decline undoubtedly include the obsolescence of our industrial plants, the dwindling of our internal energy resources, the strength of our foreign competitors, and the short-sightedness of both our managerial and labor policies.[59] The SEC and the securities laws, therefore, cannot bear much of the responsibility for creating our na-

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mandate promotion of capital formation by the SEC, but suggests that amendment along the lines suggested by Karmel would be inappropriate:

> Congress did [not] tell us to facilitate capital formation. It told us to protect investors. Congress knew that by doing that, and by assuring fair and orderly markets, the SEC would indirectly be assuring that the marketplace would be an excellent way to form capital and transfer capital. You facilitate capital formation directly through tax policy, fiscal and monetary policy, not through what we are doing—except indirectly.

Special Report: Concern Over Congressional Reactions Affects SEC Actions, 15 SEC. & L. REP. (BNA) 566, 571-72 (1983).

58. For a useful summary of those developments, see Parnell, Kohl & Huff, *Private and Limited Offerings After A Decade of Experimentation: The Evolution of Regulation D,* 12 N.M. L. REV. 633 (1982).

59. The flight of investment capital from equity to debt also had a negative impact on capital formation, but this phenomenon has much more to do with the macroeconomic causes of high interest rates than with the federal scheme of securities regulation. For general considerations of the current economic quandry, see Thurow, *How to Rescue a Drowning Economy,* N.Y. REV. BOOKS, Apr. 1, 1982, at 2; Rohatyn, *Reconstructing America,* N.Y. REV. BOOKS, Mar. 5, 1981, at 16; Galbraith, *The Conservative Onslaught,* N.Y. REV. BOOKS, Jan. 22, 1981, at 30.

tional problems with respect to capital formation, nor can they do much to solve them. Karmel's argument that the SEC should direct its energies toward capital formation thus involves not only a misconception of the agency's role but also an exaggeration of its importance.

Third, Karmel's assertion that the SEC's sensitive payments program constituted a distortion of the agency's mandate to promote full and fair disclosure suffers from a failure to appreciate the real benefits of mandatory disclosure. Karmel argues that the SEC's sensitive payments program could not be justified as a means of promoting full and fair disclosure because such payments were not matters of material information which would be important to the ordinary investor.[60] Since the ordinary investor would not be interested in disclosure of such payments, Karmel concludes that the issuers in question should not have been punished for failure to disclose them. This argument, however, fallaciously presumes that the SEC-mandated disclosure is valuable because it gives the potential investor the material information needed for an educated investment decision. As Homer Kripke and other critics have pointed out,[61] this presumption is false because: (1) the ordinary investor is often unable to understand the information he is given; (2) the information provided about one issuer does not necessarily permit a meaningful comparison of that investment opportunity with others; (3) investment decisions are often made on the basis of other factors which have little if anything to do with the information an issuer is required to disclose; and (4) information is often not delivered until after the transaction is completed.[62] In short, SEC-mandated disclosure cannot be defended as a technique of creating a class of informed investors. Karmel's attack on the sensitive payments program is thus flawed because it defines the policy of full and fair disclosure solely as a response to the needs of the mythical informed investor. Karmel fails to recognize the real public concerns served by this disclosure system, and accordingly fails to see how the agency's sensitive payments program may in fact be justifiable in terms of the policy of full disclosure.

The SEC's policy of full disclosure has at least three beneficial effects. First, mandatory disclosure forces corporate managers to tell the truth. As corporate managers become accustomed to telling the truth, they may begin to see that full and fair disclosure is not only a way to

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60. REGULATION BY PROSECUTION 148-51; *see supra* text accompanying notes 22-24.

61. *See, e.g.*, J. BROOKS, THE GO-GO YEARS: WHEN PRICES WENT TOPLESS 347 (1973); H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 24-36 (1979); H. MANNE & E. SOLOMON, WALL STREET IN TRANSITION 51 (1974). For evaluations of these critiques see Ratner, *The SEC: Portrait of the Agency As A Thirty-Seven Year Old*, 45 ST. JOHN'S L. REV. 583 (1971); *New Approaches To Disclosure In Registered Security Offerings—A Panel Discussion*, 28 BUS. LAW. 505 (1973).

62. Ratner, *The SEC: Portrait of the Agency as a Thirty-Seven Year Old*, 45 ST. JOHN'S L. REV. 583, 586-87 (1971).

avoid liability, but also a way to help the issuer's business by broadening the market for its securities.[63] Second, mandatory disclosure has improved corporate managers' performance with respect to the institutions they serve. As David Ratner points out:

> There are many questionable arrangements which corporate managers [would] set up if they [could] do so in secret, but which they [would] not set up if [those arrangements] [had] to be disclosed on a public record. The motivation [against such arrangements] may be fear of lawsuits, or simply embarrassment, but, regardless of the exact cause, I would guess that the SEC's disclosure requirements have deterred more questionable deals than all the substantive rules laid down in state corporation laws or court decisions.[64]

Third, mandatory disclosure generates the type of information which the marketplace needs to operate efficiently. The premise of the semi-strong version of the efficient market hypothesis is that all publicly available information about securities is processed efficiently by the market and is fully reflected in the prices of the securities.[65] The corollary of this hypothesis is that securities prices will be "fair" only if the market has accurate and complete information upon which to act. Accordingly, the SEC's disclosure systems (especially the 1934 Securities Exchange Act's periodic disclosure system) are important to the fairness of the securities markets.

When the public concerns served by mandatory disclosure are defined in these terms, it may be possible to justify the SEC's sensitive payments program. The doctored books and phony reports used to hide payments to foreign officials may have been of little interest to the ordinary investor, as Karmel suggests, but they represent a gross departure from the tradition of managerial honesty which SEC-mandated disclosure has attempted to foster. While the agency may have overreacted by devoting an excessive amount of time and money to this program, it could not have countenanced such a departure without undermining its long-term efforts to promote managerial responsibility and the fair operation of the market.

Finally, Karmel's criticism of the SEC's performance in the 1970's, while accurate at points, suffers from a lack of historical perspective.

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63. *Id.* at 587-88. Ratner admits that this may be wishful thinking, but it is possible that the institutionalization of reporting procedures may eventually make managerial truth-telling normative.
64. *Id.* at 588.
65. For a concise explanation of the efficient market hypothesis in its weak, semi-strong and strong forms, see Walker & Hadaway, *Merit Standards Revisited: An Empirical Analysis of the Efficacy of Texas Merit Standards*, 7 J. CORP. L. 651, 656-57 (1982) and the authorities cited therein; *see also* H. KRIPKE, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 309-11 (1979); J. LORIE & M. HAMILTON, THE STOCK MARKET: THEORIES AND EVIDENCE 70-110 (1973); THE TRANSFORMATION OF WALL STREET 563-68.

For example, when the SEC's corporate governance initiatives are regarded in historical perspective, they seem less questionable. The evolution of American corporate law has been marked by the gradual but inexorable removal of restraints on the ability of corporate management to disregard the interests of not only public shareholders but also the public at large.[66] Although the SEC's corporate governance initiatives may have exceeded or misconstrued the agency's specific statutory mandate, they were the first real attempt to redefine the role of the public corporation in American life. It may not have been entirely appropriate for the SEC to undertake that redefinition, but it was perhaps necessary for someone to do it.

The historical perspective which Karmel's book lacks is provided brilliantly by Joel Seligman's *The Transformation of Wall Street.* His book reminds us of two facts which are so basic that they tend to be forgotten. First, American finance has been fundamentally transformed in the last fifty years. Gone are the days in which the financial markets were dominated by an exchange once described as a "private club" possessing "elements of a casino."[67] No longer are the markets abused by the use of "bear raids,"[68] "preferred" stockholder lists,[69] "pyramiding"[70] and the many other manipulative and dishonest practices for which there were no adequate legal remedies. Today's

66. The literature on corporate governance is voluminous, so only a few of the most important works can be cited here. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (rev'd ed. 1968); M. EISENBERG, THE STRUCTURE OF THE CORPORATION (1976); M. MACE, DIRECTORS: MYTH AND REALITY (1971); R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976); C. STONE, WHERE THE LAW ENDS (1975); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977); Douglas, *Directors Who Do Not Direct*, 47 HARV. L. REV. 1305 (1934).

67. This was Douglas' description of the New York Stock Exchange. SEC Press Release, Nov. 23, 1937, *reprinted in* W. DOUGLAS, DEMOCRACY AND FINANCE 65, 70 (1940), *quoted in* THE TRANSFORMATION OF WALL STREET 73.

68. "Bear raids" were conspiracies to depress the market so that the raiders could profit from short-selling. *See generally* THE TRANSFORMATION OF WALL STREET 8-16. Seligman offers this particularly lucid explanation of "short-selling":

> Usually an investor purchases stock and later sells it, earning a profit if the sales price of the security exceeds the purchase price. A short sale reverses the chronology. The investor who believes the market price of a security will decline sells the stock first, borrows shares from a broker to deliver to the purchaser, and profits if the price of the share does, in fact, decline, by purchasing shares at a lower price to return to the lending broker.

Id. at 9.

69. "Preferred" stockholder lists were lists of insiders who management would allow to purchase securities at secret, discount prices before the securities would be offered to the public. *See* THE TRANSFORMATION OF WALL STREET x.

70. Stock "pyramiding" was a device by which private banks like J.P. Morgan and Company or individuals like Samuel Insull could control public utility holding company empires despite having only minority common stock ownership. The key to the device was the purchase of voting control in a holding company placed

financial markets are subject to abuse, but they surely cannot be painted in such lurid hues. Second, this transformation of American finance has been achieved principally through the SEC's administration of the federal securities statutes. Seligman's book is thus aptly subtitled *A History of the Securities and Exchange Commission and Modern Corporate Finance.*

Seligman develops these themes in great detail through clear exposition of the legal and financial technicalities, and through meticulous attention to the primary source materials. His tone throughout is scholarly and objective. This is not to say, however, that Seligman lacks a point of view, because, in fact, he has a pronounced one. He never explicitly states his point of view, but it would seem to include a belief in certain inherently anti-social tendencies of modern corporate enterprise, a corollary skepticism about the effectiveness of industry self-regulation, and a disdain for the free market enthusiasts. It also includes a faith in the efficacy of the administrative process, a conception of the large corporation as a quasi-public entity with clear social responsibilities, and a basic belief in the ability of men to consciously reshape economic institutions in order to achieve the public good. In short, Seligman brought to bear on this work the ideas and attitudes expressed most directly in his earlier book, *Taming the Giant Corporation,*[71] which was co-authored by Ralph Nader and Mark Green, two leaders of the corporate governance movement. Despite the presence of such a strong point of view, however, Seligman allows his argument to be made through the accumulation of evidence and the careful assessment of different opinions rather than through conclusory theorizing, ill-tempered polemics, or *ad hominem* attacks. It can thus be said that this first complete history of the last fifty years of American finance and its regulation will set the standard for many years to come.[72] Any attempt

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at the top of a pyramid of holding companies. *See* THE TRANSFORMATION OF WALL STREET 128.

71. R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976).
72. While THE TRANSFORMATION OF WALL STREET is the first complete history of the SEC, there is literature on specific portions of the SEC's history. For example, the early years of the agency were the subject of R. DEBEDTS, THE NEW DEAL'S SEC (1964); M. PARRISH, SECURITIES REGULATION AND THE NEW DEAL (1970). Useful discussions of the same era can also be found in M. PARRISH, FELIX FRANKFURTER AND HIS TIMES: THE REFORM YEARS 234-37 (1982); D. RITCHIE & J. LANDIS: DEAN OF THE REGULATORS 43-78 (1980); and Jennings, *Mr. Justice Douglas: His Influence on Corporate and Securities Regulation,* 73 YALE L.J. 920, 934-51 (1964). Relatively little attention has been paid to the SEC of the 1940's and 1950's. Of some value is a collection of articles included in a *Symposium on the Securities and Exchange Commission,* 28 GEO. WASH. L. REV. 1 (1959); *see also* SEC, A TWENTY-FIVE YEAR SUMMARY OF THE ACTIVITIES OF THE SECURITIES AND EXCHANGE COMMISSION, 1934-1959 (1961). The SEC of the 1960's and 1970's has received more attention, although mostly in the form of memoirs and journalistic accounts of particular events. *See, e.g.,* J. BROOKS: THE GO-GO YEARS: WHEN PRICES WENT TOPLESS (1973); W. CARY, POLITICS AND THE REGULATORY AGENCIES (1967) (memoirs of a former SEC chairman); K. PATRICK, PERPETUAL JEOPARDY: THE TEXAS GULF SULPHUR AFFAIR (1972). The sparse-

to write a history which is more critical of the SEC and its effects on American finance will have to contend with this formidable book.

While *The Transformation of Wall Street* is mostly the history of the SEC's success, it is, in some respects, also the history of its failures. Seligman suggests that these failures have resulted from certain structural weaknesses in the agency's organization and in its statutory mandate. For example, the SEC's status as an independent agency (a kind of stepchild of both the Executive and the Congress) has, at times, left it without the kind of political clout needed to achieve its goals.[73] In addition, the breadth of the agency's statutory mandate has occasionally left it unable to deal effectively with dramatic developments, such as the "back office" crisis and conglomerate craze of the late 1960's, because the agency's limited resources were absorbed elsewhere. Similarly, the range of the SEC's responsibilities and the limitations of its resources exacerbate a tendency to solve problems through *ad hoc* litigation rather than through precise economic analysis and careful rule-making. Finally, the old-fashioned compartmentalization of the financial world implicit in the SEC's enabling statutes may hinder its ability to deal effectively with the current reorganization of financial institutions. Thus, Seligman's historical analysis also reveals a current need for reform of the agency and the laws it administers.

It perhaps makes little sense to compare a book as scholarly and ambitious as Seligman's with a book as personal as Karmel's. The writers had different goals, and their works will be put to different uses. By way of comparison, then, let it suffice to say that *The Transformation of Wall Street* offers, among its other riches, a clear and convincing corrective to much that is disturbing in *Regulation by Prosecution.*

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ness of this list suggests that there was a real need for THE TRANSFORMATION OF WALL STREET.

73. The vulnerability of an independent agency like the SEC is one of Seligman's major themes. Indeed, he begins his book with the following quote from former SEC Chairman William Cary: "Without the cooperation of both Congress and the Executive, little constructive can be achieved. To reemphasize the point, an agency is literally helpless if either branch is uninterested or unwilling to lend support." THE TRANSFORMATION OF WALL STREET vi.