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SEC REVIEW: COMFORT OR ILLUSION?

Abba David Poliakoff †

Registration statements and proxy materials filed pursuant to federal securities laws undergo various types of scrutiny by the Securities and Exchange Commission (the "SEC" or the "Commission") to determine compliance with applicable regulations and forms and the adequacy of disclosures required to be made in such documents. The more selective review procedures presently employed by the SEC and the proliferation of litigation related to allegedly inadequate disclosures raise the issue of whether a clearance of that document by the SEC should be accorded any evidentiary value. The author first outlines the review procedures applicable to registration statements and proxy materials. Then the author addresses the evidentiary question, examining opposing viewpoints expressed by statute and through case law, and concludes the SEC determinations should be accorded some evidentiary weight.

If suit is filed against a company for fraud or misrepresentation under the federal securities laws, an unsettled and, to some, unsettling question often arises: to what extent may the company rely upon the review and clearance of its disclosure documents by the SEC as evidence of the adequacy of the disclosure contained therein? Part I of this article examines the review procedures employed by the SEC with respect to registration statements and proxy material. Part II critiques the two divergent judicial viewpoints regarding what evidentiary value should be accorded the Commission's review and clearance of disclosure documents filed with the Commission.¹

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1. The issue presented here centers on the evidentiary value of the Commission's, or its staff's, determinations and actions or inaction, not on the issue of an estoppel claim against the Commission. It is generally accepted that, except in the case of an "egregious injustice," estoppel cannot be asserted against the SEC in an enforcement action. *See, e.g., Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715, 722 (8th Cir.), *cert. denied*, 419 U.S. 1107 (1974); *SEC v. Culpepper*, 270 F.2d 241, 248 (2d Cir. 1959); *Klein v. SEC*, 224 F.2d 861, 864 (2d Cir. 1955); *SEC v. Blavin*, 557 F. Supp. 1304, 1310 (E.D. Mich. 1983), *aff'd*, 760 F.2d 706 (6th Cir. 1985); *SEC v. Gulf & Western Indus., Inc.* [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,704 (D. D.C. Nov. 28, 1980); *SEC v. Cooper*, 402 F. Supp. 516, 524 (S.D.N.Y. 1975); *cf. SEC v. Harwyn Indus. Corp.*, 326 F. Supp. 943, 955-57 (S.D.N.Y. 1971).

I. BACKGROUND OF THE REVIEW PROCESS

A. *Statutory Framework*

Section 5 of the Securities Act of 1933² (the "1933 Act") is the operative section governing the registration of securities.³ Section 5(a) provides that it is unlawful to sell, offer to sell, or send for the purpose of sale⁴ a security⁵ through the mails or any instrumentality of interstate commerce unless a registration statement⁶ is in effect⁷ (or unless the offer or sale is made pursuant to an available exemption).⁸ Section 5(b)(1) prohibits the transmittal of any prospectus relating to any security for which a registration statement has been filed, unless the prospectus meets the requirements of section 10.⁹ Section 5(b)(2) prohibits the transmittal by mail or in interstate commerce of any security for the purpose of sale

2. Codified at 15 U.S.C. §§ 77a - 77aa (1982 & Supp. 1987).

3. See 15 U.S.C. § 77e (1982) (Securities Act of 1933, § 5).

4. 15 U.S.C. § 77b(3) (1982) (Securities Act of 1933, § 2(3)) defines the terms "sale" and "sell" as inclusive of "every contract of sale or disposition of a security or interest in a security, for value" and defines the terms "offer to sell," "offer for sale," and "offer" as inclusive of "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." *Id.*

5. 15 U.S.C. § 77b(1) (1982) (Securities Act of 1933, § 2(1)) defines the term "security" as:

any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, . . . or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

6. A registration statement consists of two parts. Part I, the prospectus, contains information regarding the company and the offering and is required to be delivered to investors at the time that any offer or sale is made. Part II contains certain other information required to be filed with the SEC but not required to be delivered to investors. Section 7 of the 1933 Act requires that the registration statement contain the information called for in Schedule A to the 1933 Act codified at 15 U.S.C. § 77aa (1982). Foreign governments or political subdivisions of foreign governments registering securities are required to provide the information set forth in Schedule B.

7. 15 U.S.C. § 77e(a) (1982).

8. Sections 3 and 4 of the 1933 Act provide specific exemptions from the registration requirements of the 1933 Act. The exemptions fall into two classes: exempted securities and exempted transactions. See 15 U.S.C. §§ 77c(a)(2)-(a)(8) (1982) (exempted securities); *id.* §§ 77c(a)(1), (a)(9)-(11), (b), (c), 77d(1)-(6) (exempted transactions).

9. *Id.* § 77e(b)(1). Section 10 of the 1933 Act, governing prospectus disclosure, requires that the prospectus contain the information called for by Schedule A or B, whichever is applicable, or such other information as the SEC requires by rule or regulation "as being necessary or appropriate in the public interest or for the protection of investors." *Id.* § 77j(c) (1982). The term "prospectus" is defined as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security," excluding certain contemporaneous communications which accompany,

unless accompanied or preceded by a prospectus meeting the requirements of section 10.¹⁰ Section 5(c) prohibits any offer to sell or offer to buy any security unless a registration statement has been filed.¹¹ The 1933 Act also imposes stringent liability for any false or misleading statement of a material fact in the registration statement, or any omission of a material fact either required to be contained in the registration statement or necessary to make the statements contained therein not misleading.¹²

follow, or refer to a prospectus, provided that the latter conforms to statutory requirements. *Id.* § 77b(10).

In addition to the information required by section 10 of the 1933 Act, section 7 of the 1933 Act empowers the Commission to prescribe further information to be contained in a registration statement. *See id.* § 77g. The Commission has promulgated various regulations regarding registration statements. *See* Regulation S-K, 17 C.F.R. §§ 229.10-.800 (1987); Regulation S-X, 17 C.F.R. §§ 210.1-01 to .12-29 (1987); Regulation C, 17 C.F.R. §§ 230.400-.499 (1987); *see also* 17 C.F.R. §§ 239.0-1 to .500 (1987) (forms prescribed under the 1933 Act).

The purpose for prescribing this disclosure is to provide full and fair disclosure to the investing public; therefore, the prospectus must include all information that an investor would consider material to making a decision as to whether to purchase the securities. H.R. Rep. No. 85, 73d Cong., 1st Sess. 3-4 (1933). For a discussion of the contents of a registration statement and the various forms prescribed by the Commission, see 3A H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* §§ 7.09-7.19 (1983).

Section 10(a)(3) requires that a prospectus be updated to provide current information. 15 U.S.C. § 77j(a)(3) (1982). In most cases, updating is accomplished by means of post-effective amendments to the registration statement. Section 10(d) gives the SEC the authority to classify prospectuses according to the nature and circumstances of their use or of the security, issue, issuer or otherwise. *Id.* § 77j(d).

10. *See Id.* § 77e(b)(2).

11. *Id.* § 77e(c).

12. Section 11 of the 1933 Act lists those persons who may be liable to purchasers for any material misstatements or omissions in an effective registration statement. *See Id.* § 77k. *See generally* *Feit v. Leasco Data Proc. Equip. Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971); *Escott v. Barchris Constr. Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968). The statute also provides certain affirmative defenses to section 11 liability if such persons (other than the issuer) meet a specific standard of knowledge or conduct with respect to the material misstatements or omissions. 15 U.S.C. § 77k (1982). The most important defense is where such person

had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading. . . .

Id. § 77k(b)(3); *see also id.* § 771 (any person who "offers or sells a security [in violation of section 5] shall be liable to the person purchasing such security from him, who may sue . . . to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon"); *id.* § 771(2) (imposing civil liability on any person who offers to sell or sells securities by means of any written or oral communication containing material misstatements or omissions, whether or not made pursuant to a registration statement); *id.* § 77q (making it unlawful to offer or sell securities by means of fraud or misrepresentation while using the facilities of interstate commerce or the mails); *id.* § 77x (subjecting violators of the anti-fraud provisions of *id.* § 77q to criminal penalties).

B. Review of Registration Statements

In practice, after the registration statement has been filed with the Commission,¹³ the registration statement is assigned to one of the operating branches of the Commission's Division of Corporation Finance.¹⁴ The Commission's staff reviews the registration statement to determine its compliance with the informational requirements of the 1933 Act and the forms, regulations and policies of the staff. After commenting on (or determining not to review) the registration statement, and determining that any amendment filed complies with the staff's comments, the staff, on behalf of the Commission, will issue an order declaring the registration statement effective, and the company will commence the public offering.¹⁵

The 1933 Act does not specifically provide for this type of review of registration statements filed with the Commission. In fact, section 8(a) of the 1933 Act provides that a registration statement will become effective automatically twenty days after it is filed with the Commission, or twenty days after any amendment to the registration statement is filed with the Commission.¹⁶ The 1933 Act expressly envisions formal proceedings in the event the disclosure in a registration statement is deficient or misleading.¹⁷ Under section 8(b) of the 1933 Act the Commission may issue an order refusing to permit the effectiveness of a registration statement if the registration statement appears to the Commission to be incomplete or inaccurate in any material respect.¹⁸ After the registration statement has become effective, section 8(d) of the 1933 Act provides that the Commission may issue a stop order suspending the effectiveness of an effective registration statement if the Commission determines that the registration statement includes an untrue statement of a material fact or fails to state a material fact required to be stated or necessary to make the statements in the registration statement not misleading.¹⁹

The Commission learned, however, in its early years soon after the enactment of the 1933 Act, that the formal process of challenging the registration statement was not the best method of policing disclosure. Because of the overwhelming number of registration statements which were filed with the Commission each year, the Commission devised the "letter of deficiencies" review method, later renamed the "letter of comment" method, to effectuate the statutory aims of assuring full and fair

13. See *id.* § 77f (procedure for filing registration statements); see also 17 C.F.R. §§ 230.402 - .403 (1987) (filing rules).

14. The Commission's Division of Corporation Finance is responsible for processing registration statements and reports. See 17 C.F.R. § 200.30-1 (1987).

15. See *supra* note 9 and accompanying text.

16. 15 U.S.C. § 77h(a) (1982). The effective date may be sooner than the twentieth day after filing if the Commission accelerates effectiveness. *Id.*; see *infra* notes 28-35 and accompanying text.

17. See *id.* § 77h(b), (d), (e).

18. *Id.* § 77h(b). The Commission has never issued an order under this section.

19. *Id.* § 77h(d).

disclosure without invoking the unduly harsh consequences of formal process under section 8.²⁰ Under this method of operation, the Commission's staff reviewed the initial filing of a registration statement and issued a detailed letter of comment advising the issuer's counsel of any deficiencies in the registration statement that the staff believed needed correction.²¹ This revised method of operation, adopted for the review of registration statements subject to the 1933 Act, offered a distinct advantage to all parties, including the Commission's staff and public investors. The new technique was so successful that it received explicit congressional approval by incorporation in the Investment Company Act of 1940.²²

In 1980, the Commission refined the review process by implementing a system of selective review in order to allow the Commission's staff to keep pace with the increasing number of disclosure documents filed with the Commission.²³ Under this selective review system, first-time is-

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20. See TENTH ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. Doc. No. 158, 79th Cong., 1st Sess. 16 (1945) (using the term "letter of deficiencies"); Thirteenth Annual Report of the Securities and Exchange Commission, Fiscal Year Ended June 30, 1947, H.R. Doc. No. 461, 80th Cong., 2d Sess. 2 (1948) (using the term "letter of comment").

At about the same time, section 8(a) was amended to grant authority to the Commission to accelerate the effective date of registration statements and any pre-effective amendments so that the issuer would not have to wait twenty days for the registration statement to become effective. Act of Aug. 22, 1940, ch. 686, Title III, § 301, 54 Stat. 857. Initially, the securities industry lobbied in Congress to permit "blue chip" companies to become effective in less than twenty days by acceleration of the effective date. The Commission saw this as an opportunity to better effectuate the purposes of the 1933 Act and to perform its function more efficiently, and joined the lobbying effort. *Id.*

21. The Commission's comments are not necessarily limited to the specific material disclosure items contained in or omitted from the registration statement, but also may refer to the form and readability of the registration statement. Expediting Registration Statements Filed under the Act, Securities Act Release No. 4970, [1961 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,705 (May 1, 1969). See generally Orlanski, *SEC Comments on the Offering Prospectus*, 17 REV. SEC. REG. 887 (1984). Although there are no legal consequences for failing to respond to a letter of comment, the issuer's failure to respond to the letter of comment carries with it the implied threat of a formal stop order proceeding. Accordingly, rather than risk the adverse consequences of formal action, issuers will comply readily with the staff's comments contained in the letter of comment.
22. 15 U.S.C. § 80a-8(e) (1982). Act of Aug. 22, 1940, ch. 686, Title I, § 8, 54 Stat. 803. Receipt of a letter of comment, however, is not a "right" which may be demanded or enforced. When a registration statement is grossly deficient or when the deficiencies appear to stem from a careless disregard of the statutory and regulatory requirements, the staff is not obligated to pinpoint each alleged inadequacy. "[T]o require it to do otherwise would unduly interfere with administrative efficiency and delay the processing of other filings that do not present comparable disclosure problems." *Boruski v. Division of Corp. Fin.*, 321 F. Supp. 1273, 1276 (S.D.N.Y. 1971). In such cases, a brief letter usually is sent which merely highlights some of the major areas of deficiency.
23. In a speech delivered during November, 1980, then SEC Chairman Harold M. Williams announced a change in the procedure followed by the Commission's staff with respect to filings made under the 1933 Act and the Exchange Act. *Commission to*

suers usually receive a full review by the Commission, while offerings by seasoned issuers or companies meeting certain criteria are reviewed, if at all, only on a selective basis. The Commission has not made public the criteria for determining whether the staff will review a registration statement under the selective review system.

In the course of the review process, registration statements are usually amended at least once in response to a letter of comment from the Commission's staff recommending corrections or clarifications. In order to prevent the registration statement from becoming effective in deficient form automatically after the twenty-day statutory period, issuers include a legend, referred to as the "delaying amendment," on the facing page of the initial filing of the registration statement.²⁴ The delaying amendment

Implement Changes to Reduce Delays in Processing of Registration Statements, SEC Reg. & L. Rep (BNA) No. 579, at A-14 (November 19, 1980). Williams stated that beginning November 17, 1980, the procedure formerly followed by the Commission's staff will be replaced by a system of "selective review" in order to allow the concentration of increasingly scarce manpower on the most high priority areas. *Id.* See generally *The Division of Corporation Finance's Procedures Designed to Curtail Time in Registration Under the Securities Act of 1933*, Securities Act Release No. 5231, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,509 (Feb. 3, 1972) (setting forth review procedure followed formerly). No formal release on selective review was issued by the Commission. Although the selective review procedure has not been formally adopted or codified, its existence has been acknowledged by the Commission. See *Delayed or Continuous Offering and Sale of Securities*, Securities Act Release No. 6470, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,362 (June 9, 1983) ("Staff processing of shelf registration statements is done in accordance with the same selective review procedures applied to all Securities Act Filings."). Under these procedures, the Commission's staff screens each registration statement filed in order to determine whether it will be reviewed. Certain 1933 Act registration statements are not reviewed, and in such cases, requests for acceleration of effectiveness are treated as a confirmation by participants in the offering of their awareness of their sole responsibility for the accuracy of disclosures. See *Commission to Implement Changes to Reduce Delays in Processing of Registration Statements*, Sec. Reg. & L. Rep. (BNA) No. 579, at A-15 (November 19, 1980).

The Commission also announced that an issuer whose preliminary proxy statement or information statement has been on file for the required ten days may mail such materials without awaiting any notice or comments from the staff. *Id.* If the Commission's staff has or will have comments on a preliminary proxy statement or information statement, the staff will advise the issuer as soon as the staff determines that it may have comments, but in any event prior to the tenth day. If an issuer has not been so advised by the Commission's staff in the ten days after filing a preliminary proxy statement or information statement, the issuer may proceed without comments thereon. Therefore, it is not necessary to advise issuers or respond to issuer inquiries concerning the review status of a preliminary proxy statement or information statement, and the Commission's staff has discontinued the practice. The Division of Corporation Finance also advised that, except in cases of opposing solicitations, it no longer will exercise its delegated authority to grant requests for acceleration of the ten-day filing period under Rule 14a-6(a) or Rule 14c-5(a). *Id.*

24. The delaying amendment is a notation on the cover of a registration statement pursuant to Rule 473 that "amends" the registration statement every twenty days, preventing it from becoming effective automatically by lapse of time, until the Commission, the issuer and underwriters are prepared to permit the offering to commence. See 17 C.F.R. § 230.473 (1987). The delaying amendment consists of the following language:

postpones the automatic effective date of the registration statement until the issuer has amended the registration statement to comply with the comments of the Commission's staff.

C. *Acceleration of Effectiveness and Post-Effective Amendments*

When the issuer has finally amended the registration statement to the satisfaction of the Commission's staff and is ready to initiate the public offering, the issuer will then request that the Commission "accelerate" the effective date of the registration statement.²⁵ Under section 8 of the 1933 Act, the Commission has authority to set the effective date of a registration statement earlier than the twentieth day after filing of a registration statement or any pre-effective amendment.²⁶ The Commission is authorized also to fix the effective date of an amendment to the registration statement filed after the registration statement has become effective.²⁷ In practice, the effective date is accelerated to a date specified by the issuer by letter to the Commission received at least two days before the requested effective date.

Section 8 of the 1933 Act articulates the standards to be met in order for the Commission to accelerate the effective date of a registration statement and to fix the effective date of a post-effective amendment. Section 8(a) provides that the Commission may accelerate the effective date of a registration statement, "having due regard to the adequacy of the information respecting the issuer theretofore available to the public . . . and to the public interest and the protection of investors."²⁸ Applying similar standards, section 8(c) empowers the Commission to fix the effective date of a post-effective amendment "if such amendment, upon its face, appears to the Commission not to be incomplete or inaccurate in any material respect . . . , [the Commission] having due regard to the public interest and the protection of investors."²⁹ In this context, the Commission has delineated, in SEC Rules 460 and 461, some of the factors which must be considered in determining whether the section 8 stan-

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the registration statement shall become effective on such date as the Commission acting pursuant to said Section 8(a), may determine.

17 C.F.R. § 270.473 (1987).

25. Acceleration is governed by 15 U.S.C. § 77h(a) (1982); *see also infra* notes 28-35 and accompanying text.

26. *See id.* § 77h(a). Pursuant to this statutory authority, the Commission has delegated to the Division of Corporation Finance the authority to grant acceleration. 17 C.F.R. 200.30-1(a)(5)(i) (1987).

27. 15 U.S.C. § 77h(c) (1982).

28. *Id.* § 77h(a).

29. *Id.* § 77h(c). Post-effective amendments are filed subsequent to the effective date of the registration statement generally to disclose material changes since the effective date of the registration statement or to update the prospectus. *Id.*

dards have been met, principally relating to the adequacy of the disclosure and the dissemination of information regarding the issuer by means of distributing the preliminary prospectus.³⁰

One factor which may be cause for the Commission to deny a request for acceleration is the existence of a current investigation of the issuer by the Commission pursuant to any of the Acts of Congress that it administers.³¹ Notwithstanding any such investigation, the Division of Corporation Finance must make its finding under section 8, without undertaking any inquiry which could interfere with an ongoing investigation, that acceleration would be in the public interest. If, however, the material facts of a registration statement are the subject of an active investigation, then the adequacy of the disclosure cannot be ascertained, and no determination can be made that the offering would be in the public interest and that investors would be adequately protected.

In this situation, the staff may be concerned that if the Commission actually takes affirmative action (*i.e.*, signs the order of effectiveness) to declare the registration statement effective, then the issuer may attempt to use the order of effectiveness as evidence of the Commission's approval and as a defense in any action instituted (by the Commission or others) under the securities laws. The staff is therefore unwilling to sign an order explicitly declaring the registration statement effective. The issuer, on the other hand, is also placed in a dilemma: the staff is generally unwilling to offer the issuer comments on the adequacy of the disclosure regarding the investigation, even where the staff may have reason to question the disclosure. Comments by the staff could result in the involvement of the

30. 17 C.F.R. §§ 230.460, 230.461 (1987) (Regulation C). Rule 461 provides in part:

Having due regard to the adequacy of information respecting the registrant theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the registrant issuer and the rights of holders thereof can be understood, and to the public interest and the protection of investors . . . it is the general policy of the Commission, upon request . . . to permit acceleration of the effective date of the registration statement as soon as possible after the filing of appropriate amendments, if any.

17 C.F.R. § 230.461(b) (1987). The rule does provide, however, that "[a] person's request for acceleration will be considered confirmation of such person's awareness of the person's obligations under the [1933] Act," *id.* § 230.461(a), and sets forth certain instances in which the Commission may refuse to grant acceleration. *Id.* § 230.

Rule 460(b) provides:

As a minimum, reasonable steps to make the information conveniently available would involve the distribution, to each underwriter and dealer who it is reasonably anticipated will be invited to participate in the distribution of the security, a reasonable time in advance of the anticipated effective date of the registration statement, of as many copies of the proposed form of preliminary prospectus permitted by Rule 430 as appears to be reasonable to secure adequate distribution of the preliminary prospectus.

31. *Id.* § 230.461(b)(3).

staff in the investigation or a prejudgment of the results of the investigation.

In order to resolve this "standoff" and to avoid undue delay, the issuer can remove the delaying amendment on the face of its registration statement, thereby rendering the statement effective automatically in twenty days by operation of the statute *without* Commission approval. In that event, however, the issuer is denied the benefit of any comments on the disclosure and runs the risk of a stop-order³² or institution of other administrative proceedings against it by the Commission.³³

If the filing in question is a post-effective amendment, the Commission *must* make its section 8 determination in order to fix the effective date of such amendment. Because the twenty-day automatic effectiveness provision does not apply to post-effective amendments,³⁴ the issuer has no alternate means of having its post-effective amendment becoming effective.³⁵

Under both of the above circumstances, the Division of Corporation Finance has, from time to time, requested a statement from the registrant which represents that the company is aware of its disclosure obligations, that the staff has not commented on matters under investigation, and that the company agrees not to assert the Commission's order of effectiveness as a defense in any proceeding instituted under the federal securities laws. Upon receipt of these representations, the registration statement (or amendment) usually is declared effective.

The staff's action indicates its sensitivity to the use of its order of effectiveness as a substantive approval of the disclosure; thus, through this representation letter process, the adverse effects to the issuer of a delayed offering caused by the investigation are ameliorated without placing the Commission in a potentially vulnerable legal position in connection with its investigation and in any legal action subsequently brought against the issuer. While the staff views this procedure as prophylactic in nature, and does not concede any evidentiary value of the review process, the use of these measures in and of itself would indicate the staff's recognition that some probative value may be attributed to the review process.

32. See 15 U.S.C. §§ 77h(d), (e) (1982).

33. See *id.* § 77t.

34. See *id.* § 77h(c); *supra* note 25.

35. The problem was more acute when the registration statement covered an employee benefit plan filed on Form S-8 or a post-effective amendment thereto. In that situation, the employees, the primary beneficiaries of the offering, were the ones who suffered the adverse effects of any delay occasioned by the investigation. On February 22, 1980, however, the Commission promulgated new rules to provide means whereby all employee benefit plans filed on Form S-8 will become effective automatically without staff review. Amendments to Registration Statement Form S-8 and Related New and Amended Rules Under the Securities Act of 1933, Securities Act Release No. 6190, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,457 (Feb. 22, 1980).

D. Review of Proxy Material

The Commission's proxy rules, promulgated under section 14 of the Securities Exchange Act of 1934 (the "Exchange Act"),³⁶ also envision a review procedure for proxy statements and other soliciting material. The proxy rules generally prohibit the solicitation³⁷ of proxies³⁸ from the holders of securities registered pursuant to section 12 of the Exchange Act³⁹ unless the solicitation is accompanied or preceded by a proxy statement⁴⁰ either meeting the requirements of Schedule 14A of the proxy rules or included in a registration statement filed under the 1933 Act.⁴¹

Generally, Schedule 14A requires that proxy statements disclose all material information necessary to enable the shareholder to make an informed voting decision.⁴² Additionally, it requires certain information regarding management and a description of the matters to be voted upon at the stockholders' meeting.⁴³ In the event of any false or misleading disclosure in a proxy statement, or any omission of a material fact required to make statements contained in a proxy statement not misleading,⁴⁴ the Commission may institute an action to enjoin the use of the

36. 15 U.S.C. § 78n(a) (1982) (Exchange Act, § 14(a)). Section 14(a) states:

It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78l of this title.

Id. The proxy rules are set forth at 17 C.F.R. §§ 240.14a-1 to .14a-102 (1987).

37. 17 C.F.R. § 240.14a-1(j)(1) (1987) defines the terms "solicit" and "solicitation" as inclusive of:

(i) [a]ny request for a proxy whether or not accompanied by or included in a form of proxy; [sic] (ii) [a]ny request to execute or not to execute, or to revoke, a proxy; or (iii) [t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

38. 17 C.F.R. § 240.14a-1(d) (1987) defines the term "proxy" as including "every proxy, consent or authorization within the meaning of section 14(a) of the [Securities Exchange] Act," which consent or authorization "may take the form of failure to object or to dissent." *Id.*

39. See 15 U.S.C. § 78l (1982). Securities registered pursuant to section 78l generally include securities traded on a national securities exchange and securities of issuers with assets exceeding one million dollars and 500 or more holders of record of a class of equity securities. *Id.*

40. See 17 C.F.R. § 240.14a-1(e) (1987) (defining term "proxy statement").

41. *Id.* § 240.14a-3(a).

42. See *id.* § 240.14a-101 *Items 1-6, 21*.

43. See *id.* § 240.14a-101 *(Items 7-20)*.

44. See *id.* § 240.14a-9 (prohibiting false or misleading statements in proxy statements), which provides in part:

(a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting, or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or mis-

proxy statement.⁴⁵ More commonly, the stockholders may bring an action to enjoin the stockholders' meeting, require a resolicitation of proxies, or set aside the stockholder vote.⁴⁶

Unlike the review procedure for registration statements, the Exchange Act does not provide for a formal review and clearance of proxy statements. Rather, the proxy rules require that, except where election of directors and appointment of accountants are the only proposals submitted to stockholders, preliminary proxy material be filed with the Commission at least ten days prior to the dissemination of the definitive proxy statement to stockholders.⁴⁷ The Commission normally does not review

leading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

* * *

Note: The following are some examples of what, depending upon particular facts and circumstances, may be misleading within the meaning of this section.

(a) Predictions as to specific future market values.

(b) Material which directly or indirectly impugns character, integrity or personal reputation, or directly or indirectly makes charges concerning improper, illegal or immoral conduct or associations, without factual foundation.

(c) Failure to so identify a proxy statement, form of proxy and other soliciting material as to clearly distinguish it from the soliciting material of any other person or persons soliciting for the same meeting or subject matter.

(d) Claims made prior to a meeting regarding the results of a solicitation.

45. See 15 U.S.C. § 78u(e) (1982); see also *id.* 78t(a) (providing joint and several liability for any person who directly or indirectly controls any person liable under the 1934 Act or the proxy rules, unless the latter acted in good faith); 15 U.S.C. § 78ff (1982 & Supp. 1987) (providing for criminal liability for willful violation of 1934 Act).

If the Commission believes a violation of the 1934 Act or the proxy rules has occurred, it may seek injunctive relief or it may seek a negotiated settlement of proceedings between the Commission and the alleged violator, leading to a consent decree under which the alleged violator agrees not to violate the proxy rules in the future. In a number of instances involving consent decrees, the defendant agrees to take steps, such as changing internal procedures, to avoid future violations of the 1934 Act. See *Hycel, Inc., Order Instituting Proceedings Pursuant to Section 15(c)(4), Exchange Act Release No. 14,981, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,676 (July 20, 1978)*. The Commission may also require recirculation of proxy materials or a new shareholders' meeting. See *Securities and Exchange Commission Staff Report on Proxy Solicitations in Connection with Compass Investment Group, Exchange Act Release No. 16,343, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,352 (Nov. 15, 1979)* (issuers have an affirmative duty to correct proxy materials which are inaccurate).

46. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 431-34 (1965). The effect of *Borak* has been to make the federal courts the appropriate battleground for disputes arising out of proxy contests.
47. 17 C.F.R. § 240.14a-6(a) (1987); see also *Proxy Rules-Comprehensive Review, Exchange Act Release No. 22,195, [1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,901 (July 1, 1985)*. The note to Rule 14a-6(f) provides:

all preliminary proxy statements filed with the Commission.⁴⁸ If the issuer does not receive verbal notice from the staff within ten days after filing of the preliminary proxy statement, the definitive proxy statement may be mailed to stockholders.⁴⁹ Generally, when extraordinary corporate action is proposed, the Commission will advise the issuer within the ten-day period to delay the mailing of the proxy statement until the Commission's staff has reviewed the proxy statement.

A serious question has arisen, particularly in proxy contests, whether the proponent of a proxy statement and/or the staff in its review of the proxy statement bears any responsibility with respect to previously published materials used as part of the soliciting material. Rule 14a-11(h) of the Exchange Act governs the use of reprints and reproductions in proxy contests.⁵⁰ Although there is no case law directly on this point, in the legislative history of Rule 14a-11(h),⁵¹ the Commission explained that the publication of reprints or reproductions of previously published material "may involve the publication or distribution of proxy material which is subject to and should be filed with the Commission pursuant to the provisions of the rules."⁵²

Former SEC Chairman J. Sinclair Armstrong, in his testimony before the Senate Subcommittee on Securities relating to proxy contests, addressed the pervasive use of previously published material, containing critical or damaging statements, in proxy material as a character assassination tactic.⁵³ The Chairman stated:

It has been the Commission's opinion and the Commission's position that material of this character when submitted as proxy material must be scrutinized and dealt with as though the charges made were being made directly, that the person filing is responsible for truth and accuracy, and that a person cannot, consistent with the statute and fair administration of the

Where preliminary copies of material are filed with the Commission pursuant to this rule, the printing of definitive copies for distribution to security holders should be deferred until the comments of the Commission's staff have been received and considered.

48. See *supra* note 23 and accompanying text (discussing selective review procedure).

49. 17 C.F.R. § 240.14a-6(a) (1987); see also *supra* note 47.

50. Rule 14a-11(h) of the 1934 Act, 17 C.F.R. § 240.14a-11(h) (1987), requires that the reprint or reproduction in soliciting material of previously published material state the author, name, and date of the prior publication; identify unnamed persons quoted in the previously published material; state whether consent has been obtained for the use of such material; and state the circumstances under which any consideration was paid for such use.

51. Adoption of Amendments to Proxy Rules, Exchange Act Release No. 5,276, [1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,380 (Jan. 17, 1956) (adopting Rule 14a-11(h)).

52. *Id.*

53. *Stock Market Study (Corporate Proxy Contests), Hearings before a Subcomm. of the Comm. on Banking & Currency, United States Senate, 84th Cong., 1st Sess. 1507, 1553-55 (June 15, 1955) (statement of J. Sinclair Armstrong, SEC Chairman) [hereinafter *Hearings on Corporate Proxy Contests*].*

rule, do indirectly that which is objectionable if done directly.⁵⁴

At the time of these subcommittee hearings, it was customary for the Commission's staff to make certain inquiries of persons filing reprints and excerpts from previously published materials, immediately upon such filing, not to pass upon the accuracy of the initial publication, but rather to ascertain the accuracy of the reprint.⁵⁵

Thus, Rule 14a-11(h) apparently was intended to codify the Commission's view that the proponent bears full responsibility for the accuracy of the reprint as original proxy material. Accordingly, the staff scrutinizes the reprinted material in the same manner and for the same reasons as original proxy material, and requests the factual bases for the statements made. The staff need not question or investigate the author or sources quoted since they are not before the Commission and cannot then be required to comply with the staff's requests. The party using the material is the one who must ascertain the truthfulness and accuracy of the facts contained therein. Because it is considered original proxy material, the proponent must take responsibility for the reprint and subjects himself to liability therefor under Rule 14a-9.⁵⁶

As in the case of a registration statement,⁵⁷ the Commission is in a strained position when an issuer that is under investigation by the Commission files a preliminary proxy statement. The Commission will not request a representation from the sponsor that it will not assert the Commission's clearance of the proxy material as evidence of the proxy material's compliance with the requirements of the Exchange Act, because, unlike registration statements, the use of proxy statements is not contingent upon formal affirmative action by the Commission (*i.e.*, signing an order of effectiveness). Nevertheless, as an added precaution, the staff usually will advise the issuer that it will not comment on the disclosure, and that the issuer must proceed on its own responsibility without the benefit of any comment from the staff.⁵⁸ Thus, the staff avoids any implication that it has approved the disclosure and precludes the possibility that its "approval" will be asserted as a defense in any subsequent legal proceeding.

54. *Id.* at 1554.

55. *Id.* at 1560.

56. 17 C.F.R. § 240.14a-9(a) (1987).

57. See *supra* notes 31-35 and accompanying text.

58. See, e.g., *Pabst Brewing Co. v. Jacobs*, 549 F. Supp. 1068, 1076 (D. Del. 1982). In *Pabst*, the court quoted from a Commission clearance letter as follows:

The responsibility for the form and content of the proxy soliciting material rests with the persons making the solicitation. The fact that such material has been filed with or reviewed by the staff of the Commission shall not be deemed a finding by the Commission that such material is accurate and complete or that the Commission has passed upon the merits of or approved any statement contained therein or any matter to be acted upon by securityholders.

Id. at 1076.

II. EVIDENTIARY VALUE OF THE REVIEW PROCESS

The Commission's concern regarding the implications of its clearance of a disclosure document is not unfounded. Indeed, the staff's review and clearance of a registration statement or approval of proxy material at times has been proffered in subsequent legal proceedings as evidence of the company's compliance with the disclosure requirements and antifraud provisions of both the 1933 Act and the Exchange Act.⁵⁹ The result has been the development of two lines of case law propounding opposing viewpoints.

A. *The Commission's Position: The Strict View*

The Commission maintains that its review and clearance of disclosure documents has no evidentiary value in determining the adequacy and accuracy of the information contained therein. In a release relating to curtailed review of registration statements, the Commission stated:

Notwithstanding the type of review applied to registration statements, the Commission hereby again advises registrants that the statutory burden of disclosure is on the issuer, its affiliates, the underwriter, accountants and other experts; that as a matter of law this burden cannot be shifted to the staff; and that the current workload is such that the staff cannot undertake additional review and comments.⁶⁰

59. In considering the impact of the Commission's review procedure, no distinction is made in this article as to whether the disclosure document is filed under the 1933 Act, such as registration statements, or under the Exchange Act, such as proxy statements (of course, certain proxy material, such as merger proxies, are also filed under the 1933 Act to register shares of stock being offered in the merger). While one may argue that more deference should be accorded the staff's clearance of registration statements under the 1933 Act because the Commission actually issues an order of effectiveness of the registration statement, the contrary view may also be taken, *i.e.*, that more weight should be given to the staff's review of proxy material since Congress did not prescribe the disclosure standard, as it did in Schedules A and B to the 1933 Act. Under the latter position, one would propound the theory that the Commission is given more latitude under the Exchange Act to set and adjust the disclosure standard as may be deemed appropriate by the Commission, and therefore the Commission's determination should be conclusive. However, as is evident from the cases cited herein, the courts themselves, in considering the weight to be accorded the staff's review, have made no distinction as to whether the document reviewed was filed under the 1933 Act or the Exchange Act. Instead, the focal point is, and the author agrees that the emphasis should be, the role played by the Commission staff in the disclosure area generally, how that role may be perceived and whether it is to be relied upon.

60. The Division of Corporation Finance's Procedures Designed to Curtail Time in Registration Under the Securities Act of 1933, Securities Act Release No. 5231, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,509 (Feb. 3, 1972). With respect to the Commission's review of proxy material, Rule 14a-9(b) provides:

The fact that a proxy statement, form of proxy or other soliciting material has been filed with or examined by the Commission shall not be deemed a finding by the Commission that such material is accurate or complete or not false or misleading, or that the Commission has passed upon the mer-

Language in both the 1933 Act and the Exchange Act supports the Commission's position. Section 23 of the 1933 Act specifically states that neither the filing nor the effectiveness of a registration statement, nor the fact that a stop order is not in effect with respect to the registration statement, shall be deemed a finding by the Commission that the registration statement complies with the informational requirements of the 1933 Act.⁶¹ Additionally, the Commission requires each prospectus to carry a legend stating that the Commission has not passed on the accuracy or adequacy of the prospectus and that a contrary representation constitutes a criminal offense.⁶² Similarly, with respect to the Commission's review and clearance of proxy statements, section 26 of the Exchange Act states that no action or failure to act by the Commission with regard to any statement or report examined pursuant to the Exchange Act shall be deemed a finding by the Commission that "such statement or report is true and accurate on its face or that it is not false or misleading."⁶³ The proxy rules specifically reiterate this caveat.⁶⁴

Many courts have followed the Commission's position and have refused to accord any weight to the Commission's review and clearance of registration statements and proxy material.⁶⁵ This refusal is based pri-

its of or approved any statement contained therein or any matter to be acted upon by security holders. No representation contrary to the foregoing shall be made.

17 C.F.R. § 240.14a-9(b) (1987); *see also In re Universal Camera Corp.*, 19 S.E.C. 648, 656-59 (1945); Investment Company Act of 1940, 15 U.S.C. § 80a-34(a) (1982).

61. 15 U.S.C. § 77w (1982).

62. 17 C.F.R. § 229.501 (1987).

63. 15 U.S.C. § 78z (1982).

64. 17 C.F.R. § 240.14a-9(b) (1987); *see supra* note 60 (quoting Rule 14a-9(b)). The history of this disclaimer in the proxy rules is instructive. In testimony explaining the proxy rules before the Senate Subcommittee on Securities in 1955, then SEC Chairman J. Sinclair Armstrong explained the Commission's position on the Commission's review of proxy statements as follows:

Out of this administrative practice [of reviewing proxy material] has come the popular notion that we "approve" . . . or "clear" or "permit" the use of proxy material. These characterizations of our action or nonaction are not accurate. What actually is involved is that the staff of the Commission concludes on the basis of the submitted proxy material and any other information available to the Commission that, on its face, there has not been a failure, on the part of the person who has submitted the material, to comply with the standards of the proxy regulations.

The Commission does not vouch for, underwrite, or defend the accuracy or adequacy of the proxy material. The accuracy of the statements made and the truth and adequacy of proxy material are the responsibility of the persons soliciting proxies. It is not the Commission's. At the administrative level, at least, the burden is on the user to establish that his facts, arguments, and charges are true and not misleading. It is not and cannot be the Commission's function to prove the truth, accuracy, and fairness of every piece of proxy material filed with us.

Hearings on Corporate Proxy Contests, supra note 53, at 1545-46.

65. *See, e.g., Klastorin v. Roth*, 353 F.2d 182, 183 n.2 (2d Cir. 1965); *Holt v. Katy Indus.*, 71 F.R.D. 424, 427 (S.D.N.Y. 1976). *Contra Pabst Brewing Co. v. Jacobs*,

marily upon the large number of disclosure documents filed each year with the Commission. Because this number greatly exceeds the ability of the Commission's staff to examine each one in detail, the Commission's review and clearance of each document does not reflect upon the issuer's compliance with federal securities laws.⁶⁶ Even if the Commission had the manpower to examine thoroughly each disclosure document filed with the Commission, the Commission lacks the issuer's day-to-day familiarity with the facts, which would enable the Commission to appraise the truth and accuracy of the statements contained in the documents.⁶⁷

This strict view of the effect of the Commission's review was propounded by the United States Supreme Court, in *J.I. Case Co. v. Borak*,⁶⁸ a case in which the Court found a private right to enforcement of the proxy rules. The plaintiff stockholder in *Borak* alleged that the defendant corporation had used false and misleading proxy material to obtain stockholder approval of a merger.⁶⁹ Noting the large number of proxy statements filed each year with the Commission⁷⁰ and that time does not permit the Commission to examine each proxy statement on other than an expedited basis, the Court stated that this time limitation "results in the Commission[s] acceptance of the representations contained therein at their face value, unless contrary to other material on file with it."⁷¹ Consequently, the Court held that this inability of the Commission to review independently each proxy statement filed with the Commission requires that a stockholder be entitled to bring suit as a result of injury which the stockholder suffers from corporate action pursuant to a deceptive proxy solicitation.⁷²

In *Millimet v. George F. Fuller Co.*,⁷³ the United States District Court for the Southern District of New York broadly interpreted the Supreme Court's holding in *Borak* as mandating that the Commission's review of proxy material be given no weight.⁷⁴ Thus, the district court

549 F. Supp. 1068, 1076 ("A limited exception exists, however, where the precise factual or legal question has been brought to the attention of the SEC prior to the issue of the form, and the SEC has subsequently allowed the form to be sent to the shareholders without modification. In that situation, the SEC's inaction may be accorded some weight.").

66. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964); *Medical Comm. for Human Rights v. SEC*, 432 F.2d 659, 665 (D.C. Cir. 1970), *vacated*, 404 U.S. 403 (1972); *Holt v. Katy Indus.*, 71 F.R.D. 424, 427 (S.D.N.Y. 1976).

67. See *GAF Corp. v. Milstein*, 453 F.2d 709, 721 (2d Cir. 1971), *cert. denied*, 406 U.S. 910 (1972).

68. 377 U.S. 426 (1964).

69. *Id.* at 432-33.

70. *Id.* at 432.

71. *Id.*; see also *Boruski v. Division of Corp. Fin.*, 321 F. Supp. 1273, 1276 (S.D.N.Y. 1971); *Miller v. Steinbach*, 268 F. Supp. 255 (S.D.N.Y. 1967).

72. *J.I. Case Co. v. Borak*, 377 U.S. 426, 431-33 (1964).

73. [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,570 (S.D.N.Y. 1965).

74. *Id.* at 95,156. The district court stated:

[The proxy sponsor] argues that "great deference should be paid" by this Court to "clearance" of the proxy statement by the Commission. . . .

interpreted the Supreme Court's holding in *Borak* as an endorsement of the Commission's position. The *Millimet* case is representative of the view that despite SEC review and clearance, a court is not precluded from finding a violation of the Commission's rules.⁷⁵

B. The Broader View

Notwithstanding the Commission's position and supporting cases, there is a broader view espoused by a line of cases indicating that the Commission's review and clearance procedures in fact carry some evidentiary value, particularly where the Commission's staff has directed its attention to the disclosures in question.⁷⁶ This view is not in contradiction with the statutory disclaimers, and in fact finds its roots in the policy scheme of the 1933 Act and, to some extent, in the Supreme Court's decision in *Borak*.

In adopting the strict view, the district court in *Millimet* relied upon the Supreme Court's pronouncement in *Borak*. The court, however, overlooked an essential feature of the *Borak* reasoning and therefore reached a result which is not wholly supported by the Supreme Court's

This argument cannot be accepted. "Clearance" by the Commission . . . [is] merely an indication by the Commission that it will take no action under Section 21(e) of the [1934] Act to enjoy (sic) use of the proxy statement. It is specifically provided in Section 26 of the [1934] Act that failure of the Commission to act shall not be construed to mean any approval.

- Id.* (quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964)); see also *Subin v. Goldsmith*, 224 F.2d 753, 774 (2d Cir.) (Medina, J. dissenting in part), *cert. denied*, 350 U.S. 883 (1955). Judge Frank, concurring in part, expressed a novel approach apparently supporting the Commission's position and countering the defendant's defense that the allegedly misleading proxy materials were prepared in conjunction with and approved by the staff. Judge Frank wrote that "those subordinates cannot bind the Commission, and do not speak for it without its approval, not given here." *Id.* at 767. This line of reasoning, however, does not appear to have prevailed. See, e.g., *Miller v. Steinbach*, 268 F. Supp. 255 (S.D.N.Y. 1967); *Sherman v. Posner*, 266 F. Supp. 871 (S.D.N.Y. 1967); cf. *Spielman v. General Host Corp.*, 402 F. Supp. 190 (S.D.N.Y. 1975), *aff'd per curiam*, 538 F.2d 39 (2d Cir. 1976).
75. See, e.g., *Miller*, 268 F. Supp. 255; *Leighton v. One William Street Fund, Inc.*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,561 (S.D.N.Y. 1965); *Subin*, 224 F.2d 753 (Medina, J. dissenting in part). Judge Medina wrote in the *Subin* case:

The Commission gave no formal approval nor was any adjudication made as to the sufficiency of the Statement and we agree that such participation in the preparation of the Proxy Statement by staff members of the SEC as may have taken place cannot affect the sufficiency as a matter of law of the allegations of the complaint.

224 F.2d at 774.

76. Virtually all of the cases giving weight to the staff's review involve the dismissal of an action for a preliminary injunction against the registrant's use of the material, voting of the proxies or holding of the stockholder's meeting. Plaintiffs in such actions bear a high burden of proof which necessitates the showing of such things as the likelihood of success on the merits, irreparable harm to the plaintiff if the relief is not granted, and that the harm to defendants as a result of granting the relief is commensurate to the harm which is to be averted. *Sherman*, 266 F. Supp. 871; *Mack v. Mishkin*, 172 F. Supp. 885 (S.D.N.Y. 1959).

analysis. The strict view, upon which the *Millimet* holding was based, accorded no evidentiary value *per se* to the review process *in general*. However, the *Borak* holding was based upon a determination that the staff *generally* does not have the time or information necessary to make a meaningful determination. It is therefore implicit from the *Borak* analysis that *only under those circumstances* (*i.e.*, where the staff did not have the tools necessary to properly focus upon the issue) no inference may be drawn from the Commission's review. Contrary to *Millimet's* strict *per se* rule, the ultimate decision as to whether or not an inference may be drawn from the Commission's review depends on the circumstances of the specific case, and particularly the facts known to the Commission's staff at the time of its review. This feature of the *Borak* analysis, overlooked by *Millimet*, implicitly supports a case-by-case assessment of evidentiary value of the staff's review based upon whether the staff was aware of facts which allegedly made the disclosure document misleading. Courts adopting this broader view have studied such factors as the conspicuousness and critical nature of the particular facts in order to determine whether the staff noted such facts during the review process.⁷⁷

When it is clear that the Commission is aware of the facts in question, and particularly when the Commission takes an affirmative position to support the clearance of a disclosure document, some weight should be accorded the staff's review and clearance of that document.⁷⁸ Notwithstanding the strict view espoused by the Commission and the cases supporting it, some courts have accorded probative value to the staff's review and its determination of the completeness of the disclosure even when the staff did not specifically address or comment upon the item of disclosure in question.⁷⁹ Thus, the broader interpretation of

77. See *Norte & Co. v. Huffines*, [1967-1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,204, at 96,939 (S.D.N.Y. 1968). The court in that case noted:

There is no indication that the SEC was aware, as were the defendants, of the inflation in the . . . earnings figures used in the proxy solicitation material, and it is difficult to believe that if the SEC had in fact noted the reference, which is buried away at the tail end of an irrelevant section, to the recent arm's length sale . . . , it would have permitted the proxy material to be circulated without placing that vital information where it would be more likely to be noted by . . . stockholders. We can only conclude that the SEC was misled and that it failed to note the burial of this vital information, which was not included in the initial draft submitted to it for clearance.

Id. at 96,951.

78. See *Sunray DX Oil Co. v. Helmerich & Payne, Inc.*, 398 F.2d 447, 451-52 (10th Cir. 1968). The *Sunray* case is extraordinary in the sense that the Commission had taken an affirmative stand on the sufficiency of the disclosure in a proxy statement that was subject to litigation. *Id.* Most often the Commission is silent beyond the order of effectiveness or the informal review and clearance of a proxy; it is in these instances when the question regarding the degree of comfort available to the registrant from the review process is most poignant.

79. See *Armour & Co. v. General Host Corp.*, 296 F. Supp. 470 (S.D.N.Y. 1969), in which the court stated:

Borak has been expanded to accord some evidentiary value to the Commission's order of effectiveness, in and of itself.

Cases espousing the broader view of the staff's review function have also developed a new theory in support of this broad view: the Commission, which is primarily charged with the duty of protecting investors, is unquestionably an "expert" in these matters; therefore, its review must be accorded some weight in determining "the validity of [the registrant's] activities."⁸⁰ Although the staff's failure to require further clarification of the disclosure does not mean that no violation of the federal securities laws has occurred, it may indicate that the Commission finds the document adequate for its purposes.⁸¹ Recognizing that the review and clearance of disclosure documents by the staff is not a determinative ruling on the merits, one court has stated that nevertheless, "it would be odd indeed . . . that a violation of the Commission Rule [14a-9] went by unnoticed."⁸² This is particularly true when the Commission's staff possesses

There is also the fact that the SEC permitted the registration statement to become effective. Indeed, it would be remarkable that, after Armour had pinpointed its various claims of violations of the securities laws, the Commission, if there were substance to any claim that remained uncorrected, allowed the registration statement to become effective and the securities to be offered to the public. To be sure, the registration of the securities carries with it neither the approval nor disapproval of the Commission. Yet, when the very charges [the] plaintiff advanced before the Commission are renewed on this motion and denied by the defendants, the SEC's clearance of the registration statement may be accorded some weight.

Id. at 475 (footnotes omitted). In a related case involving the continuing saga of General Host Corporation's attempted exchange offer for the shares of Armour & Co., *Spielman v. General Host Corp.*, 402 F. Supp. 190 (S.D.N.Y. 1975), *aff'd*, 538 F.2d 39 (2d Cir. 1976), the Commission itself, rather than the Division of Corporation Finance, declared the registration statement effective notwithstanding the issuer's questions as to the disclosure. The court again clarified its stance as related to the order declaring the registration statement effective:

While the registration of securities by the SEC does not constitute Commission approval of the language of the prospectus and cannot relieve this Court of its duty to exercise an independent judgment on the adequacy of disclosure, clearance by the Commission in the face of charges identical with those presented here may be given some weight, and the documentary evidence of arguments pressed by Armour's counsel upon the Commission makes this a particularly appropriate case in which to give some credit to the Commission's clearance.

402 F. Supp. at 197.

80. *Abramson v. Nytronics, Inc.*, 312 F. Supp. 519, 526 (S.D.N.Y. 1970); *see also* 601 West 26 Corp. v. Solitron Devices, Inc., 291 F. Supp. 882, 886 (S.D.N.Y. 1968), *aff'd*, 420 F.2d 293 (2d Cir. 1969); *General Time Corp. v. Talley Indus.*, 283 F. Supp. 832, 835 (S.D.N.Y.), *aff'd*, 403 F.2d 159 (2d Cir. 1968) (Friendly, J.), *cert. denied*, 393 U.S. 1026 (1969); *Kauder v. United Board & Carton Corp.*, 199 F. Supp. 420 (S.D.N.Y. 1961); *Shvets v. Indus. Rayon Corp.*, 212 F. Supp. 308 (S.D.N.Y. 1960); *Weeks v. Alpert*, 131 F. Supp. 608 (D. Mass. 1955); *Doyle v. Milton*, 73 F. Supp. 281 (S.D.N.Y. 1947).
81. *Twentieth Century Fox Film Corp. v. Lewis*, 334 F. Supp. 1398, 1402 (S.D.N.Y. 1971).
82. *McConnell v. Lucht*, 320 F. Supp. 1162, 1166 (S.D.N.Y. 1970).

some knowledge of the factual background.⁸³ The Supreme Court's qualification in *Borak* that disclosures are accepted by the Commission at face value "unless contrary to other material on file [with the Commission]"⁸⁴ is consistent with this theory; the *Borak* analysis suggests that if the Commission's staff is aware of the facts in question, yet deliberately permits use of the disclosure document as is, the staff's determination has probative value.⁸⁵

The question of evidentiary value was considered in *Union Pacific Railroad Co. v. Chicago & North Western Railway Co.*⁸⁶ from another angle. In *Union Pacific*, the Commission's staff expressed serious concerns regarding the disclosures in proxy material.⁸⁷ After holding that the Commission's failure to bring an injunctive action did not prejudice the plaintiff's case, the United States District Court noted further that "[w]here, as here, circumstances assure that agency consideration has been given to the merits of a question, the determinations and positions of the responsible authorities of the SEC carry significant weight and command deference in the courts."⁸⁸

C. Reconciliation with the Statutory Disclaimers

Courts espousing the liberal or broader view according evidentiary

83. See *Abramson*, 312 F. Supp. 519, 526; *General Time Corp.*, 403 F.2d 159; *Mack v. Mishkin*, 172 F. Supp. 885 (S.D.N.Y. 1959); *Dunn v. Decca Records*, 120 F. Supp. 1 (S.D.N.Y. 1954) (Kaufman, J.); see also *Subin v. Goldsmith*, 224 F.2d 753, 767 (2d Cir.) (Frank, J. dissenting, but concurring with textual proposition), *cert. denied*, 350 U.S. 883 (1955).

84. *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).

85. See *Kerner v. Crossman*, [1957-1961 Transfer Binder] Fed. Sec. L. Rep. (CCrI) ¶ 91,030 (S.D.N.Y. 1961) ("The fact that the S.E.C. has known about the transaction since the clearance of the prospectus . . . and has done nothing is of some relevancy."). The issue discussed in this article is very different from the question raised in *Dillon v. Berg*, 326 F. Supp. 1214, 1229 (D. Del.), *aff'd*, 453 F.2d 876 (2d Cir. 1971) (involving allegedly inadequate proxy material) in which the court held that the Commission's failure to institute *legal proceedings* against the defendants can be accorded no weight in determining whether the proxy material in fact contained inadequate disclosure. The simple distinction is that a decision to institute legal proceedings involves a large number of other factors not present in the context of a simple review of and commentary upon SEC filings, including litigation manpower, egregiousness of the violation, geographic considerations, allocation of resources based on pending caseload, and generally the totality of circumstances in the case.

86. 226 F. Supp. 400 (N.D. Ill. 1964).

87. *Id.* at 405-07.

88. *Id.* at 406. The deference accorded the staff's views is reflected by the court's statements that "the violation committed here cannot be passed as mere technicality, since when the Report did in fact receive SEC consideration, the staff found it to be sufficiently objectionable to request that distribution cease." *Id.* at 408; see also *Boruski v. Division of Corp. Fin.*, 321 F. Supp. 1273, 1276 (S.D.N.Y. 1971).

Nevertheless, the court was unclear and seemed to imply that the staff's failure to comment on a filing would carry little or no weight ("This distinction between viewing inaction as approval and deferring to specific and particular disapproval finds tacit recognition in the governing act of Congress.").

value to the review process do not adequately reconcile that viewpoint with the statutory disclaimers contained in the 1933 Act and the Exchange Act.⁸⁹ While acknowledging these disclaimers, the courts have nevertheless held that some weight must be given to the staff's review and clearance of disclosure documents.⁹⁰

Moreover, an apparent conflict exists between the controlling statutory provisions. Both section 23 of the 1933 Act and section 26 of the Exchange Act state that the fact that a registration statement is in effect should not be deemed a "finding" by the Commission regarding the accuracy of the statement. Nevertheless, section 8 establishes certain statutory standards⁹¹ which must be met before the Commission accelerates the effective date of a registration statement. Furthermore, under the Exchange Act, the Commission's rules mandate the review of filed proxy statements.

The inconsistency between the broad view and the statutory disclaimers was demonstrated in *Schwayder v. Beatrice Foods Co.*⁹² Responding to the plaintiff's allegation of a misleading proxy statement, Beatrice filed a memorandum attempting to treat the SEC's failure to take action to prevent distribution of Beatrice's proxy statement as evidence of the adequacy of the disclosure.⁹³ The plaintiff countered that no inference should be drawn from the SEC's inaction, citing Rule 14a-9(b),⁹⁴ which disavows any implication of approval by virtue of the staff's review and prohibits any such representation.⁹⁵ Defendant Beatrice replied, "[t]he obvious purpose of the Rule upon which plaintiff relies is to prevent companies from including a legend on their proxy statements which denotes SEC approval. It has nothing to do with evidentiary questions presented to a federal court. That is the Court's province."⁹⁶

89. See *supra* notes 61-63 and accompanying text.

90. See, e.g., *Sherman v. Posner*, 266 F. Supp. 871 (S.D.N.Y. 1966), in which the court stated:

Notwithstanding the Commission's rules, this court is not disposed, as some would suggest, to completely emasculate the actions of the Commission of any meaning. It is submitted that the action, or inaction, as the case may be, of the Commission is to be accorded some weight where, as in our case, the information which forms the basis for an injunctive motion previously has been brought to the attention of the Commission and the Commission has presumably approved issuance of the material.

Id. at 874. The court merely glossed over the conflict between the liberal view and the statutory disclaimers without attempting to reconcile the two.

91. See *supra* notes 26-30 and accompanying text.

92. No. 79-C-1850, (N.D. Ill. Aug. 1, 1979) (unpublished).

93. Defendant's Trial Memorandum, *Schwayder v. Beatrice Foods Co.*, No. 79-C-1850 (N.D. Ill. Aug. 1, 1979) (unpublished) (regarding relevance of SEC review and release of proxy material).

94. See *supra* note 60.

95. Plaintiff's Trial Memorandum at 2, *Schwayder v. Beatrice Foods Co.*, No. 79-C-1850 (N.D. Ill. Aug. 1, 1979) (unpublished) (regarding relevance of the inaction of the SEC).

96. Defendant's Supplementary Memorandum at 2, *Schwayder v. Beatrice Foods Co.*,

While the response of Beatrice correctly notes the inconsistency, it does not address the reason for the disclaimer and the prohibition against using the review as a stamp of approval. In order to reconcile the apparent statutory inconsistency, and to reconcile the broad view with the statutory disclaimers, the statutory references to the Commission's findings or determinations must be interpreted as referring to two different types or levels of findings or determinations: (1) section 8 refers to an internal or "lesser finding" or determination, on the one hand, and (2) section 23 of the 1933 Act and section 26 of the Exchange Act refer to a dispositive determination by the Commission on the other hand. While the Commission is charged with the responsibility of making *some* determination under section 8, to the best of its ability, as to whether the statutory standards have indeed been met,⁹⁷ this is an internal determination or "lesser finding" made by the Commission in the performance of its duties under the Acts. On the other hand, the findings referred to in section 23 of the 1933 Act and section 26 of the Exchange Act admonish that this "lesser finding" pursuant to section 8 should not be misconstrued as a dispositive finding on the adequacy of the disclosure. The reason this "lesser finding" may not, *per se*, be viewed as dispositive is because of the very factors described in *Borak*: the staff usually does not have the time or information necessary to make a dispositive finding.⁹⁸ Consequently, the Acts specifically place the burden of full and fair disclosure upon the registrant,⁹⁹ and any representation that the Commission has made such a dispositive finding is unlawful.¹⁰⁰ The question which the courts have struggled with is how much, if any, probative value to accord this "lesser finding" or "internal determination." Courts espousing the liberal view of the review process recognize as probative, and accord some weight, although not dispositive, to the Commission's *actual determination* regarding the adequacy of the disclosure.¹⁰¹

No. 79-C-1850 (N.D. Ill. Aug. 1, 1979) (unpublished) (proving relevance of SEC review and release). The suit was settled without an adjudication on the merits.

97. The language used in *Investors Research v. SEC*, 628 F.2d 168 (D.C. Cir.), *cert. denied*, 449 U.S. 919 (1980), is instructive. In that case, involving a registered investment advisor providing services to an investment company registered under the Investment Company Act of 1940, the defendants argued that the Commission sanctioned the disclosure in the investment company's prospectus by failing to comment on the arrangement in question. The court responded that "[i]n these circumstances, without benefit of the additional information it acquired through its public proceedings, the Commission had no duty to challenge the natural implication of petitioners' assertion." *Id.* at 174 (emphasis added). The court appears to recognize some type of inherent duty of the staff in the review process.
98. See *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964).
99. See Act of May 27, 1933, ch. 38, § 11, 48 Stat. 87 (codified at 15 U.S.C. § 77k (1982)).
100. Act of May 27, 1933, ch. 38, § 23, 48 Stat. 87 (codified at 15 U.S.C. § 77w (1982)); Act of June 6, 1934, ch. 404, § 26 (current version at 15 U.S.C. § 78z (1982)).
101. The prevailing sentiment of the courts justifying deference to the staff's review is expressed in *Burke v. Wilson Brothers*, [1964-1966 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,705 (S.D.N.Y. June 16, 1966). "Although SEC approval is by no means determinative and, indeed, not entitled to great weight, it is by no means

III. CONCLUSION

The standards for acceleration of the effective date of registration statements have been mandated by statute; the review processes, both of registration statements and of proxy material, are firmly established in the Commission's rules and procedures. Judicial pronouncements have made clear that *some* evidentiary value may be and is attributed to the staff's determination. A logical corollary then is that the person filing disclosure documents should be entitled to *rely* upon the SEC's review and clearance process to the extent of the information presented to the staff.¹⁰² Indeed, it appears that the bar perceives the review function in this context.¹⁰³ It is true that the Commission does not, and should not, "approve" conclusively the disclosure document or the merits of the transaction; nor can the disclosure responsibilities be shifted to the staff. The full facts of each case are uniquely within the knowledge of the registrant and its professional advisers. When the facts, however, are presented to the staff and are subject to its scrutiny, the registrant should benefit from the staff's objective consideration. Consequently, if the adequacy of a disclosure document subsequently is questioned, the views of the SEC staff, as "experts" in disclosure, should be recognized to some extent as a legitimate source of comfort to which the registrant is entitled.

entitled to no weight whatsoever. If this were the case, it is difficult to perceive what is gained by subjecting the proxy statement to SEC scrutiny in the first place." *Id.* at 95,595, n.3.

102. It is noteworthy that the staff takes this position in practically all no-action and interpretive letters by the Division of Corporation Finance. At the end of each letter the following caveat appears:

Because this position is based upon representations made to the Division in your letter, it should be noted that any different facts or conditions might require a different conclusion.

103. In *Schwayder v. Beatrice Foods Co.*, No. 79-C-1850 (N.D. Ill. Aug. 1, 1979) (unpublished), the Commission approved the original proxy statement, then asked to meet with Beatrice officials, informing Beatrice that the proxy statement "may be misleading." The judge noted that "the SEC is setting a very bad precedent. . . . [Y]ou ought to know whether you can rely on the SEC's approval and disapproval." *Wall Street Journal*, May 15, 1979, at 2, col. 2 (these remarks were made off the record).