U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

Remarks to

The Brookings Institution
Conference For Corporate Operations

March 26, 1987

NECESSARY CONSTRAINTS ON THE FREE MARKET: THE ROLE OF THE SEC

Aulana L. Peters
Commissioner

The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Necessary Contraints on the Free Market:
The Role of the SEC 1/

Good afternoon, ladies and gentlemen. I am pleased to have the opportunity to spend an hour with such a distinguished group. I will spend a portion of our time together addressing my assigned topic, the role of the SEC as a necessary constraint on the free market. Following that presentation, I look forward to answering your questions.

When the Brookings Institution informed me of the topic they wished me to address, I confess to wondering whether, in considering the role of the SEC, the Institution intended to place a question mark after the phrase "necessary constraint on the free market." If the question were posed, I am confident that some would respond with a resounding "No!" While I am not a proponent of regulation for the sake of regulation, there is no doubt in my mind that the SEC and the laws it administers are not only necessary, but make important and beneficial contributions to our free enterprise system.

As I explore with you the need for SEC regulation, I will focus on two of the better known aspects of the securities laws, namely, the philosophy of full disclosure and the proscriptions against fraud. The mandatory disclosure requirements of the Securities Act of 1933 2/ for corporate securities offerings are

---

1/ These remarks were prepared by Commissioner Peters with the assistance of her legal counsel Andrew Feldman.

2/ Hereinafter "1933 Act."

a good example of the former and the Securities Exchange Act of 1934's 3/ prohibition against trading while in possession of material nonpublic information is an example of the latter. The Commission's enforcement efforts in both of these areas have been criticized by proponents of free market economics. I intend to discuss some of the arguments offered to support the proposition that SEC regulation is an unnecessary evil, and explain why I find those arguments unpersuasive. If we have time, I will conclude with a few remarks demonstrating that the Commission's historical approach to mandatory corporate disclosure and insider trading prohibitions has been structured to impose as few burdens and restraints on our capital markets as are consistent with investor protection.

Much of the criticism of SEC regulation is advanced by commentators writing in the increasingly influential discipline of law and economics. Its practitioners include several Federal Circuit Court of Appeals Judges and a growing flock of academics. 4/ I must preface my brief overview of law and economics with the caveat that I will be over-simplifying these concepts out of necessity because I am a lawyer, not an economist or mixture of the two.

3/ Hereinafter the "1934 Act."

4/ See Barrett, A Movement Called 'Law and Economics' Sways Legal Circles, Wall St. J., Aug. 4, 1986, at 1.

As I understand it, law and economics is the application of theories developed in economics to the study of law. It provides a means of critically assessing the economic rationale for established legal principles, and can be used to support as well as to oppose regulation. In the securities law context, some practitioners tend to predicate their analyses of the need for regulation on the "efficient market hypothesis" 5/ and the "theory of the firm." 6/ Proponents of the efficient market hypothesis argue that the securities markets are "efficient" because prices always fully reflect available information. On the basis of this assumption, it has been argued that securities laws' disclosure requirements may provide few benefits because, in the view of some, the efficient market ensures that all material information, whether or not publicly available, is fully reflected in the price of a security. 7/

5/ See generally Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Fin. 383 (1970).

6/ See generally Jensen & Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. of Fin. Econ. 305 (1976).

7/ See Manne, Economic Aspects of Required Disclosure Under Federal Securities Laws, in WALL STREET IN TRANSITION 21 (1974). This argument is based on the strong form of the efficient market hypothesis. Writers in law and economics more commonly apply the semi-strong form, which measures whether all publicly available information is reflected in stock prices, and the weak form, which tests whether historical price data is fully reflected.

Proponents of the theory of the firm argue that corporate managers have economic incentives to regulate the corporation's securities-related activities by contract, which is the most appropriate and cost-effective approach. Thus, they conclude that mandatory corporate disclosure is unnecessary because it is in corporate management's economic self-interest to disclose material information necessary for sound investment decisions. Finding few benefits to the laws, it has been argued that the costs of the laws make them undesirable. 8/

Some advance similar arguments against the need for federal prohibition of insider trading. It has been argued that insider trading helps the markets operate efficiently by causing stock prices to move to their proper levels. 9/ It also has been argued that inside information is a corporation's property right and that the permissibility of trading on the basis of that information should be determined by reference to contract law. Under this approach, a license to trade on nonpublic, material corporate information could be used as part of a compensation scheme to align management actions with shareholder

---

8/ *See* Bentson, *The Effectiveness and Effects of the SEC's Accounting Disclosure*, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 23 (1969). *See also* Ross, *The Economics of Information and the Disclosure Regulation Debate*, in ISSUES IN FINANCIAL REGULATION 177 (1979).

9/ *See* H. Manne, INSIDER TRADING AND THE STOCK MARKET 47-110 (1966).

interests. The corporation could countenance insider trading both by its own insiders (*i.e.*, directors, officers, and other employees) as well as by outsiders with whom it has a contractual relationship (*i.e.*, investment bankers, attorneys, and financial printers). 10/

The free market economics arguments against federal securities regulation I have just outlined are truly provocative. I frequently find the law and economics approach a helpful addition to legal analysis. In fact, most of us at the SEC appreciate the insights to be gained from economic analysis. However, at present I am not persuaded that the public's economic interest would be best served by wholesale elimination of our mandatory disclosure system and of current prohibitions against insider trading. I base my skepticism on the lessons of history, 11/ on logic, and on practical notions of fairness and efficiency, all of which militate against the concept of unreserved applicability of the efficient market hypothesis and the theory of the firm to securities laws.

10/ *See id.* at 111-158. *See also* Carlton & Fischel, *The Regulation Of Insider Trading*, 35 Stan. L. Rev. 897 (1983).

11/ Empirical research has been done by both sides, but does not provide conclusive support for either the arguments in favor of or in opposition to the mandatory disclosure system and the prohibitions on insider trading.

The lessons of history clearly support the need for regulation. Our mandatory disclosure system was adopted in 1933 and 1934 and was extended to certain over-the-counter securities thirty years later because Congress found that corporations, and others, often did not disclose material information concerning their new or already issued securities to the detriment of investors and the markets. 12/ Furthermore, insider trading also apparently was so widespread in the years leading up to the Great Depression that one of Congress' underlying purposes in adopting the federal securities laws was to put an end to this practice. Thus, the rule prohibiting fraud and deception in connection with the purchase and sale of securities was construed to require persons possessing material nonpublic information to disclose that information or abstain from trading. 13/

In contrast, there is no historical evidence which indicates that these laws were unnecessary when enacted or have become overly burdensome. Quite to the contrary, under SEC oversight United States capital markets have grown to be, as Chairman Shad often has remarked, the fairest, deepest and most liquid markets in the world.

12/ See Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1 (1983). See also Seligman, The Reformulation of Federal Securities Law Concerning Nonpublic Information, 73 Geo. L. J. 1083, 1104-07 (1985) [hereinafter cited as Reformulation of Law Concerning Nonpublic Information].

13/ See Reformulation of Law Concerning Nonpublic Information, supra note 12, at 1103-1117.

Considerations of fairness and efficiency similarly support my position. The SEC's mandatory corporate disclosure system fosters public confidence in the securities markets, and it is that confidence which brings investors into the capital markets. The system is fair because investors, large and small, are provided with a common base of information prepared by the person in the best position to do so, the issuer. The system is efficient for that reason, and because it quickly brings material corporate information to the marketplace in a standardized and useable format. This would not likely occur if the market were permitted to operate on its own because firms may have sufficient incentive to withhold the optimal amount of information, particularly negative information, necessary for effective evaluation. Furthermore, once a common base of information is made available, professional analysts can use their resources to improve the supply of available data by verifying corporate disclosures and by probing for other material information. Thus, even if the market were truly efficient as some economists maintain, a mandatory disclosure system would nevertheless seem to be the most effective way in which to convey necessary information to the marketplace. 14/

In defending our mandatory disclosure system, I do not ignore the fact that such a system imposes real costs on our financial markets. Nor am I oblivious to the possibility that

---

14/ See Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 Va. L. Rev. 717 (1984).

what was necessary fifty years ago may not be necessary today. For example, I think that legitimate questions can be asked about the cost/benefit ratio of the registration provisions of the 1933 Act in today's context. We continue to ask these questions and adjust (or not adjust) our regulatory system accordingly.

Insider trading prohibitions also can be justified on grounds of fairness and efficiency. First, with respect to efficiency, I must say that I have never understood the claim made by some that insider trading is simply the beneficial transmission of information to the market. In fact, no information is transmitted other than the fact that someone is buying. There is no disclosure of who or, more importantly, why. In order for insider trading to be profitable, material information must remain undisclosed. Therefore, it is not an efficient transmission of information to the market.

Permitting insider trading would impair, not enhance, the workings of the hypothetical efficient capital market by providing corporate managers with a license and financial incentive to trade secretly on that information. The delayed disclosure of material information could provide ample opportunities for costly market manipulation. 15/ Furthermore, prohibiting insider

---

15/ See Cox, Insider Trading and Contracting: A Critical Response to the "Chicago School," 1986 Duke L. J. 628. See also R. Posner, ECONOMIC ANALYSIS OF LAW 392-93 (1986).

trading enhances the integrity of the market because investors can be confident that corporate insiders and those who share their confidences cannot take advantage of otherwise unobtainable material nonpublic information. This enhanced integrity draws investors into the market 16/ and provides market professionals an incentive to engage in legitimate research and arbitrage activity.

Earlier in my remarks, I suggested that SEC regulation is not really as restrictive as it might appear. In fact, over the years, the regulatory system has been implemented flexibly in order to facilitate the growth of our capital markets. This flexible approach has never been more important than it is today as the world's capital markets are rapidly becoming internationalized. In response to the increasing tendency for securities to be issued and traded worldwide, the SEC is considering a number of far-reaching modifications to its disclosure requirements. These measures are designed to permit public investors to participate in the investment opportunities created by the growth of international markets and by the same token to facilitate foreign issuers' access to this country's capital base.

Let me tell you about three of these measures. For example, the SEC's staff is currently formulating proposals to implement a reciprocal prospectus approach to facilitating multi-national

---

16/ See Reformulation of Law Concerning Nonpublic Information, supra note 12, at 1115-17.

offerings. 17/ At the moment, the staff is inclined to recommend that any initial experimentation with reciprocal prospectuses be limited to certain countries. The use of such prospectuses may also be limited to debt offerings by world class issuers and rights offerings and exchange offers to persons already holding foreign stocks.

In addition, the SEC's staff is exploring whether and to what extent to permit unregistered foreign securities to be traded in the U.S. It has been suggested that the private placement exemptions might be expanded to create a "free trade zone" in which certain institutions may trade domestically certain unregistered foreign securities. Finally, the SEC's staff is considering reformulating its longstanding interpretive position on when securities offered overseas should be subject to the federal securities laws. 18/

Plans to liberalize disclosure requirements at the international level, I believe, foretell further liberalization for domestic corporations. One may legitimately question whether

---

17/ See Securities Act Release No. 6568 (Feb. 28, 1985), 50 FR 9282. See also Securities and Exchange Commission Division of Corporation Finance, Summary of Comments on Concept Release: Facilitation of Multinational Securities Offerings (Jan. 10, 1986).

18/ See Address by Linda C. Quinn, Director of the Securities and Exchange Commission's Division of Corporation Finance, Redefining "Public Offering or Distribution" for Today, Federal Regulation of Securities Committee Annual Fall Meeting, Washington, D.C. (Nov. 22, 1986).

the SEC can continue to require the current level of disclosure from U.S. issuers if it believes investors would be adequately protected under a less extensive disclosure system for foreign issuers. I believe that the question must be answered in the negative, and that this may ultimately result in a reduction of disclosure requirements on domestic issuers.

To illustrate what this might entail, let me cite a series of recent disclosure-related developments which represent anything but slavish adherence to a rigid regulatory framework. To the contrary, they represent a subtle but significant shift away from the basic philosophy of full disclosure prior to every securities transaction. These developments include the Commission's adoption of the integration doctrine, shelf registration under Rule 415 and the facilitation of the preparation of traditional annual reports to shareholders.

Prior to the implementation of the integration doctrine, the reporting requirements of the 1934 Act were premised on the assumption that adequate disclosure required a full and complete statement of statutorily mandated information in each filing. Relying at least in part on the notion that the market absorbs and retains disseminated information, the Commission developed a system which incorporated by reference already published information, thereby significantly reducing the amount of information required to be filed under certain provisions of the securities laws. 19/ It was but a short additional step to permit securities to be registered and put on the shelf for continuous distribution over a period of years without requiring the filing of disclosure documents concurrently with the issuance of the securities. 20/

In a recent development, the staff of the Division of Corporation Finance agreed to permit the General Motors Corporation to omit, under certain circumstances, information from GM's glossy annual report which normally would be required to be included in a company's annual report to shareholders. General Motors proposed, and the staff agreed, that the required information, principally the financial statements, could be omitted as long as it was delivered to shareholders as an appendix to the company's annual meeting proxy statement and was included in the company's annual 10-K filing with the Commission. The staff found that the GM proposal, which of course may be followed by other companies, offered a sound means to permit the free writing desired by the company in its glossy report while assuring that shareholders received the timely information mandated by the Commission's proxy rules. The staff did caution that GM should take care that the information contained in the glossy report be

---

19/ See Securities Act Release No. 6231 (Sept. 2, 1980), 45 FR 63630.

20/ See Securities Act Release No. 6499 (Nov. 17, 1983), 48 FR 52889.

consistent with the information contained in the company's filings with the Commission. 21/

Returning again to insider trading, I believe that the SEC's fulfillment of its enforcement mandate similarly is characterized by restraint. This case is a little bit more difficult to make because we are talking about efforts to enforce a prohibition against fraud. Clearly those efforts must be as far-reaching as the fraud we are charged with rooting out and prosecuting. I certainly cannot point to any instances in which the SEC has taken steps to narrow the scope of this antifraud prohibition. Indeed to date, the agency has resisted calls for a definition of insider trading. However, what I can emphasize is that the SEC's recent enforcement efforts against insider trading are well within clearly defined boundaries established by existing case law. Notwithstanding suggestions to the contrary, the Commission's recent insider trading cases have not been based on novel and untested legal theories.

In conclusion, I would again like to restate my view that for the most part, the SEC plays an important yet reasonably unintrusive role in regulating the U.S. financial markets. I hope that my presentation has given you food for thought, and now I would like to open the floor to questions.

21/ See Letter to F.A. Smith, Executive Vice President, General Motors Corporation, from Linda C. Quinn, Director, Division of Corporation Finance, Securities and Exchange Commission (Jan. 20, 1987).