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

News Release

Address

to the

Securities Law Luncheon Group

New York City
March 25, 1992

(Edited and expanded text)

"DEAR MR. PRESIDENT: ..."

Edward H. Fleischman
Commissioner
Securities and Exchange Commission
Washington, DC 20549

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

OFFICE OF
THE COMMISSIONER

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 25, 1992

The Honorable George H. W. Bush,
President of the United States
The White House
Washington, DC 20500

Dear Mr. President:

The Memorandum on the subject of "Reducing the Burden of Government Regulation", that you sent to the Chairman of this Commission under date of January 28, 1992, is the most exciting and challenging document of all the thousands of pages I have read in my 6-1/4 years as a Commissioner of the Securities and Exchange Commission. The moratorium that you directed has received more publicity, but it is the review and prospective revision of existing regulations and programs that you requested that carry the potential for truly long-lasting effect.

I hope you will not find it impertinent for a single Commissioner to respond in his own name, and I beg your pardon for addressing you in an "open letter". Other than one mention, in a public speech by our Chairman, to the effect that our General Counsel will be in charge of the Agency's response to your Memorandum, I have been given not an inkling of how the Agency is planning to come to grips with your request, nor do I have any reason to expect to be apprised on that score until the Agency's response has been well locked into place. I know of no way but this letter, therefore, to draw your and the public's attention to the extent of regulatory reform potentially available to this Agency. In response to your request this Commission could do so very much!

You requested that this Commission "(i) identify each of your agency's regulations and programs that impose a substantial cost on the economy and (ii) determine whether each such regulation or program adheres to the following standards:

"(a) The expected benefits to society of any regulation should clearly outweigh the expected costs it imposes on society.

"(b) Regulations should be fashioned to maximize net benefits to society.

"(c) To the maximum extent possible, regulatory agencies should set performance standards instead of prescriptive command-and-control requirements, thereby allowing the regulated community to achieve regulatory goals at the lowest possible cost.

"(d) Regulation should incorporate market mechanisms to the maximum extent possible.

"(e) Regulations should provide clarity and certainty to the regulated community and should be designed to avoid needless litigation."

I am only too well aware that a serious and faithful response to your request would turn the course of this Agency's regulatory approach nearly 180°. For example, we regularly describe performance standards as "not consistent" or "inadequate" or "not possible", and we therefore regularly impose command-and-control requirements. Further, our Chairman spoke proudly and publicly, this past December, of the fact that since mid-October 1989 this Commission had approved 57 new rules in either proposed or final form; I have not traced all 57 actions but I do not believe that more than a small fraction of those new rules were exemptive in substance. Nevertheless, I do believe that, if motivated toward compliance with your request, analysis of this Agency's regulations and programs would in fact demonstrate how the course of the Agency's regulatory approach can be turned.

For clarity of presentation, I shall divide the remainder of this letter into the following segments:

- the Commission's "mission"
- the use of rulemaking for exemptive purposes
- the consideration of costs versus benefits in rulemaking
- the use of performance standards in rulemaking
- the use of market mechanisms
- the concern over clarity and certainty
- rulemaking by official and unofficial interpretation
- the interplay of rulemaking and adjudication
- the Commission's rulebook generally
- a list of additional proposed rule revisions
- the balance of rulemaking and prosecutorial enforcement
- my conclusion

I. The Commission's "Mission"

The Securities and Exchange Commission has historically been understood to be, principally and foremost, an Agency directed to the elicitation of disclosure for the benefit of investors. It is true that certain of the statutes administered by this Commission, particularly the Public Utility Holding Company Act and the Investment Company Act, contemplate a regulatory role for the Agency that envelops the regulated entities in substantive federal oversight and review, and it is true that discrete portions of the Securities Exchange Act contemplate a similar role with respect to certain activities of regulated exchanges, securities associations, broker/dealers, transfer agents, information processors and clearing agencies. But the task of "establishing and requiring adherence to standards of business and financial disclosure" and of "establishing and requiring adherence to disclosure and procedural standards in the solicitation of proxies" remains the primary task within this Commission's general statutory standard of "the public interest and the protection of investors", only followed by the tasks of regulatory administration over the securities markets and over the more fully regulated entities that I enumerated above.

The emphasis on disclosure even in the realm of investor suffrage is clear from the Commission's own statement of its statutory authority and statutory functions in the first two rules of Subpart A of the very first Part of the Commission's chapter in the Code of Federal Regulations. For example:

> This [Securities Exchange] Act makes unlawful solicitations of proxies, authorizations or consents from holders of listed securities in contravention of rules prescribed by the Commission. These rules provide for disclosures to securities holders of information relevant to the matters which are the subject of solicitations.

Nowhere in these two rules, except in the context of investment companies, is there any reference -- or any inference -- with respect to Commission authority over the internal structure of disclosing companies or over the mechanisms for governance of those companies. The notion that this Commission has a broad charter, including authority over company governance, in a mission "to insure that our private enterprise system serves the welfare of all citizens", may be torn out of context from the preamble to the Commission's Canons of Ethics (Subpart C), but it is a notion that finds no statutory foundation. Rather, appropriate to an Agency of specified and limited jurisdiction, those same Canons enjoin the Commission to "avoid the adoption of rules which seek to extend the power of the Commission beyond proper statutory limits".

Its mandate to establish and require adherence to standards of disclosure has from time to time tempted the Commission to use that authority for purposes extraneous to the limited jurisdiction

conferred upon it by the federal securities laws, and the Commission has periodically had to draw itself back when it has succumbed or was in danger of succumbing to that temptation. Most recently in 1975, under the universally respected leadership of Ray Garrett, Jr., the Commission stated publicly, after lengthy consideration and discussion:

> [T]he Commission may require disclosure by registrants under the Securities Act and the Securities Exchange Act if it believes that the information would be necessary or appropriate for the protection of investors or for the furtherance of fair, orderly and informed securities markets or for the fair operation of corporate suffrage. Although disclosure requirements may have some indirect effect on corporate conduct, the Commission <u>may not require</u> disclosure solely for this purpose. (emphasis added)

That statement in Release No. 33-5627 is a pithy and encompassing "mission statement" for the primary activities of this Agency, including all the varied registration and reporting procedures it is mandated to enforce.

The Agency's market regulatory function is substantively related to but different from its primary focus on disclosure. The most insightful and inclusive "mission statement" for performance of the Commission's market regulatory function is not to be found in the mass of securities law literature but rather in a statement made by a professional economist during one of the many Commission meetings held to devise responses to the unprecedented stock market break of October 1987. As close as I can render it, then-Commissioner Cox said:

> There are really only two alternatives for a market regulatory agency. It can seek to promote liquidity in the marketplace, or it can throw sand in the gears. We have spent the last several days mostly trying to devise ways to throw sand in the gears when, as difficult as it may be to accomplish, we <u>should</u> be seeking means to <u>promote</u> market <u>liquidity</u>. (emphasis added)

I understand that affirmative promotion of liquidity in the marketplace is for the most part beyond the capability of this Agency, but that does not justify the Agency's habitual role of throwing sand in the market's gears. Rather, <u>removal of barriers</u> to market liquidity (as the Commission's staff demonstrated in its administration of the "buyback" rule during the 1987 market break) is well within the Agency's competence and should be its response of choice.

Therefore, in response to your request <u>this Commission could and should</u> posit those two "mission statements", together with the principle articulated as follows in your recent <u>Economic Report</u>:

> "Regulation can ... play a direct role in improving the performance of the market system. <u>Any proposal to regulate the</u>

market, however, should be tempered by an understanding that regulation can be at least as imperfect as the market it is trying to improve. The goal ... is to eliminate or revise those [regulations] that impose costs that exceed their benefits, and insure that other regulations are implemented in a cost-effective manner." (emphasis in original)

as the cornerstones, promoting both the public interest and the protection of investors, on which all its regulations and programs ultimately rest.

II. The Use of Rulemaking for Exemptive Purposes

The several statutes administered by the Commission vary in the structure of their delegation of exemptive authority. The Securities Act specifies only two areas for exemptive rulemaking: securities issuances of $5,000,000 or less, and securities issuances by small business investment companies. The Securities Exchange Act similarly bestows no general exemptive authority, but permits exemption in a variety of discrete contexts and allows for additional exemptive rulemaking in the many areas where the statutory language prohibits conduct "in contravention of such rules and regulations as the Commission may prescribe". The Public Utility Holding Company Act combines specification of the substantive requirements for certain exemptive rulemaking and a broad grant of exemptive authority, limited however in application to subsidiary companies and affiliates, "if and to the extent that [the Commission] deems the exemption necessary or appropriate in the public interest or for the protection of investors or consumers and not contrary to the purposes of this title." The Trust Indenture Act, the Investment Company Act and the Investment Advisers Act all vest broad exemptive authority in the Commission in language substantively similar to the Public Utility Holding Company Act language I just quoted.

During its early decades, when the Securities Act was the principal focus of its administration, the Commission compensated for its lack of general exemptive authority under that Act by expansive and creative use of its power to "defin[e] ... technical and trade terms used in this title." As a result, by 1955 the definition of such terms as "sale", "offer to sell", "participates", "commission", "prospectus", "transactions ... not involving any public offering", and "preceded by a prospectus" had effectively exempted a variety of practices and transactions from the registration requirements of the Act, often in straightforward performance-standard fashion. Somewhere along the way, that approach became unfashionable, giving way (for example) to a style of Securities Act rulemaking that defines technical and trade terms such as "underwriter" or "issue" by affixing paragraph after paragraph of conditions, and thereby engenders volume after volume of staff letter interpretations, as command-and-control limitations on the "safe harbor" definitional/exemptive status conferred by the particular rule. That style of rulemaking has also been adopted for rules implementing Exchange Act rulemaking authority,

where the exceptions to the general prohibition of the particular rule are, in substance, exemptions hedged about with command-and-control limitations.

The peculiarity of this rulemaking approach is that frequently there is a core element sought to be achieved or avoided by the particular rule, which, in the exemptive arena, is easily susceptible of articulation in performance-standard fashion as an alternative to if not as a substitute for the multiply-conditioned "safe harbor" that in some contexts suits both the regulating and regulated persons. For example, a very important but also very intrusive Commission market-regulatory rule (Rule 10b-6), which is four detailed pages long and is said to be "objective" in nature so that no intent is needed to find a violation of any of its detailed provisions, contains a proviso introducing the 13 carefully hedged exceptions to the general prohibition of the rule:

> Provided, however, That [this rule] shall not prohibit the following [13 detailed categories of transactions], if not engaged in for the purpose of creating actual, or apparent, active trading in or raising the price of any ... security [covered by the rule]....

In fact, the underlying objective of the rule, which is to allow the free forces of supply and demand to fix the trading price for securities in distribution, would be achieved so long as persons interested in the distribution did not engage in transactions for the purpose (specified in the proviso) of creating actual or apparent active trading or of raising the price of the distributed security. The battalion of conditions that currently surround this core element of the rule addresses the Commission's fear that some day it will be unable to prove, in court, the specified purpose on the part of some malefactor, but that battalion of conditions also carries with it enormous costs to the distributive process and to all the honest companies and all the honest underwriters that participate in that process. In response to your request this Commission could and should supplement the present rule to state that there is exempted from its coverage any transaction not engaged in for that specified purpose. This very approach to identification of and focus upon the core element sought to be achieved or avoided, with the same kind of cost-removal effect, has been taken once recently by the Commission in connection with a regulation relating to offerings made abroad (Regulation S, Rule 901), and in response to your request this Commission could and should take this same approach with respect (among others) to the Commission's safe harbor rules relating to company stock repurchases, sales of so-called restricted and control securities, and sales of securities in limited offerings.

Under those statutes which themselves grant the Commission broad exemptive rulemaking authority, the Commission has been reluctant to exercise that authority except (as phrased in 1941) for "special situations that might have been overlooked or that could not be

foreseen at the time the [particular statute] was drafted". However appropriate that attitude may have been in the years shortly after the National Industrial Recovery Act was voided by the Supreme Court, the Commission in 1992 should have no more reluctance to exercise exemptive rulemaking authority conferred by the statutes it administers than to exercise the inclusive or extensive rulemaking authority so conferred. My constant prodding on this issue over the last few years did at least result in a public Commission statement that the source of its exemptive authority under the Investment Company Act

> provides the Commission with standards that, applied with circumspection, allow it to exempt particular vehicles and particular interests from those provisions of the Investment Company Act that inhibit competitive development of new products and new markets offered and sold in or from the United States.

The impact of that statement in Release No. 40-17534 depends, of course, on whether the phrase "with circumspection" is given the meaning of "carefully and meagerly" or of "carefully but flexibly". For example, in its current Small Business Capital Formation Initiative, the Commission this very month accepted its staff's recommendation to propose a possible future statutory amendment rather than proceeding by rule under its presently existing exemptive authority. In response to your request <u>this Commission could and should</u> publicly express its receptivity to careful <u>but flexible</u> use of its exemptive rulemaking authority, to the extent conferred by the Trust Indenture Act, the Investment Company Act and the Investment Advisers Act, by a Release quoting the several statutory grants of authority -- which are very broadly worded -- and by utilizing that authority to select appropriate exemptive rule proposals from the inventory of proposals, <u>including</u> those passed over in the so-called Small Business Capital Formation Initiative in favor of proposed legislative amendments, that have been considered by or presented to the Commission's staff in recent years.

III. The Consideration of Costs Versus Benefits in Rulemaking

In the commercial sphere regulated by this Agency, the articulation and assessment of benefits implicit in proposed rulemaking is always easier than the articulation and assessment of the related costs. Further, the assurance of achievement of benefits needs no confirmation since the proposed rulemaking is in each case crafted to that end, while in contrast the reliability of estimates of related costs is considered low both because of the wide differences in the range of estimates often presented to the Agency and because of the perceived likelihood of exaggeration by the persons presenting those estimates. As a result, evaluations by the Agency of benefits in comparison to related costs are frequently superficial and perfunctory. On those occasions on which real consideration is in fact given to that kind of evaluation, the indirect consequences of

the prospective rulemaking are usually outside the consideration accorded.

Two important recent examples illustrate this process. In the late 1980s the Commission was faced with an increasingly unacceptable degree of fraudulent and manipulative practices in the off-exchange markets for low-priced stocks, and it responded in 1989 by proposing and adopting a command-and-control rule prescribing in detail a set of highly intrusive sales practice requirements. The Commission knew the benefits it intended to achieve, and assessed the related costs as "minimize[d]" and "justifie[d]"; it did somewhat foresee, but gave only peripheral consideration to, the withdrawal of legitimate dealers from the trading markets in securities of legitimate companies because of the difficulty and resultant cost of establishing and implementing the fulsome procedures necessary to satisfy those requirements. Similarly in the late 1980s, the Commission also was faced with an increasingly unacceptable rate of non-compliance with its rules for reporting of acquisitions and dispositions of "equity securities" by officers, directors, and 10% stockholders of public companies, and in this context was faced with the additional possibility that those rules no longer reflected the economic realities of the contemporary marketplace, and the Commission responded in the period 1988 through 1991 by proposing and adopting a complete new set of reporting rules directed at allaying its concerns. The Commission again knew the benefits it intended to achieve, and assessed the related costs as "some[what] additional" and "outweighed"; it did not foresee, and therefore did not take into consideration, the transition costs in adjusting from one highly complex set of rules to an even more highly complex set of rules that were imposed on 10,000 public companies.

I have not heard a dollar estimate of the indirect costs to legitimate companies whose securities were deprived of much if not most of their liquidity after imposition of the 1989 sales practice requirements and the ensuing proposal of additional requirements pursuant to new legislation directed at the same problems, but the anecdotal reports of loss of market liquidity have come from small broker dealers and small public companies all over the country. I <u>have</u> been given a dollar estimate of the transition costs imposed by the 1991 revision of acquisition and disposition reporting rules on companies in the Silicon Valley area alone. That estimate, which was given to me by a former colleague on the Commission who was a participant in the Silicon Valley transition program, is "upwards of $10,000,000". In response to your request <u>this Commission could and should</u> resolve that no non-emergency rulemaking be allowed to proceed to adoption without well-considered evaluation of direct costs related to the benefits intended to be achieved or without a fulsome professional effort to evaluate and foresee the indirect consequential costs of that rulemaking proceeding.

IV. The Use of Performance Standards in Rulemaking

This Agency's single most renowned rule (Rule 10b-5), which has been likened to an acorn from which an entire judicial oak has grown, is a performance standards rule that was adopted in 1942. As recently as 1990 in its adoption of a general rule governing unregistered securities offerings made outside the United States (Regulation S, Rule 901), the Commission demonstrated that it still knows how to craft performance standards rules. Between those two adoptions, however, and again since the end of April 1990, the Commission has rarely based its rulemaking on performance standards. On the second page of this letter I recited some of the descriptions the Agency applies to the performance-standards alternative in its Regulatory Flexibility Analyses; there certainly must be contexts in which performance standards rules are "not consistent" with the direct mandate of the particular statutory provision, but the assertion that performance standards rules are "inadequate" for the particular rulemaking need is in many cases an admission that the persons engaged in the drafting process have devoted insufficient efforts to the search for an alternative to command-and-control requirements, and the conclusion that performance standards rules are "not possible" is almost always an admission that no effort at all was devoted to such a search.

Of course performance standards rules are "possible" as long as they are not directly inconsistent with the particular statutory provision. Even when (as was the case with Rule 901, mentioned above) performance standards are used to state the generality and are complemented by intrusive command-and-control requirements affording a "safe harbor" within the generality, the very presence of the performance-standards-based general rule affords a safeguard against, and an alternative to, the extremes of intrusiveness of the command-and-control requirements. And there are clearly many instances in which the performance standards rule can stand alone. In response to your request this Commission could and should insist on whatever effort is necessary to devise performance standards rules that are adequate for the intended rulemaking initiative whenever they are in fact possible, standing alone (like Rule 10b-5) whenever they can do so and providing an alternative to the command-and-control requirements when it is necessary or desirable to proceed in that manner.

V. The Use of Market Mechanisms

Peculiarly for a market regulatory agency, this Commission has rarely considered or utilized any natural mechanism of the market as a regulatory device. To the contrary, perhaps owing to the distrust of the market that infused the imperfect but widespread public understanding after the Crash of 1929, the very object of Commission rulemaking is frequently to inhibit the operation of naturally-occurring market mechanisms. The opportunity to use diverse market mechanisms as regulatory devices is actually afforded to the Agency in

a variety of contexts (not always recognized for the opportunities they afford), of which I might mention three as exemplary.

The most recurring example is the Commission's reliance on monopoly or near-monopoly exchange market franchises. When standardized and offsettable option contracts were introduced for trading by the Chicago Board Options Exchange, the desire of the Exchange for the initial patent-like fruits of its long research and development process coincided with the fear of the Commission that these new instruments would be used for market manipulative purposes. Market surveillance would obviously have been infinitely complicated by multi-market listing and trading of any series of options, so an inter-exchange options allocation system was sanctioned. Only after years of effort was it decided to allow the options exchanges to list each other's options, and to this day an informal moratorium (via a sequence of letters from our Chairman) effectively postpones the time for implementation of that decision while a rivalry between proposals for inter-exchange information coordination and trade execution capacity preserves the status quo. The real market advantage in this context has lain in the inertia attaching to "first out of the gate" status, but, when presented (by one of its own then members) with the suggestion that that advantage be discarded periodically by means of an auction to re-assign trading franchises, the Commission gave that suggestion no consideration at all. In response to your request this Commission could and should implement its own decision on multi-exchange options listing and could and should direct its economic and market regulatory staff to recommend criteria (as in evaluation of stock exchange specialist performance) for review and reallocation of options listings.

On the analogous topic of stock exchange limits on member firm trading of listed securities, the ever-expanding development of domestic "third market" and "fourth market" facilities and the ever-increasing capability for effecting trades overseas, taken together with the Agency's single action in 1979-80 (barring application of those limits to trades in securities listed after April 1979), have brought the pressure of market mechanisms to bear incrementally over this past decade. Mr. William Heyman, the new Director of the Agency's Division of Market Regulation, has now taken the initiative to commence a "Market 2000" study that should complete this process. In response to your request this Commission could and should support Mr. Heyman's effort in every possible way.

A different context in which performance of the Agency's market regulatory function could benefit from the use of market mechanisms is the context of regulation of short sales. The "bear raids" of the 1920s were manipulative at their core; prevention of such raids is addressed by general anti-manipulative rules. By contrast, most short sales are informative of, or responsive to, ordinary market action. Even in 1934 the short sale area was understood to be sufficiently tender and technical, and to have sufficient likelihood of adverse impact on the trading markets, that Congress prohibited only those

short sales made "in contravention of such rules and regulations as the Commission may prescribe". The Commission's "uptick rule", applicable to short sales on stock exchanges, was adopted in February 1938. In the intervening fifty years the traditional fear of "the short side" has been diminished by cumulative experience, particularly (during the last fifteen years) experience with risk-shifting instruments (options and futures) the markets for which would not exist without an equal and opposite "short side". It is therefore all the stranger that this Agency's "uptick rule" not only persists but is now under consideration for adaptation into the off-exchange market, without any serious consideration being given (although a then-majority of Commissioners proposed such consideration only a few years ago) of the market costs and benefits that that rule imports. In fact, studies by the Agency's Office of Economic Analysis, made recently in response to market participants' complaints about the absence of an "uptick rule" in a specified segment of the off-exchange market, were unable to find statistically significant support for those complaints. In response to your request <u>this Commission could and should</u> direct its economic and regulatory staffs jointly to review and report on the market impact in 1992 of short-selling generally and of the Agency's short sale regulations in particular (including the separate rule that the Commission designated as "temporary" in response to the studies mentioned immediately above, but that the Commission has not since reviewed), and <u>could and should</u> revise its short sale regulations in light of the resulting report.

A final context, this time in the arena of disclosure, in which the Agency could properly use market mechanisms, is the context of mandated quarterly reports by public companies. It has been thirteen years since Homer Kripke, once a senior staff official of this Agency and for decades one of its most constructive critics, concluded as follows in a chapter on "Market Forces and Disclosure":

> If we assume an absence of SEC compulsion, those aspects of the SEC system that are considered material to their decisions will be required by lenders and investors without the Commission's prompting, and will be furnished. Other parts will not be demanded.

Professor Kripke buttressed his conclusion with a separate description of the inertial forces that have always held this Agency back from serious consideration of the validity and market implications of the position he had reached. The Commission has twice in the recent past heard, from one of its own members, the formal suggestion that in light of the twice-yearly financial reporting provided by public companies through much of the industrialized world, it should consider withdrawing its mandate for quarterly reporting by part or all of the universe of domestic public companies. That suggestion was, of course, based on use of the market mechanisms fundamental to Professor Kripke's position, and would have afforded the Agency a controlled environment in which to test the functioning of those market mechanisms. Neither that suggestion nor anything similar to it has

ever been acceptable to this Agency. In response to your request this Commission could and should remove from its mandated periodic disclosures the requirement dictating quarterly reports from domestic public companies, for such period of time as it believes is necessary to ascertain whether market mechanisms will elicit substitute information "considered material to their decisions ... by lenders and investors without the Commission's prompting", and thereafter could and should take follow-up measures on the basis of what it has so ascertained.

VI. The Concern over Clarity and Certainty

More than twenty years ago I chaired a Bar subcommittee that brought to the Commission's staff an alternative version of a proposed rule then under consideration for adoption. We had tried carefully to draw some bright and clear lines in an area that had previously been subject to rather amorphous legal concepts. I remember well the response we received from a then-Commissioner who participated in our meeting, to the effect that "uncertainty surrounding the limits of the law is desirable because the 'crooks' can never be sure when they have overstepped the bounds". I have always believed that response to be wrong; the honest entrepreneur and the lawyer earnestly trying to give proper legal advice -- of whom there are many more than there are "crooks -- are equally hindered by uncertainty from pursuing legitimate transactions. But to this day this Commission follows the tradition of the response that I heard in 1971.

For example, a key item that required disclosure in the takeover battles that characterized the late 1980s was "whether or not any negotiation is being undertaken or is underway by the [target] company in response to the tender offer...." The Commission has initiated several prosecutorial enforcement actions for failure to make prompt disclosure of a "negotiation", as if that word had a clear and generally understood meaning. In connection with one such enforcement matter I collected a group of newspaper articles evidencing that, in diplomacy as in business, what is reported in the press as a "negotiation" can range from face-to-face bargaining to messages conveyed by an intermediary and to separate statements separately released to separate audiences. This Commission, even in its quasi-adjudicative decision on this issue, has manifested its own inability to clarify the meaning of the term ("the discussions between and among [the participants] constituted negotiations as of the time period from the evening of September 26 to September 29" -- but without specification of precisely when during that time period). Most recently, last June, as has been pointed out in the legal journals, this Commission simply avoided an opportunity to address the issue. As a result, managers of and advisers to target companies are constrained from having any dialogue, however preliminary and non-negotiatory, with outside parties in response to an unwanted tender offer, unless they are willing either to give the tender offeror the additional advantage of premature information or they are willing to run the risk of prosecution for disclosure law violation. The cost of

that constraint is measured in potential profits not realized by target company securityholders. In response to your request this Commission could and should remove that cost by amending its disclosure requirements to clarify the elements (actual or apparent authority, participation of outside persons, discussion of some particulars of price and structure, or whatever the Commission deems appropriate) which, when present together, identify a "negotiation". This very approach to precise identification of the elements sought to be included within the definition of a particular term that imposes substantive obligations, with the same kind of cost-removal effect, has been taken twice in recent years by the Commission in connection with rules turning on the definition of "beneficial ownership" (Rule 13d-3 and Rule 16a-1, which use different elements in different contexts), and in response to your request this Commission could and should take this same approach with respect (among others) even to definitions of terms as common and as consequential (although undefined) as "tender offer" and "insider trading".

VII. Rulemaking by Official and Unofficial Interpretation

The variety and status of Commission Interpretative Releases will be referred to in Part IX of this letter. Those Releases themselves divide into statements of Commission positions and statements of staff positions. Their effect, in whichever category, would be beneficent in assisting regulated entities and their professional advisers in complying with the applicable law and rules, were it not for their very profusion (which itself suggests that the rulebook needs re-writing). But behind and beyond those Releases lies a mass of staff interpretive and "no-action" correspondence that traces back to the issuance of opinions of the Commission's General Counsel, initiated in the first months of the Commission's existence nearly sixty years ago as an informal procedure for rendering advice and assistance to affected members of the public.

In earlier years knowledge of the very existence of that correspondence was a professional advantage limited to a few *cognoscenti*. Once it was made publicly available, however, the self-renewing stream of interpretive and no-action letters was treated by securities lawyers just like other decisional materials: individual letters and groups of letters in particular fields were reviewed and subjected to comparison, to compliment, to criticism, to study for guidance on conduct prohibited, and to analysis for suggestions of activity permissible, for similarly-situated persons. For its part the Commission, in rulemaking proceedings, in prosecutorial briefs, in its Annual Reports to Congress, in its *amicus* program, in settlement orders, and in its adjudicated opinions, has cited these letters for a variety of purposes: to respond to adversary arguments, to establish consistency in administrative practice, sometimes to highlight permissible conduct, but in each case implicitly accepting those letters as statements of the relevant Division's view of a generally applicable position; and the staff officially draws attention to "significant" letters, conducts seminars devoted in part to exposing

and expounding on recent letters, and from time to time recommends, for publication by the Commission, Releases that compile, correct, restate, and cite to, entire groupings of prior correspondence.

It is very strange, then, to realize that this mass of letters is disavowed by the Agency through an official description that they "are not rulings of the Commission or its staff on questions of law or fact". The interpretive and no-action process has far more elasticity, and presents far less danger to the Commission's administration of the federal securities laws, than that formula recognizes. In response to your request this Commission could and should recognize the realities of contemporary securities law practice, both inside and outside the Agency, by officially acknowledging that members of the Bar and the public are entitled to rely on staff no-action and interpretive letters as representing the current views of the relevant Division and may in good faith reason from those particular views to derive general propositions concerning both permitted and prohibited conduct, although reiterating that any analysis or extrapolation from particular staff views runs the professional risk of being wrong.

VIII. The Interplay of Rulemaking and Adjudication

The combination of quasi-judicial work with the work of policy determination, whether in its quasi-executive (prosecutory) or in its quasi-legislative (rulemaking) form, raises recurrent problems for this Agency. The Commission has been vested with the duty to ensure compliance with the federal securities laws. The performance of that duty involves policy determination by implementary rulemaking and by statutory and regulatory interpretation as well as by prosecutorial enforcement. It is undoubtedly true that this power of policy determination "must be exercised consistently and, therefore, by the same body, not only to realize the public purposes which the statutes are designed to further but also to avoid confusion of private interests." It is also true, however, that, as the administrative reach of the federal securities laws has repeatedly been extended in recent decades to include new persons and additional conduct, Commission policy-making via interpretation of the successive statutory enactments has necessarily gathered ever-greater scope, and consistency in that policy-making has assumed an increasingly self-generative character. As a result, the more consistency the Commission as a body achieves in application of administrative policies, the more committed the Commission as a body becomes to the vindication of the policies thus consistently applied.

While the Supreme Court has concluded that the maintenance by the Commission, in quasi-adjudicative proceedings, of policy positions developed in the performance of administrative responsibilities outside the proceedings themselves contravenes no "constitutional compulsions", nevertheless the shift to the Commission's quasi-adjudicative role ought at least to evoke a clear attitudinal distinction as to the discharge of the two responsibilities -- a

withdrawal by the Commissioners, in the performance of quasi-adjudicative duties, from those "[p]ressures and influences properly directed toward officers responsible for formulating and administering policy". The fundamental issue here is fairness and the appearance of fairness in the Agency's quasi-adjudicative process, both of which are adversely affected by confusion with the forces commanding consistent policy determination in the rulemaking and interpretative process. In response to your request this Commission could and should invoke upon itself a course of self-restraint, and even in appropriate cases dismissal, in the Commission's quasi-adjudicative proceedings in order to assure that the risk of unfairness to respondents in those proceedings is never allowed to reach a level that is unacceptable as a matter of Agency policy even if not yet so "intolerably high" as to be impermissible as a matter of constitutional law.

IX. The Commission's Rulebook Generally

To effectuate its disclosure mission and to govern the more fully regulated entities, the Commission has a rulebook of more than 1,100 pages of 8-point and 6-point type in the Code of Federal Regulations. (I have omitted from that total the additional 100 pages that contain only tables of contents or superseded rules.) But that total is misleadingly low, because eight separate Parts of the Code consist of lists of an aggregate of more than 500 Interpretive Releases (perhaps another 1,500 pages) that are incorporated by reference into various portions of the formal rules. Six further Parts consist of summary descriptions of all the many forms (another few hundred pages) on which filings with the Commission are made, each of which (and the set of instructions to each of which) is formally considered by the Commission to be a Commission rule, since under each Act administered by the Commission there is a rule stating generally:

> The term rules and regulations refers to all rules and regulations adopted by the Commission pursuant to the act, including the forms for registration and reports and the accompanying instructions thereto.

With a rulebook this thick and this diffuse, it is impractical to select more than a few exemplary pieces for comment. I shall mention three, in quite diverse contexts, that fit nowhere else in this letter but merit separate discussion.

The rulebook contains one Part (Regulation S-K) that sets forth "Standard Instructions for Filing Forms" under the Securities Act and the Securities Exchange Act. An entrepreneur or a business lawyer seeking guidance from that Part is met with the following introductory sentence:

> This Part (together with the General Rules and Regulations under [the two Acts], the Interpretative Releases under these Acts ... and the forms under these Acts ...) states the requirements applicable to the content of the non-financial statement portions

of [registration statements, reports, and proxy and information statements] ....

Perhaps the entrepreneur or lawyer can actually find all those rules, regulations, releases and forms. Since they would all be applicable even in the absence of that introductory sentence, perhaps the entrepreneur or lawyer is benefitted by being put on notice of the necessity to search elsewhere, both inside and outside the rulebook, to find much of what is required by way of disclosure. Certainly, in response to your request this Commission could and should pare, consolidate, and publish in a single source, this multiplicity of disclosure requirements, and could and should codify (if worth retaining) or discard this myriad of interpretive glosses.

The rulebook includes one Part (Regulation S-X) that prescribes the "Form and Content of and Requirements for Financial Statements" under the several Acts administered by the Commission. This nearly-100-page Part incorporates from a separate Part the Commission's Financial Reporting Releases (now numbering nearly 40), one of which alone is a perhaps-100-page often-amended Codification of Financial Reporting Policies that is nowhere published by the Commission. The same separate Part also lists, without specifying the status of, the Commission's Staff Accounting Bulletins (which now number more than 90) and Accounting and Auditing Enforcement Releases (which now number more than 350). Undoubtedly, in response to your request this Commission could and should pare, consolidate, and publish in a single codification, this labyrinth of accounting requirements and auditing practice analyses. More important: during these past 55 years, generally accepted accounting principles have greatly developed and have matured under the aegis of the (non-Governmental) Financial Accounting Standards Board and its predecessors, but the prescriptions of this entire substantive Part and of the Codification of Financial Reporting Policies incorporated into this Part continue to be mandatorily applicable above and beyond the requirements of GAAP. In response to your request this Commission could and should delete those large portions of this Part that prescribe format and presentation or that substantially overlap GAAP disclosure and substantive standards, with minimal if any impact on the quality of financial information flowing to the public markets.

The rulebook also contains a three-page rule (Rule 14a-8), relating to the procedural requirements for inclusion of shareholder proposals in the annual proxy statements of public companies, that includes nearly a full page prescribing the subject matter of proposals that need not be so included. The result is to involve the Commission and its staff, annually, in tens upon tens of interpretations and reinterpretations, and reversals of prior interpretations, of the limits on matters that, except for compliance with disclosure standards and procedural requirements, rest primarily on state law and should be determined by shareholder-management negotiation or by state chancery courts if that process of negotiation fails. In fact, in 1982 the Commission proposed revising the rule so

that "all proposals that are proper under state law and that do not involve the election of directors should be included in an issuer's proxy statement, subject to a numerical maximum," but the Commission ultimately preserved the status quo with minor changes. Now, in response to your request this Commission could and should revive that aborted approach in order to withdraw itself from an intrusive regulatory role, revising the rule to prescribe only procedure and disclosure and leaving determinations on the substantive law of shareholder rights to the state courts of equity.

X. A List of Additional Proposed Rule Revisions

Above and beyond the regulatory changes suggested in the preceding Parts of this letter, a list of additional proposed rule revisions follows.

A. Rules Relating to Organization etc., Practice, Procedures and Investigations (Parts 200, 201, 202 and 203 of Title 17, Code of Federal Regulations)

1. §200.23 The Commission should review and revitalize the responsibilities assigned under this rule to its Chief Economist and its economic analysis staff. A market regulatory Agency that regulates without considering economic analysis and economists' advice as to likely market impact, costs and benefits, is an Agency that regulates markets blindly and that has disabled itself from responding to your request. This Commission has discouraged and devalued economic analysis and advice.

2. §200.53 The Commission should delete the portion of this rule that suggests a regulatory jurisdiction more appropriate to an Executive Department or to the Federal Reserve Board than to this Agency.

3. §200.58 The Commission should amend this rule to reflect the desirability of policy discussion and coordination with the President as well as the Congress.

4. §200.67 The Commission should duplicate the portions of this rule that enjoin it (i) not to exercise its power beyond proper statutory limits, (ii) not to stifle or discourage legitimate business enterprises, and (iii) not to interpret its power so as unduly and unnecessarily to burden regulated persons with onerous obligations, so that those injunctions apply not merely to rulemaking but to all its actions.

5. §202.1(d) The Commission should rewrite this rule to reflect the position that members of the Bar and of the public may in good faith reason from the particular views expressed in staff no-action and interpretive letters to derive general propositions, at the risk of being wrong, and may in good faith disagree with staff views so expressed.

6. §202.3(a) The Commission should adapt the portions of this rule that relate to staff actions taken if a filing appears to afford inadequate disclosure and if a filing appears to afford adequate disclosure, so that the performance standards of §12 and §17(a) can replace staff review of a greater proportion of the filings that would otherwise receive full staff review.

B. Rules Relating to Accounting Principles and Auditing Standards (Parts 210 and 211 of Title 17, Code of Federal Regulations)

1. §210.4-01(a)(1) The Commission should review and revise the portion of this rule that presumes misleading or inaccurate any financial statements not prepared in full accordance with GAAP regardless of accompanying explanatory disclosures.

2. §210.10-01(a)(5) The Commission should expand the applicability of the initial portion of this rule, relating to (i) the presumption that users of unaudited interim information have access to prior audited financial statements, and (ii) the determination of the adequacy of additional disclosure needed for a fair presentation, so that it applies in Regulation A and other filings where other-than-interim unaudited statements are presented.

3. §210.11-03 The Commission should compare this rule with its alternative, §210.11-02(b)(3) through (7) and (c)(2) through (4) and the accompanying instructions, and should simplify the alternative in light of this rule.

C. Rules Relating to Disclosure Requirements, and Other Rules Under the Securities Act (Parts 229, 230, 231 and 239 of Title 17, Code of Federal Regulations)

1. §229.10(c) The Commission should relinquish its self-appointed role of designating which organizations qualify as "nationally recognized securities rating organizations". National recognition is

determinable in the marketplace according to objective standards, without Commission confirmation.

2. §230.144A(d)(4) The Commission <u>should strike</u> the onerous conditions imposed by this rule on the availability of exemption for the securities of private companies, which include particularly the smaller business enterprises that are the subject of the Commission's current Small Business Initiative.

3. §230.147 The Commission <u>should adopt</u> an analog to this rule, under its small offering exemption authority, to provide a local transaction exemption directed at transactions limited geographically to standard metropolitan statistical areas that cross state lines.

4. §230.153(a) The Commission <u>should complement</u> this rule with a similar rule providing for prospectus delivery to the National Association of Securities Dealers when transactions in the registered security are effected on NASDAQ.

5. §230.157 The Commission <u>should amend</u> the definition of "small business" and "small organization" in this rule to be consonant with whatever definition of "small business issuer" it adopts for its "Small Business Initiative".

6. §230.175 The Commission <u>should expand</u> its reliance on the presentation "in good faith" of disclosure information for which the reporting person has "a reasonable basis" to believe that the information is true and complete. That standard of care, and therefore of liability, should apply to any forward-looking statement whether or not made in a document filed with the Commission, and to categories of present and historical statements as well.

7. §230.261 The Commission <u>should amend</u> this rule to specify, and to limit, those provisions of the rule that result in retroactive law violation as a result of entry of a suspension order.

8. §230.330(b) The Commission <u>should also expand</u> its reliance, particularly in respect of small issuers as defined for Regulatory Flexibility Act purposes, on the presentation of disclosure information as to which no material fact known to the reporting

person has been omitted, the inclusion of which would reasonably appear necessary, in the circumstances, to make other information not misleading.

9. §230.401(g) The Commission should adopt rules under those of its exemptive regulations that require filing of offering statements with the Commission, so that offering statements so filed have the protection of being deemed to be filed on the proper form unless objection to the form used is made by the Commission prior to the date of release for use in definitive form.

10. §230.405 The Commission should utilize the experience it has gained from the special materiality rule made applicable to its mandated Management Discussion and Analysis, to recognize the differences in determination of materiality in different contexts.

11. §230.461(b) The Commission should formalize and publicize other general policies affecting its review and processing of disclosure information, by inclusion of such policies in rules like this one.

12. §230.502(b)(2) The Commission should recognize the existence of circumstances in which audited financial statements are not, solely because of the audit, "material to an understanding of the issuer, its business, and the securities being offered".

13. §230.502(c) The Commission should amend this rule to allow some face-to-face contacts presently prohibited as "general solicitations", for example, presentations by entrepreneurs to venture capital forums regularly sponsored by independent professional firms.

D. Rules under the Securities Exchange Act (Parts 240, 241 and 249 of Title 17, Code of Federal Regulations)

1. §240.3b-8 The Commission should delete from non-exemptive definitional rules like this one those provisions pursuant to which non-compliance with other unrelated rules has the additional effect of precluding a regulated entity from continuance of activity to which the definition is directed.

2. §240.10b-17 The Commission should adopt an additional provision for this rule based on performance standards.

3. §240.12g-3(d)(3) The Commission should revoke the exclusion of NASDAQ securities from the exemption provided by this rule. The reasons advanced by the Commission in 1984 for adopting this exclusion no longer support the exclusion.

4. §240.13d-101 Item 4 The Commission should delete the requirement in this item for description of "proposals", which are by definition less developed and more subject to alteration than the companion "plans" that are in any event required to be disclosed.

5. §240.14a-3(b)(6) and (11) The Commission should expand its reliance on disclosure that is "in any form deemed suitable by management" and "will, in the opinion of management, indicate the general nature and scope of the business" or other particular subject matter relating to the reporting person.

6. §240.15c3-1f The Commission should struggle, if necessary, to find shorter, more direct and more comprehensible approaches to the computation of minimum net capital required of broker dealers. There just must be a better alternative by which to approach this computation than the 41 pages of this incomprehensible rule.

7. §240.17a-11 The Commission should revoke the requirement for telegraphic notice that is the principal reason for this rule. Experience has demonstrated that broker dealers out of compliance with net capital requirements are not particularly concerned about failure to meet telegraphic notice requirements.

8. §240.17Ad-2(f) and (g) The Commission should substitute the approach taken in these rules, relying on a mandate that regulated entities "shall have appropriate procedures to assure, and shall assure, ...", for the command-and-control requirements characteristic of other rules under Section 17A.

E. Rules under the Public Utility Holding Company Act (Parts 250, 251, 256, 257 and 259 of Title 17, Code of Federal Regulations)

1. §250.100 The Commission should specify, in other exemptive contexts, its intention to exercise its exemptive authority, whether upon application or upon its own motion, in appropriate circumstances.

F. Rules under the Trust Indenture Act (Parts 260, 261 and 269 of Title 17, Code of Federal Regulations)

1. §260.4a-1 The Commission should adopt exemptive rules like this one, for de minimis transactions not likely to be affected with a federal interest, in each context in which it has the authority to do so.

G. Rules under the Investment Company Act and the Investment Advisers Act (Parts 270, 271, 274, 275, 276 and 279 of Title 17, Code of Federal Regulations)

1. §270.17d-1 The Commission should limit the reach of this rule in reliance on the ability of independent directors of registered investment companies to discharge their fiduciary responsibilities properly and competently, particularly in transactions in which the investment company's participation is on a basis no different from, and no less advantageous than, the participation of other parties including participating affiliates.

2. §275.205-1 The Commission should utilize, more frequently, computation exhibits like the one appended to this rule.

3. §275.206(3)-2 The Commission should adapt the approach of this rule, providing for prospective general written consent, transaction confirmation disclosure, periodic disclosure, and repeated notice of revocability, in other contexts where investors may be presumed to be able to authorize trading activity by means of informed consent.

XI. The Balance of Rulemaking and Prosecutorial Enforcement

What always seems most difficult -- what is and should be central to an S.E.C. Commissioner's response to your request -- is the balancing of investor protection, on the one hand, and, on the other, removal of cost from the securities offering and securities trading markets in particular and the United States economy in general. I see no necessary contradiction between those two. Early this month a former Commissioner pointed out, to a group of present and former members and senior staff of this Commission, that reform of this Agency's regulatory program has the inevitable concomitant of expansion of the Agency's policing and prosecuting program. I agree with that analysis, and it leads me to the ultimate conclusion that this Commission's enforcement program can fulfill the resulting additional responsibility and can fulfill it well -- at a far lesser systemic cost than prevails under the Commission's present regulatory approach. After 6-1/4 years as a Commissioner of this Agency and after the prior 26-1/2 years of law practice in the field regulated by

this Commission, I firmly believe that in response to your request this Commission could and should be willing to rely more heavily on a well-directed policing and prosecuting program to remove a real amount of systemic cost without removing anywhere near an equal extent of direct and indirect benefits to investors.

Performance standards, market mechanisms, and clarity in rulemaking all contribute to removal of systemic costs. To the extent that in the securities markets those regulatory methods rely on enforcement by market forces, by self-regulatory organizations and by this Agency, that reliance is both well-founded and well-directed to the maintenance of the fundamental investor protections that have made and have kept the primary and secondary securities markets in the United States, in the words of former Commission Chairman John Shad, "the deepest, the most liquid and the fairest securities markets anywhere in the world".

XII. My Conclusion

I shall finish where I began, Mr. President. This letter is far too long and still it reaches only part of the way, reflecting a single Commissioner's individual response to the excitement and challenge of your January 28, 1992 request. One thought from the opening of this letter merits repeating here at the end: In response to your request this Commission could do so very much! All that is needed is the determination to do so.

Very truly yours,

Edward H. Fleischman
Commissioner