Common Sense, Flexibility, and Enforcement of the Federal Securities Laws

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INTRODUCTION

Philip Howard’s popular book, The Death of Common Sense (Common Sense), makes some interesting observations about our society and how we govern ourselves.1 Howard believes that we have become slaves to reams of detailed government regulations. Whether these rules make sense seems, to him, less significant than that they exist. By having established rules, Howard observes, we are comforted by their clarity yet enslaved by their uncompromising requirements.

The thesis of Common Sense is that the existing system hinders society. In his view, the world is best governed by fewer detailed rules and more broad principles administered by regulators with discretion, flexibility, and a lot of common sense: “Law should articulate goals . . . but law should almost never provide the final answer . . . . Law can’t think, and so law must be entrusted to humans and they must take responsibility for their interpretation of it.”2

Mr. Howard criticizes government and regulators for seeking refuge in the safety of detailed regulations,3 and criticizes society’s fear of regulators, who are empowered to apply broad principles fairly and flexibly. Assessing society’s view of regulators in general, Howard observes:

We seem to believe a regulator is either bound by a clear rule or roams free with his sword unsheathed and a smirk on his face . . . . Relaxing a little and letting regulators use their judgment is the only way to liberate our judgment. Discretion, it is vital to understand, works both ways. If the regulator has flexibility to interpret a general standard, so do we. We can think for ourselves. As the head of a large

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2. Id. at 186.
3. “Responsibility is the last thing bureaucrats want.” Id. at 181.
company said recently: "The majority of people will do right if they’re given goals and left to get the job done . . . . Regulations telling us how long our ladders should be are not useful."4

In a less than charitable assessment of the government and public servants in general, Howard asserts that

[i]t is perhaps a hateful thought to give government officials a measure of discretion, but that’s the only way for them to do anything, and the only way for us to know who to blame; as New Dealer Jim Landis5 noted, “We must take into account that government will be operated by men of average talent and average ability.”6

There is reason to reflect on Howard’s observations, notwithstanding the indictment of public servants by former Securities and Exchange Commission (SEC or Commission) Chairman Landis.

For years, the SEC has approached enforcement of the federal securities laws by relying on some of the same principles espoused in Howard’s book. From the foreign payments program to the more recent initiatives in the municipal securities markets, the SEC has tried to address new issues that have emerged in our rapidly changing capital market system without the benefit, or the hinderance, of precise proscriptions. Instead, the agency has relied on the general proscriptions contained in the federal securities laws and has tried to apply them practically and with common sense. While there have been numerous amendments to the federal securities laws over the past sixty-odd years, the most basic standards have remained unchanged: the antifraud rules7 and the requirement that publicly traded companies keep accurate books and records.8

Not surprisingly, the SEC’s efforts have not always been greeted with the same warm reception that Howard’s book has received. With each new initiative, some lawyers, academics, and those whose behavior has been challenged have complained: where is it specifically written that this behavior is illegal? If there is no blackletter rule, they argue, the government’s efforts amount to ex post facto punishment reflecting the bureaucratic proclivity to expand power and broaden jurisdiction. The Commission’s approach, however, has not been improperly expansive, nor has it involved after-the-fact regulation. Rather, the SEC has tried to adopt a reasoned,

4. Id. at 180.
5. James M. Landis, a former Dean of the Harvard Law School, was a member of the Securities and Exchange Commission from 1934 to 1937 and its Chairman from 1935 to 1937.
6. HOWARD, COMMON SENSE, supra note 1, at 180-181 (footnote added).
common sense application of the basic requirements of the federal securities laws to new market conditions as they have evolved over the years.

Interestingly, when the SEC has been most creative, its critics have been most vociferous. This Article reviews four important enforcement initiatives undertaken over the past two decades in which the Commission has responded to market developments by applying basic provisions of the federal securities laws to meet new and serious market abuses.

**THE FOREIGN PAYMENTS PROGRAM**

In 1974, Stanley Sporkin, then the director of the SEC's Division of Enforcement, was intrigued by revelations in the Watergate hearings that certain U.S. companies had kept corporate funds "off-the-books" to be used for purposes such as political contributions. Sporkin wondered how these companies accounted for the cash and for the payments, and whether shareholders, the various boards of directors, or the outside auditors were informed of this use of corporate assets. Thus began a series of SEC staff inquiries which led to what became known as the SEC's foreign payments program.

These inquiries revealed that many major U.S. companies had not only made illegal political contributions at home, but also made illegal or questionable foreign payments, including bribes of many millions of dollars, to foreign officials and agents in their pursuit of foreign business opportunities.9 Further inquiries disclosed that those companies—many of them "Fortune 500" companies—typically falsified corporate books and records to conceal the questionable payments and had even created clandestine slush funds, all outside the normal financial accountability system.10 Some companies admitted that top management was aware that such payments were made and that corporate books and records were falsified to hide the existence of the payments.11

To Sporkin's amazement, this practice had become common among major U.S. public companies. Many public companies had significantly compromised the integrity and reliability of their books and records and financial information which they filed with the Commission and released to the public. Their conduct threatened the integrity of the disclosure system established by the federal securities laws. In an SEC report con-

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9. In a landmark report to the Senate Banking, Housing and Urban Affairs Committee, the SEC summarized information it had gathered in the course of its inquiries concerning improper foreign payments by major U.S. companies, along with the actions it had taken to date addressing resulting violations of the federal securities laws. REPORT OF THE SECURITIES AND EXCHANGE COMMISSION ON QUESTIONABLE AND ILLEGAL CORPORATE PAYMENTS AND PRACTICES, 94th Cong., 2d Sess. (Comm. Print 1976) [hereinafter SEC REPORT].
10. See id. at 3.
11. Id. at a.
cerning the matter to the Senate Banking, Housing and Urban Affairs Committee, the SEC stated

The almost universal characteristic of the cases reviewed to date by the Commission has been the apparent frustration of our system of corporate accountability which has been designed to assure that there is proper accounting of the use of corporate funds and that documents filed with the Commission and circulated to shareholders do not omit or misrepresent material facts. Millions of dollars of funds have been inaccurately recorded in corporate books and records to facilitate the making of questionable payments.12

No specific provision of the federal securities laws addressed the practice of foreign payments. Sporkin and the Commission, however, had a more direct, and in some respects, more common sense reaction to these issues, long before Phil Howard put pen to paper. Sporkin believed that existing SEC regulations, which required a company to disclose financial information accurately, must cover foreign payments. A public company could not meet its obligations to prepare accurate and complete financial statements while maintaining off-the-books slush funds and making questionable payments which were hidden by falsified accounting records.

Soon the SEC brought injunctive actions against several major corporations for falsifying books and records to conceal the improper payments.13 The consent decrees directly addressed the illicit practices, requiring each defendant corporation to create a special review committee of outside directors to conduct internal investigations into the activities leading to the enforcement actions.14 The consent decrees then ordered the committees to report the results to the court, the SEC, the board of directors, and shareholders.15

In addition, Sporkin and Alan Levenson, then Director of the Division of Corporation Finance, developed the "voluntary disclosure program."16

12. Id.
13. The SEC Report summarizes the facts of various injunctive actions brought by the SEC concerning improper foreign payments. In most of the actions, the SEC alleged violations of one or more of §§ 10(b) (antifraud), 13(a) (reporting/books & records) and 14(a) (proxy solicitation) of the Exchange Act and the various rules promulgated thereunder. SEC REPORT, supra note 9. Among the companies the SEC brought enforcement actions against were American Ship Building Company, Ashland Oil, Inc., Gulf Oil Corporation, Minnesota Mining and Manufacturing Company, Phillips Petroleum Company, Northrop Corporation, Braniff Airways, Inc., General Tire & Rubber Corporation, Kalvex, Inc., Lockheed Aircraft Corporation, Missouri Public Service Company, Sanitas Service Corporation, United Brands Company, and Waste Management, Inc. Id.
14. Id. at 4.
15. Id.
16. The voluntary program was announced in several public statements. See, e.g., Hearings Before the Subcomm. on International Economic Policy of the House Comm. on International Relations, 94th Cong., 1st Sess. (1975) (testimony of SEC Commissioner Philip A. Loomis).
The SEC invited all public companies that might have made undisclosed foreign payments to conduct their own internal investigations and report the results in public filings with the SEC.\textsuperscript{17} While the Commission promised no immunity from follow-up scrutiny or prosecution, those companies participating in the program were promised fair consideration by the agency as to whether further action would be taken.\textsuperscript{18} The clear implication was that cooperation would be rewarded.

The Commission's actions, which forced disclosure of corporate slush funds and questionable or illegal foreign payments, led to an onslaught of criticism that the SEC was acting beyond its legal authority. Some critics contended that the SEC had imposed its own rules of morality on corporations in an area wholly outside the scope or intended reach of the federal securities laws. For example, Roberta Karmel, a former SEC Commissioner, denounced the Commission's foreign payments program as a "witch hunt" reaction to Watergate.\textsuperscript{19} Other critics questioned whether the best interest of investors and the public were served by public disclosure of foreign payments and slush funds.\textsuperscript{20} Given the quantitative insignificance of the payments themselves, others argued, foreign payments and slush funds were not material to the companies' financial statements and so disclosure was not required. Some critics noted that payments to high government officials and their favored agents were essential prerequisites for doing business in certain foreign countries. These critics contended that the SEC should not interfere with business practices necessary for a corporation to compete successfully in the global market place with foreign corporations who routinely made such payments.\textsuperscript{21} Indeed, some foreign governments permitted tax write-offs for such illegal payments.

While critics even today may disagree, the SEC's foreign payments program was highly successful, not only because the agency took the steps necessary to maintain the integrity of corporate financial disclosure, but because it approached the problem with creativity and common sense. Suppose the SEC, after hearing evidence of slush funds and foreign payments, read the statutes and the rules narrowly and decided the federal securities laws should not be applied? Without the Commission's leadership on this issue, bribery and secret payments likely would have proliferated. The Commission and its staff defied the mediocrity that SEC

17. In its report, the SEC included a table which summarized the disclosures to date by 89 companies concerning improper payments by the company. SEC REPORT, supra note 9, at Exhibit A.
18. Id. at 8 n.7.
Chairman Landis had predicted of government officials over sixty years ago. Rather than create a new volume of rules and regulations or await congressional action, the SEC found sufficient basis in existing law, read broadly, to preserve one of the most basic principles of the acts it administers—the accuracy of corporate books and records. It cannot have been surprising for the SEC to act on the premise that public companies must maintain accurate books and records, a fundamental prerequisite to the ability to prepare accurate financial statements.22

The SEC did not dictate corporate practice with respect to the disposition of corporate assets. Nor did the agency forbid companies from making improper or illegal payments.23 The SEC simply required that if companies made such payments, they had to book them accurately to maintain reliable records and prepare accurate financial statements. In addition, that corporate officials were willing to make such payments, without proper accounting, "raise[d] questions regarding improper exercise of corporate authority" and was "relevant to the [integrity or] 'quality of management' "—important issues that should have been disclosed to the shareholders.24

The primary thrust of the SEC's program was to restore confidence in corporate financial disclosure and accountability.25 The SEC encouraged public companies to address the misconduct through their own corporate structures. As a result of the SEC's initiatives, more than 450 companies came forward and admitted to making improper payments not reflected on their books and records. Both the voluntary disclosure program and the special board committees required by the various consent orders resulted in improved self-policing programs and better, more accurate, financial reporting. In the end, the SEC had successfully challenged conduct that most Americans found unacceptable. All of this was accomplished without adding a single page to the Code of Federal Regulations.

22. "Basic to the system is the principle that all funds belonging to the corporation, and thus to its shareholders, are adequately maintained within the corporation's system of financial accountability." SEC REPORT, supra note 9, at 23.


24. SEC REPORT, supra note 9, at 15.

25. These efforts coincided with a substantial SEC effort under Chairman Harold Williams to impose corporate governance and to sensitize corporate directors to their fiduciary duties. See Harold Williams, Corporate Accountability, Address Before the Fifth Annual Securities Regulation Institute, at 26 (Jan. 18, 1978) (on file with The Business Lawyer, University of Maryland School of Law); Harold Williams, Corporate Accountability and Corporate Power, Address Presented at the Fairless Lecture Series (Oct. 24, 1979) (on file with The Business Lawyer, University of Maryland School of Law). See generally MARC I. STEINBERG, CORPORATE INTERNAL AFFAIRS (1983).
PARKING SCHEMES

During the 1980s, in the midst of the merger and acquisition boom and some of the SEC's most highly publicized insider trading cases, the SEC staff encountered a practice on Wall Street known as "parking." "Parking," a term not found in any statutory provision, describes a situation where one party transfers the legal title of certain securities to another, while secretly maintaining control and beneficial ownership of those same securities. Despite its innocuous name, "parking" has been used to facilitate a variety of fraudulent schemes.

Initially, some small firms parked securities to avoid a net capital deficiency. The firms placed securities in the accounts of principals, employees or relatives, almost as a team effort, in order to keep current in their net capital requirements.26 In the midst of the Boesky/Drexel scandals, the SEC learned that certain large brokerage firms had also engaged in parking schemes, conspiring among themselves to manufacture compliance with net capital requirements.27 Such parking arrangements among large

26. The federal securities laws require that brokerage firms maintain a certain amount of net capital to continue in business:

In calculating its regulatory net capital, a broker-dealer, pursuant to Rule 15c3-1, 17 C.F.R. § 240.15c3-1, must deduct specified percentages from the fair market value of the securities it holds. The deduction . . . varies according to what type of security the broker holds and whether the security is readily marketable. See, 17 C.F.R. § 240.15c3-1(c)(2)(vi)(J) (30% deduction for most securities); § 240.15c3-1(c)(2)(vi)(K) (40% deduction for securities having a limited market). . . . Arnold M. Axelrod, 46 S.E.C. 752, 753 n.5 (December 28, 1976). See Capital Securities [43 S.E.C. 758 (Mar. 14, 1968)] and Sumner B. Cotzin [45 S.E.C. 575 (June 12, 1974)]. But see Hibbard & O'Connor, 46 S.E.C. 1045, 1047-49 (September 12, 1977) (scheme involving parking of bonds with a bank).

27. See SEC v. Jefferies, Litig. Release No. 11370, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,171 (S.D.N.Y. Mar. 19, 1987). The SEC alleged that Boyd Jefferies entered into an agreement at Ivan F. Boesky's ('Boesky') request whereby, Jefferies & Co. received transfers of securities from Seemala Corp. ('Seemala'), a registered broker and dealer, which were structured to appear in form as bona-fide 'purchases' by Jefferies & Co. but which were, in substance, 'parks' because Jefferies agreed with Boesky that Jefferies & Co. would hold the securities for Seemala and that Seemala would 'buy' back the same securities shortly thereafter, receive all profits or sustain all losses from those transactions and compensate Jefferies & Co. for its cost of carrying such securities. . . . Jefferies & Co. parked approximately $56 million [dollars] worth of three securities for Seemala.

Id. at 95,761. As a result, Seemala appeared to have the minimum net capital required by the SEC, thus enabling it to continue to operate despite net capital deficiencies. (Jefferies also parked $47 million dollars in six of its own securities positions at Boesky-controlled entities). See also SEC v. Kidder Peabody & Co., Litig. Release No. 11452, [1987 Transfer
broker-dealers were particularly alarming because they raised serious doubts about the financial and managerial integrity of major market participants.28

In addition, SEC investigations of the takeover activity at that time revealed other disturbing purposes for parking. The SEC discovered that broker-dealers used parking schemes both to manipulate stock prices29 and to enable corporate raiders to avoid required disclosure of significant purchases of a target's securities.30

The SEC staff sought to deal with these parking schemes by applying existing rules addressing the core of the conduct: misrepresentation. This approach permitted the SEC to respond immediately to what was clearly a serious market problem. Where parking concealed net capital deficiencies, the SEC charged violations of the net capital requirements of the Exchange Act.31 In manipulation cases, the SEC charged defendants with violating general anti-fraud provisions and rules of the Exchange Act.32

Where parking was used to avoid disclosure requirements under the Wil-


28. When major market participants take part in these schemes, doubts about the industry's ability and willingness to police itself effectively are inevitable... the parking cases may further weaken the industry's ability to command investor confidence.... The willingness of established firms to participate in schemes of this magnitude, which circumvent a fundamental element of the regulatory framework is alarming.

MCLUCAS & DETORE, RECENT SEC ENFORCEMENT ACTIONS, supra note 26, at 2, 11.

29. See SEC v. Blinder Robinson & Co., 542 F. Supp. 468 (D. Co. 1982), aff'd, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,491, (10th Cir. 1983). The case involved a best efforts "all or none" underwriting of a stock offering by a new company, American Leisure Corp. The underwriter, Blinder Robinson, was required to sell all of the offered shares of stock within ninety days. If Blinder was unable to complete the underwriting, however, all proceeds were to be refunded to the investors and the offer terminated. Such a requirement protects the investor who "is comforted by the knowledge that unless his judgment to take the risk is shared by enough others to sell out the issue, his money will be returned." Id. at 476. Blinder Robinson employed "parking" to disguise its inability to complete the offering, thus removing the protections afforded to investors by the "all or none" underwriting.

30. For example, § 13(d) of the Exchange Act, and the rules thereunder, require parties who acquire more than five percent of a company's stock to file a report with the Commission stating, among other things, why they bought the stock. 15 U.S.C. § 78m(d) (1994); 17 C.F.R. §§ 240.13d-1 to -6 (1995). By parking stock, corporate raiders could avoid filing the appropriate disclosure statements. See SEC v. First City Fin. Corp., 688 F.Supp. 705 (D.D.C. 1988), aff'd, 890 F.2d 1215 (D.C. Cir. 1989) (involving First City Financial Corporation, owned by the Belzberg family, which entered into a parking arrangement with Bear Stearns in order to avoid disclosing their purchases of shares of Ashland Oil Company).


32. See Blinder Robinson, 542 F. Supp. at 468.
liams Act, the SEC charged defendants with violating section 13(d) of the Exchange Act. Again, critics in the securities industry and some securities lawyers claimed the SEC had overstepped its authority by criminalizing parking, a technical violation that had gone on for years. These parking practices, which were designed to thwart the net capital regulations, threatened the financial soundness of the brokerage business and jeopardized the safety of the accounts of every brokerage firm’s customers. Parking impaired the accuracy of a firm’s books and records and frequently violated margin requirements, threatening the solvency of a firm. Because parking directly affected the financial integrity of major market participants, it directly affected the integrity of the market as a whole. When parking was used to avoid beneficial ownership disclosure requirements, it deprived the market of material information about the ownership of large blocks of a company’s stock. Lastly, the SEC viewed parking as compromising the public’s overall perception of fairness, honesty, and integrity in the securities markets. Parking indicated a breakdown in self-policing by the securities industry and weakened the industry’s ability to command investor confidence. Once again, the Commission addressed a serious market problem with existing statutes and rules, applying them broadly, flexibly, and with common sense. The Commission successfully pursued its primary mission to protect investors and the market with the regulatory tools it had in hand.

**MUNICIPAL SECURITIES—“PAY TO PLAY”**

In one of his earliest public pronouncements as SEC Chairman, Arthur Levitt announced the SEC would scrutinize practices in the municipal

34. See First City Fin. Corp., 688 F.Supp. at 705.
36. In Jefferies, the SEC alleged that Jefferies aided and abetted Seemala’s violations of the SEC’s net capital regulations, as well as violating, or aiding and abetting violations, of the beneficial ownership reporting requirements (failure to file a schedule 13D and amendments disclosing their joint holdings). The SEC also alleged that Jefferies violated, or aided and abetted violations relating to books and records and reporting requirements of broker-dealers and public companies, by inaccurately recording or failing to disclose information concerning such purchases and sales, and losses and recompenation relating to the parking arrangement. Finally, the SEC alleged that the parking arrangement resulted in violation of margin requirements because the scheme effectively extended to Seemala 100% credit on securities instead of the 50% credit permitted by the applicable rules. SEC v. Jefferies, Litig. Release No. 11370, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,171 (S.D.N.Y. Mar. 19, 1987); see also SEC v. Kidder Peabody & Co., Litig. Release No. 11452, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,271 (S.D.N.Y. June 4, 1987); SEC v. Davidoff, Litigation Release No. 11390, 38 S.E.C. 61 (S.D.N.Y. Apr. 7, 1987).
securities market.\textsuperscript{37} This market, once primarily the domain of large banks and institutional investors, is now dominated by individual investors and has more than doubled in size over the past ten years (presently, it is at least a $1.2 trillion dollar market).\textsuperscript{38} As municipal securities have become an increasingly significant part of capital markets, the accompanying abuses pose an increasingly serious threat to the investing public and to the market generally.

Some critics questioned why the SEC should involve itself in a significant program to investigate financial disclosure in a market generally exempt from application of the federal securities laws. The agency’s policy recognized that, as the municipal market grew in importance to a broader segment of investors, “its enormous power—not to mention its popularity—demands that it operate with complete honesty and integrity.”\textsuperscript{39}

The SEC’s investigations in this area have uncovered a variety of unsavory practices, including the failure to disclose practices that could result in the loss of a particular security’s tax-exempt status,\textsuperscript{40} undisclosed financial arrangements involving public officials,\textsuperscript{41} underwriters,\textsuperscript{42} and advisers to municipal issuers,\textsuperscript{43} and undisclosed kickbacks and bribes.\textsuperscript{44} In short, some participants in municipal finance transactions were required to “pay-to-play”; to pay for the award of municipal underwriting or financial advisory business through political contributions or, in some cases, outright bribery of municipal or state officials. Such practices undermine the integrity of the municipal securities markets and call into question the competence and honesty of the public officials and market professionals involved in such payments.


\textsuperscript{38} \textit{See generally} Richard Roberts, Update on Municipal Securities Ethical Initiatives, Remarks to the MSRB Rule G-37 Program (June 1, 1994) (on file with \textit{The Business Lawyer}, University of Maryland School of Law).

\textsuperscript{39} Arthur Levitt, Public Funds and Public Trust at the Dawn of the Twenty-First Century, Remarks Before the Government Finance Officers Association (June 13, 1995) (on file with \textit{The Business Lawyer}, University of Maryland School of Law).


\textsuperscript{44} \textit{First Fidelity}, 61 S.E.C. 40; \textit{Rudi}, 58 S.E.C. 2330.
The securities laws do not specifically address bribery of public officials in connection with a municipal offering. In fact, the federal securities laws expressly exempt municipal securities from the registration provisions of the Securities Act. Similarly, the SEC cannot require municipal issuers to file their official statements with the Commission. Nevertheless, municipal securities are subject to the anti-fraud provisions of the Exchange Act. Simply put, whether selling equity securities that are registered, or municipal debt that is not, one may not make false statements or omit material information that would make the disclosure misleading.

Not surprisingly, some members of the bar and various municipal government officials have criticized the SEC’s actions. They argue the SEC lacks jurisdiction because Congress exempted municipal securities from federal registration requirements, and the agency is using the securities laws as a backdoor means to clean up municipal corruption, an issue best handled by local officials. Some critics argue that because pay-to-play does not affect the creditworthiness of municipal securities, the information is not material to investors and carries no disclosure requirements.

45. In April 1994, however, the Municipal Securities Rulemaking Board’s (MSRB’s) rule G-37 became effective. MUNICIPAL SECURITIES RULEMAKING BOARD MANUAL, Rules of the Municipal Securities Rulemaking Board ¶ 3681 (1996). Under this rule, a broker-dealer who makes political contributions to an issuer/client is barred from doing negotiated business with that client for two years afterward. Id. The MSRB proposed the rule to address pay-to-play practices.


47. Indeed, Section 15B of the Exchange Act expressly limited the Commission’s and the MSRB’s ability to establish municipal issuer disclosure requirements. Section 15B(d)(1) of the Exchange Act prohibits the Commission and the MSRB from requiring municipal securities issuers, either directly or indirectly, to file any application, report, or document with the Commission or the MSRB prior to any sale by the issuer. . . . Section 15B(d)(2) of the Exchange Act prohibits the MSRB, either directly or indirectly, from requiring issuers to furnish investors or the MSRB with any “report, document, or information” not generally available from a source other than the issuer. . . . These sections are collectively known as the “Tower Amendment.”


50. Id.

51. The standard applied in determining materiality of an omitted fact is whether there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." Basic Inc. v. Levinson, 485 U.S. 224, 231-32 (1988) (quoting TSC Indus., Inc. v. Northway Inc., 426 U.S. 438, 449 (1976)).
obligation.\(^5\)

Whatever exemptions from registration or filing may apply to municipal securities, no one seriously doubts the antifraud provisions apply to municipal securities.\(^5\) Clearly, pay-to-play arrangements may be material to investors. In the equity markets, investors likely view the integrity and competence of management as material to investment decision-making.\(^5\) Investors in the municipal market could reasonably view the integrity of the decisions made by public officials to award municipal finance business to be material to their investment decisions as well. Similarly, market professionals—underwriters, advisers, and lawyers—presumably obtain their municipal finance business because of expertise and honest competition, not campaign contributions or bribes. Pay-to-play arrangements "may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering," and accordingly must be disclosed.\(^5\)

Bribery, *quid pro quo* arrangements, political contributions, or other gratuities that affect the selection of underwriters and financial advisers, go to the heart of the municipal market's integrity. These practices may have serious implications for the overall health of public finance. The broad provisions of the anti-fraud rules have provided the SEC with a vehicle with which it can address abuses in the municipal securities market and protect investors, without a need for additional legislation.

**INSIDER TRADING**

Following the highly sensational cases of the 1980s, no issue has been as popularly identified with the SEC's enforcement program as insider trading.\(^5\) Over the past ten years or so, the SEC has brought over 386


55. Interpretive Release, supra note 48, at 12,751.

56. The success of Oliver Stone's movie, *Wall Street*, and Tom Wolfe's popular novel *Bonfire of the Vanities*, in the late 1980s were among the more visible indication of the extent to which insider trading had captured the fascination of the public at large. Insider trading story lines
insider trading cases, including those notorious cases of the 1980s against Ivan Boesky, Michael Milken, Dennis Levine, Martin Siegel, and others.57 The statutes, rules, and regulations that make up the federal securities laws do not include a reference to "insider trading."58 Even though it is not specifically mentioned in the text of the statutes, insider trading, pure and simple, is cheating. The Commission has long taken the position that insider trading is securities fraud and is prohibited by the general anti-fraud provisions of the securities laws.59

The early insider trading prosecutions were "traditional" cases, situations where an insider of a company, such as an officer or director, bought or sold his company's stock while in possession of material, nonpublic information.60 Such corporate insiders owe a fiduciary duty to their shareholders, either to disclose the information or abstain from trading with their shareholders.61 The failure to abstain or disclose constitutes a fraud on those shareholders.62

In the midst of the increased takeover activity during the 1970s, the limitations of the classic theory of insider trading became apparent. Persons other than corporate insiders began, often by deceitful and improper means, to take advantage of material nonpublic information by buying stock in companies that were the targets of takeovers. These traders owed no duty to the shareholders of the company whose stock they purchased. As a result, an "outsider" technically did not breach a duty to the shareholders of the target company. Traditional insider trading analysis did not proscribe such trading.63

To combat the increasing prevalence of that type of fraudulent trading, the SEC and criminal prosecutors began to argue the "misappropriation followed in the daily TV "soap operas" and played a part in other Hollywood movies such as The Secaucus Seven, James Stewart's Den of Thieves, depicting the worst of the 1980s insider trading cases, became a best-seller.


60. The SEC first addressed the issue of insider trading in In re Cady, Roberts & Co., 40 S.E.C. 907 (Nov. 8, 1961).

61. Id.

62. Id. at 911.

theory” of insider trading. The misappropriation theory posits that a person commits securities fraud when he or she deceitfully uses information, entrusted to him or her in confidence, to trade in securities. Under this theory, the fraud is perpetrated on the rightful owner of the information. Most courts considering the issue have approved the misappropriation theory. For example, in SEC v. Materia, Anthony Materia, who was employed by a printing firm that provided services to various bidders in connection with potential tender offers, misused the information he obtained as a result of his position by purchasing stock of the target corporation prior to any public disclosure of the tender offer. Affirming Materia’s conviction for insider trading under the misappropriation theory, the Second Circuit stated:

[determined to combat fraud in the securities marketplace, Congress chose to enact a comprehensive yet open-ended statutory scheme, capable of ongoing adaptation and refinement. In recent years, developments in capital formation and novel means of effecting corporate combinations have spawned a new genre of confidential information . . . . We do not believe the drafters of the Securities Exchange Act of 1934—envisaging as they did an open and honest market—would have countenanced the activities engaged in by Anthony Materia.

Commentators have expressed concern over the SEC’s broad approach to insider trading analysis. They argue insider trading under the mis-

64. There were signs that judicial approval of this approach seemed likely. For example, in Chiarella, the three dissenting justices expressed approval for such a theory. See Chiarella, 445 U.S. at 240, 245. Actually, the term “misappropriation” is a misnomer in that misappropriation cases usually involve persons who lawfully possess the confidential information, but misuse the information entrusted to them by making securities trades prior to any public disclosure of the information.


66. To date the Second, Seventh and Ninth Circuit Courts of Appeal have adopted the misappropriation theory. The misappropriation theory was first adopted by the Second Circuit in Newman. Id. at 17 (finding the defendants’ theft of information from their employers “defrauded those employers as surely as if they took their money”). The Ninth Circuit adopted the theory in SEC v. Clark, 915 F.2d 439, 449 (9th Cir. 1990) (“the misappropriation theory fits comfortably within the meaning of ‘fraud’ in § 10(b) and Rule 10b-5”), and the Seventh Circuit in SEC v. Cherif, 933 F.2d 403, 410 n.5 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992) (“There is little question that the vague term ‘fraud’ as used in Section 10(b) and Rule 10b-5 can encompass the misappropriation theory.”).


68. Id. at 203.

appropriation theory is so vague it is impossible to determine in advance when trading is lawful and when it is not.\footnote{70} In fact, on several occasions there have been efforts to craft legislation to "define" insider trading, but none have been successful.\footnote{71}

The Fourth Circuit's recent decision in \textit{United States v. Bryan},\footnote{72} rejecting the misappropriation theory, reflects some of the criticisms of the theory. Bryan, the director of the West Virginia Lottery (WVL), among other things, bought securities while in possession of nonpublic information which he obtained as lottery director. Bryan knew WVL would award lucrative contracts to certain companies, and he bought shares of stock in those companies prior to the public announcement of the contract awards. A jury convicted Bryan of two counts of mail fraud, one count of perjury, and one count of both wire fraud and securities fraud arising from his securities trades. On appeal, the Fourth Circuit affirmed Bryan's criminal conviction, but reversed the sole securities fraud count, ruling the lower court had erred in submitting the "misappropriation theory" to the jury.\footnote{73}

The court based its decision on two premises. According to the court, section 10(b) and Rule 10b-5 require the use of deception in the form of material misrepresentations or omissions.\footnote{74} Under the misappropriation theory, the court reasoned, simple breaches of fiduciary duty and similar relationships of trust and confidence, regardless of whether the breaches entailed deception, would be held to violate the statute and rule.\footnote{75} The court found this conclusion inconsistent with the U.S. Supreme Court's decision in \textit{Santa Fe Industries v. Green},\footnote{76} holding that a mere breach of a fiduciary duty, without deception, does not violate the anti-fraud provisions of the securities laws.\footnote{77}

\footnote{70. See Abramowitz, \textit{Lost Opportunity}, supra note 69.}
\footnote{71. From time to time there have been calls for a legislative effort to define insider trading beyond the analyses developed by the courts. See Abramowitz, \textit{Lost Opportunity}, supra note 69; John Sturc, \textit{Where Insiders Trade, Law Treads Uncertainly}, \textit{Texas Lawyer}, Aug. 13, 1990, at 33; Elkan Abramowitz, \textit{Define or Abstain, The Congressional Gap in Insider Trading}, N.Y. L.J., July 3, 1990, at 3; Harvey Pitt & Karl Groskaufmanis, \textit{Second Circuit's Recent Insider Trading Decision Invites Legislative Fix}, \textit{Legal Times}, May 21, 1990, at 9. While the SEC had historically taken the position that a codified definition of insider trading was unnecessary and indeed, counterproductive, two proposals offering definitions of insider trading were submitted to Congress in 1987, one supported by then SEC Chairman David Ruder. No legislative efforts in this area have been successful, however, and the Commission did not press the Ruder position after he left office.}
\footnote{72. 58 F.3d 933 (4th Cir. 1995).}
\footnote{73. \textit{Id.} at 944.}
\footnote{74. \textit{Id.} at 946-47.}
\footnote{75. \textit{Id.} at 949.}
\footnote{76. \textit{Id.} (citing \textit{Santa Fe Indus. Inc. v. Green}, 430 U.S. 462, 473 (1977)).}
\footnote{77. \textit{Id.} at 946-47 (citing \textit{Santa Fe Indus.}, 430 U.S. at 472). The \textit{Bryan} court stated that the Second Circuit must have been "unaware of the existence of the Supreme Court's decision in \textit{Santa Fe Industries}" when it first adopted the misappropriation theory in 1981. \textit{Id.} at 955. It is improbable that the Second Circuit overlooked \textit{Santa Fe Industries} because it reversed a
In fact, deceit is inherent in cases of misappropriation because a fiduciary is not going to disclose to his beneficiary that he is improperly using confidential information to make a profit. In *Newman*, the Second Circuit expressly characterized the misuse of information entrusted in confidence as a "deceptive practice[...]." The *Newman* court observed that "deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful." Indeed, the *Bryan* court's rationale that misappropriation does not involve deceit seems inconsistent with its holding that this very same conduct *was* fraud under the wire fraud statute. It seems equally inconsistent with the U.S. Supreme Court's holding in *Carpenter v. United States* that the deceitful misappropriation of information for use in securities transactions is fraud under the mail and wire fraud statutes.

In its second premise for rejecting the misappropriation theory, the *Bryan* court opined that Bryan's fraud was not "in connection with the purchase or sale of securities," a jurisdictional requirement under section 10(b) and Rule 10b-5. Under the court's reasoning, only the breach of a duty to a purchaser or seller of securities, other investors, or persons with a similar stake in an actual or proposed securities transactions can give rise to liability. Otherwise, in the court's view, the statutory requirement that the fraud be "in connection with the purchase or sale of securities" would be rendered meaningless.

The court's reading of the "in connection with" requirement seems unduly restrictive. The U.S. Supreme Court has held in other cases the fraud must only "touch" the purchase or sale of securities to meet the "in connection with" requirement. In *Bryan*, the misappropriation clearly "touched" the purchase of securities; the fraud was perpetrated through the purchase of securities. To Bryan, as to others who traded stock with misappropriated information, the information "had no value whatsoever except 'in connection' with his subsequent purchase of securities."

While the outer limits of the "in connection with" requirement are

Second Circuit decision. It is equally improbable that the Second Circuit continued to overlook *Santa Fe Industries* in subsequent cases approving the misappropriation theory, that every other court of appeals to consider the issue and approve of the misappropriation theory has overlooked the case, or that the four Justices who expressed approval of the theory in *Chiarella* and *Carpenter* were unaware of it.

79. Id.
80. Bryan, 58 F.3d at 943.
82. Id. at 25-28.
83. Bryan, 58 F.3d at 959.
84. Id. at 946.
86. SEC v. Materia, 745 F.2d 197, 203 (2d Cir. 1984).
unclear, there is little precedent for such a narrow standard. Other U.S. Supreme Court cases discussing section 10(b), such as Chiarella, Dirks v. SEC,\textsuperscript{87} and Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.,\textsuperscript{88} admittedly involved frauds against purchasers and sellers of securities. The Court, however, never limited section 10(b) to such frauds.\textsuperscript{89}

The Bryan court noted several policy reasons that supported the rejection of the misappropriation theory.\textsuperscript{90} According to the court, the uncertainty in the "law governing fraudulent securities transactions through adoption of the misappropriation theory" counseled rejection of the theory.\textsuperscript{91} The court specifically complained that "[a]bsent clearly defined rules, investors find themselves the targets of \textit{ad hoc} decisionmaking or pawns in an overall litigation strategy known only to the SEC."\textsuperscript{92}

In our view, the Fourth Circuit's literal approach to insider trading and its rejection of the misappropriation theory are both misguided. The misappropriation theory does not extend the scope of section 10(b) and Rule 10b-5 beyond what Congress intended, and does not leave market participants "uncertain" about which trading is lawful and which is not. Insider trading is about cheating; cheating a shareholder, an employer, a client, or even a friend. In each instance, however, the cheating implicates the federal securities laws because the person uses the stolen or misappropriated confidential information to purchase or sell securities. Indeed, one of the purposes of Bryan's scheme, for which he was convicted of wire fraud, was to profit from buying the stock before the public announcement of the contract awards. The misappropriation theory represents, once again, a

\textsuperscript{87} 463 U.S. 646 (1983).
\textsuperscript{88} 114 S. Ct. 1439 (1994).
\textsuperscript{89} The Bryan court adopted a standard so narrow that virtually no case could be brought employing the misappropriation theory. Yet, in many if not most of those cases, the person who was defrauded has a very strong interest in the defendant's purchase. Commonly, for example, the defrauded person in a misappropriation case is a company that is planning to bid for or otherwise acquire the securities of another company. The bidder obviously has a strong stake in secret securities transactions by persons who have misappropriated its plans. Such purchases are likely to drive up the price of the company's securities, making the bidder's acquisition of those securities more expensive.
\textsuperscript{91} Bryan, 58 F.3d at 951.
\textsuperscript{92} Id.
direct and common sense application of broad legal principles to the wrongful and deceitful conduct, which has evolved with the growth of the market and the opportunities for insider trading. The decision by the Fourth Circuit in *Bryan* is contrary to what has been a broadly accepted common sense analysis of the facts and the law. As our securities marketplace evolves, so too, it seems, should our willingness to read and apply the law with a greater measure of practicality.

**CONCLUSION**

*Common Sense* contains prescriptions to make government more responsible, more accountable, and more practical. The SEC, like virtually all institutions, both public and private, is not immune from the tendency of organizations to stagnate over time. Government institutions, in particular, need to guard against the stagnation born of mindless recitation of rules. In many respects, the SEC has shown itself adept at responding to changes in the capital markets and reacting to conduct that is fraudulent and inimical to investor protection. Whether or not one agrees with the agency's position on a particular issue, the SEC has generally kept in close step with market developments and has adapted well to market challenges. This institutional adaptability may be attributable to the traditionally high caliber of its staff, to the fundamentally dynamic nature of the marketplace, and the business of market oversight, or some combination of these. The SEC has often demonstrated an institutional responsiveness to the real world that is unusual among government institutions.

Specifically, in reviewing the agency's enforcement program over the past few decades, the controversy surrounding much of the SEC's agenda has centered on exactly the type of government behavior that Howard has held up to be laudable. The apparent anomaly of a direct correlation between criticism of government action and a government agency's creativity should not be surprising. Those whose behavior is challenged cry foul, and the lawyers who represent them argue that even offensive conduct which is not expressly prohibited, must be permitted.

Somewhere between a literal approach to enforcing the law, and the obvious unfairness that would accompany the wholesale retroactive application of newly announced standards, is a reasoned middle ground. To judge the effectiveness, fairness, and propriety of the SEC's efforts, we should look at the gravity of the conduct being challenged, the legal basis

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93. A recent article in *Financial World* described the SEC as an agency that is one of the "models for efficiency in some areas." Katherine Barrett & Richard Greene, *The Big Vision Meets the Real World*, FIN. WORLD, Oct. 26, 1993, at 32, 33. The article analyzed the management of eight agencies that are of particular interest to business. While the average grade was a C+, the authors rated the SEC the highest grade of the group, an A−: "The [SEC] defies all stereotypes. Members of the securities industry, academics, even attorneys who are suing the SEC speak about it in glowing terms." *Id.* at 49.
for the approach taken by the Commission, and the relationship of the two to the achievement of the agency’s overall mission—the protection of investors and the integrity of the capital market. In each of the areas previously discussed, as facts concerning how seriously the misconduct affected investors and market integrity became public, the defensibility of the behavior, and even some of the criticism of the agency’s approach, seems to have eroded. This may be evidence of a level of “common sense” that substantially eclipses what Howard observes in most government institutions. Howard argues: “The sunlight of common sense shines . . . whenever principles control: What is right and reasonable, not the parsing of legal language, dominates the discussion.”94 We could not have said it better ourselves.

94. Howard, Common Sense, supra note 1, at 177.