

Symposium: Current Issues in Securities Regulation

Foreword

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The authors of these articles, with the assistance of the Law Journal staff, have produced a superb, penetrating symposium covering vast portions of the almost-unlimited terrain of securities regulation, which is a subset of the law of business associations. Two students, Ms. Keller and Mr. Gehlmann start at the beginning, the Securities Act of 1933 and the Securities Exchange Act of 1934 and the story behind the enactment of those landmark statutes. The political side is correctly emphasized, for the Roosevelt Administration clearly focused upon fairness and public trust and confidence in the securities markets rather than upon narrow, but sophisticated economic theory and analysis. The focus upon the political side of political economy rather than upon limited, formal economics set the stage for the debate, which publicly surfaced around thirty years ago, between libertarian analyses and approaches that focus upon fairness. Ms. Keller and Mr. Gehlmann also note that the limited federal regulation, which is primarily disclosure-oriented, was created to work with a long-standing system of state regulation of internal affairs of corporations and of state blue sky statutes; Congress intended very little displacement of state law. This congressional decision to work with, rather than supersede, state law has forced the Securities and Exchange Commission to concentrate on improving disclosure rather than regulation of substantive issues—a restriction that, in my opinion, has proven salutary. The SEC's mission in developing uniform minimum national levels of disclosure is vital and can be performed only at the national level. The other and additional fiduciary duties of corporate promoters and insiders and the substantive law of corporate contract and property rights are, I submit, properly best developed by case-by-case evaluation under the various state statutes and court decisions.

The Insider Trading Articles

The three insider trading articles nicely illustrate my points. Commissioner Cox, a member of the United States Securities and Exchange Commission, and his Counsel, Mr. Fogarty, discuss the bases of insider trading law. They address economic considerations and "fairness" considerations in separate captions, a division of thinking that is puzzling to a lawyer, who is likely to think that courts and legislators will consider both questions as a part of the same inquiry of governance and wisdom. If, for example, present insider trading rules do result in faster public disclosure of inside information (and lawyers commonly urge insiders to trade only when all inside information has been disclosed and aid insiders in getting the

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information out), there would appear to be a benefit both to the efficiency of the markets and to a general perception of fairness. In short, what is perceived as fair may also be efficient or cause efficient results. As an example, the takeover movement is based, in part, upon an assumption that a potential target's public disclosures are largely accurate, for bids of billions of dollars in amount are based, in substantial part, on such public disclosures.

Although I disagree with Commissioner Cox's and Mr. Fogarty's perceived conflict between fairness and economic analysis, I find their analysis quite cogent. They note pitfalls in the pending insider trading bills, and they demonstrate the delicate balancing that is needed to keep insider trading sanctions "fair." They are on sound ground in criticizing proposed tests of uncertain application and of unclear scope. Since treble damages under the Exchange Act and (possibly) also treble damages under RICO are at stake, brave new departures of misty substance are not needed. In my opinion, the case-by-case adjudications by the United States Supreme Court are much to be preferred, for the Court can more carefully weigh its moves and make mid-course corrections, if needed. Commissioner Cox's and Mr. Fogarty's article illustrates just how impossible it is to define, with proper balance and discretion, all kinds of insider trading wrongs in a statute. Though Commissioner Cox and Mr. Fogarty take no position on the issue, I think the conclusion to be drawn from their subtle analysis is that legislative efforts should be killed. The types of problems they so skillfully posit and parse can be prudently decided only with the fine focus of case-by-case adjudication.

Professor Aldave's article, "The Misappropriation Theory: *Carpenter* and Its Aftermath," fits beautifully just after Commissioner Cox's and Mr. Fogarty's economic/policymaker analysis, for Aldave analyzes the current bills and court decisions of the United States Supreme Court with a law professor's sharp, detailed legal skill. She demonstrates that *Carpenter v. United States*¹ gives the government great power to curb illegal insider trading through the pantoscopic "property" theory adopted for the mail and wire fraud issue. She speaks of criminalization of insider trading, but I think the government will often use its criminal powers to force an overall civil/criminal settlement including monetary payments under the Exchange Act. In addition, as Aldave notes, *Carpenter* may vastly expand civil remedies under state and federal RICO statutes. Professor Aldave's article also uses fine-tuned technical analysis to show the lack of need for corrective legislation, the uncertainties that would be introduced by pending bills, and the advisability of leaving the issues to the courts.

Professor Ash's article, "State Regulation of Insider Trading—A Timely Resurgence?" convincingly argues for the expansion of state-law derivative actions to recapture profits by insiders who trade on material nonpublic inside information. This argument logically follows from the preceding material in the symposium. If, as is the fact, much of the law of insiders' fiduciary duty is state law and if the primary enforcement of fiduciary duties is by shareholders' derivative actions (again a fact),

1. 108 S. Ct. 316 (1987).

it logically follows that state law should allow corporate recovery of profits from wrongful insider trading. Professor Ash imaginatively ties her arguments to the disclosure demands imposed by Delaware courts in corporate amalgamations (demands that, in my opinion, exceed those under federal law) and to the overriding significance of state property, contract, and fiduciary duty law in corporate governance and operations. In developing this analysis, Ash is at variance with Commissioner Cox's and Mr. Fogarty's conclusion that the issuing corporation is not significantly harmed when its insiders wrongfully trade on undisclosed, material corporate information. She has, I think, the better of the argument, for the injury to the corporation is quite real, as evidenced by all the educational work that corporate lawyers devote to preventing such trading. She also shows that, under current United States Supreme Court decisions, federal insider trading liabilities often derive from state-law fiduciary duties; and thus, state courts should certainly recognize state-law remedies. In my opinion, she is totally correct. In the huge or notorious case, the SEC will exact appropriate sanctions. In many other cases (which will be more numerous), if corrective action is taken at all, it will be through a shareholders' derivative action under a state-law theory. To repeat my general thesis, the law of fiduciary duty is primarily state law.

Exemptions Under the Securities Act of 1933

The registration exemptions under the 1933 Act raise perplexing policy and interpretational issues. If an issuer is filing public reports under the 1934 Act, why shouldn't the issuer be free to sell new securities without registration and without restrictions on transfer? After all, one can usually do so under state blue sky laws where the issuer is listed on a stock exchange. Going further, why restrict transfer, for two or three years, of securities issued in an exempt transaction if at the end of that period the holder can publicly sell? There are answers. Without a holding period for exemptions, who would register? Moreover, any securities lawyer knows that 1933 Act documents are in fact prepared much more carefully than filings under the 1934 Act. But then a new question arises. What about affiliates? Should they be treated the same as the issuer? We answer this by saying "yes, in part." Students are driven wild by these issues and by the answers that only partially satisfy. The bottom line, of course, is that share transfer restrictions under the 1933 Act result from the requirements of the exemptions and cause a considerable discount in the purchase price paid by an investor taking in an exemption, for his or her property is partially or almost-wholly inalienable.

Happily, the three authors writing in this segment of the symposium probe both the technical and the policy issues with deep understanding and perception.

Professor Hicks' article, "The Concept of Transaction as a Restraint on Resale Limitations," goes to the legal roots of resale limitations and their effects upon affiliates and nonaffiliates. He analyzes the history of the application and misapplication of the core concept—the transaction—skillfully demonstrating that everything rides upon the proper conceptualization of this statutory term. He then turns to the proper pragmatic balancing between free transferability and investor protection that

Congress and the SEC should consider. His highly useful proposals for change would clarify and reduce the restrictions upon nonaffiliates under the 1933 Act and shift greater emphasis upon distributions by such persons to the 1934 Act.

Professor Steinberg's and Mr. Kempler's article, "The Application and Effectiveness of SEC Rule 144," is a work of great depth and worth. Rule 144 is the linchpin of the exemptive framework. The rule's forbidding provisions are provocatively and clearly examined and explained. Background, operation, and implicit policy judgments are lucidly examined. The authors make numerous suggestions for improvement of investor protection and, at the same time, for discarding what they find an inappropriate restriction on resale. In arguing for proposals moving in opposite directions, the authors raise and develop provocative policy points about a technical, all-important rule.

Mr. Schneider, one of the nation's outstanding securities lawyers and a productive contributor to the literature and to administrative reform and progress, explores the mysteries, folkways, and byways of the section "4(1-1/2)" exemption of the 1933 Act—the misty world in which holders of control or restricted securities resell without reliance upon a definite statutory or administrative exemption. In this area, securities lawyers have bootstrapped themselves and created the "law" as transactions arise—the King's subjects have improvised and acted upon their own rules of thumb. Mr. Schneider concisely and judiciously guides the reader along the hidden trails and oral tradition. At the same time, he warns readers of dangers and uncertainties. Interestingly, he concludes that formal administrative intervention to provide certainty through safe harbors would be counterproductive, for the existing creativity of the private bar would be stifled. A controversial thesis, but one supported here by a master of the trade with the best analysis possible. I will leave it to the reader to decide. Mr. Schneider performs an invaluable service by putting the cards on the table in such good order.

Management Buyouts and Leveraged Recapitalizations

Professor DeMott incisively analyzes issues concerning directors' duties in management buyouts and leveraged recapitalizations, developments caused in large measure by the boom in hostile tender offers. After exploring the finance (high leveraging), she analyzes the law, which is primarily state law of fiduciary duties, even with reference to disclosure. She proposes a complex set of rather inflexible rules to limit directors' discretion in dealing with the conflicts of interest in management buyouts. Her excellent analysis of the cases leads me to the opposite conclusion. The directors must often deal with fast-breaking competition (especially where, as is often true, a hostile tender offer is also in the picture), and the courts have been quite adept in providing meaningful early scrutiny in injunctive actions—leading me to leave the matter with directors, subject to the excellent court review that is available. My view, of course, reflects a distrust of per se rules where discretion, negotiation, and quick reaction is required. Again, the reader should decide, while noting the insightful discussion of procedural deficiencies that have caused the courts to nullify some attempted management buyouts.

Exclusive Federal Jurisdiction for Implied Rule 10b-5 Actions

Professor Sachs' article, "Exclusive Federal Jurisdiction for Implied Rule 10b-5 Actions: The Emperor Has No Clothes," is a crucial, groundbreaking study of federalism. For years too long to count, the received view has been that since section 27 of the 1934 Act provides for exclusive federal court jurisdiction, *implied* private rights of action under rule 10b-5 must be swept along and can be asserted offensively only in a federal court. Professor Sachs destroys the received view by a close analysis of history and a careful examination of policy and practice. She notes that the fiduciary duties triggering much of rule 10b-5 are state-law fiduciary duties; that there is a general presumption of concurrent jurisdiction; that rule 10b-5 actions are similar to state-law fraud actions, which are preserved by the 1934 Act; that state courts are empowered to hear the similar actions under sections 11 and 12 of the 1933 Act; and that federal courts have invariably chosen state law rather than a federal analogue for determining the limitations period in rule 10b-5 actions. She correctly concludes that *implied* offensive private actions under rule 10b-5 should be permitted in state or federal courts, and that the received wisdom is wrong. This is highly useful, correct audacity, which the courts should eventually accept and which the Congress should promulgate in the absence of such correction by the courts. Again, the ultimate primacy of state law in governing business associations and in securities regulation is demonstrated.

