Homer Kripke

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REPORT

OF THE

SECURITIES AND EXCHANGE COMMISSION

ON

PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934

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tion of section 14 beyond its present limits, the Commission does not urge its adoption. However, since it is advanced by important groups within the securities industry, the Commission does feel obligated to express its belief that the investing public would be benefited by extending to corporations generally the disclosure requirements of the proxy rules. The proposal would undoubtedly give the investing public a greater voice in the management of those corporations which would be brought under these disclosure requirements.

Representatives of the Investment Bankers Association of America and of the National Association of Securities Dealers, Inc., state that, since the proposal concerns primarily the exchanges and corporate issuers, they neither recommend nor oppose it.

M. INSIDERS' TRADING PROFITS

(1) Section 16 (a) of the act requires officers, directors, and 10-percent stockholders of corporations having equity securities registered on national securities exchanges to report their transactions in the equity securities of such corporations. Representatives of the New York Curb Exchange and the New York Stock Exchange propose that section 16 (a) be made applicable not only in the case of corporations having equity securities registered on a national securities exchange, but also in the case of companies which are engaged in interstate commerce or the securities of which enjoy an interstate over-the-counter market. In general, the extension would not apply to companies without securities registered on an exchange which have less than $3,000,000 of assets or fewer than 300 stockholders. Again, because this proposal would somewhat enlarge the area of the application of the act, the Commission's position is similar to that which it has taken with respect to the proposal to extend the proxy section. The Commission recognizes that its adoption would provide an additional important safeguard to the investing public. The position of the Investment Bankers Association of America and of the National Association of Securities Dealers, Inc., is likewise similar to that on section 14.

(2) Section 16 (b) of the act recognizes that profits realized by officers, directors, or 10-percent stockholders from any purchase and sale, or any sale and purchase, of any equity security within a period of 6 months rightfully belong to the corporation and should be recoverable in an action by, or on behalf of, the corporation. Representatives of the securities industry propose that section 16 (b) be repealed. The Commission is unalterably opposed to this suggestion, since it would strip investors of one of their most essential protections.

It has been asserted that the provision operates to deter insiders from making purchases to retard a falling market. But if an insider really wishes to cushion a decline, section 16 (b) does not make it unlawful for him to do so. It is only where the insider makes a profit within the relatively short period of 6 months that his profit is required to be turned over to the corporation. Furthermore, that particular argument for repeal of section 16 (b) presupposes that insiders would act to bolster the market by trading primarily against the trend, buying in weak markets and selling in strong markets. But, even if it be assumed that some corporate officials would so act, the mere fact that the activities of some trustees might be advantageous to their

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Moreover, even if insiders would purchase in order to bolster the market, there is serious doubt whether investors would always be benefited. If the market continued to fall after the insiders had attempted to support the market, their activities would have injured those stockholders who had been induced not to sell and those new investors who had been induced to purchase by the false appearance of stability thus created.

It has been argued that section 16 (b) applies in some instances to profits even though made without the use of inside information. This argument is clearly beside the point. The mere existence of temptation on the part of fiduciaries to abuse their position has traditionally led the courts to bar them from activities in fields where such temptations exist. Thus, where trustees acting in their own interests deal with trust assets, it has long been settled that they will be required to account for any personal profits made regardless of whether in fact they take advantage of their position in the particular transaction and regardless of whether the beneficiaries suffered. Similarly, a corporate officer may not acquire for himself an opportunity which is available to his corporation even though it cannot be demonstrated that the corporation has been damaged by the acquisition. And this is true even where the corporation has not had the financial resources to avail itself of the opportunity. The deterrent of section 16 (b) to in-and-out trading by insiders is thus consistent with the time-honored doctrine that a trustee must avoid any activity which involves even a remote possibility of a conflict of interest between his fiduciary obligations and his personal self-interests. The Commission is convinced that any legislation which sought to distinguish between situations where inside information is actually used and those where it is not used would be self-defeating because of the inherent difficulties of establishing the use of inside information in particular cases.

It may also be urged with much force that even to the extent that section 16 (b) may permit the recovery of profits made without the use of inside information it achieves a highly desirable objective. It is to be doubted whether the interests of security holders are benefited when the attention of their officers and directors is diverted from the corporation's affairs to stock market speculation in its securities.

Representatives of the securities industry couple their proposal to repeal section 16 (b) with a suggestion that section 16 (a) require that insiders, instead of reporting their transactions monthly, do so within 10 days after becoming officers, directors, or 10-percent stockholders. They assert that the publicity provisions of section 16 (a) as thus amended would be adequate to prevent abuses. Although the reporting of transactions may in some cases operate as a deterrent, it cannot be expected to prevent insiders from taking advantage of inside information. The temptations and the potential returns are too great to be effectively overcome merely by subsequent publicity. It was because the Congress did not believe that publicity alone would be sufficient that it defined the standard in section 16 (b)—that insiders, because of their fiduciary relationship, should not trade in-an-out in the securities of their companies for their personal

gain. The consequences of failing to comply with this standard are not penal. The section does not make insiders' trading unlawful; it does not even subject insiders to injunctive proceedings. It simply guards against the use of inside information since such information is not the personal property of the insiders themselves and since any profits resulting from its use belong to the insiders no more than does the inside information itself.

N. LIABILITY FOR FALSE INFORMATION FILED WITH THE COMMISSION

Section 18 (a) of the act deals with civil liabilities for false or misleading statements in documents filed with the Commission. The provision imposes on a plaintiff the burden of proving that the price at which he bought or sold was affected by a particular false or misleading statement. Although a false or misleading statement filed with the Commission is likely to have an effect upon the market price of a security, it would be difficult, if not impossible, to prove in a given case that a particular statement had produced a fluctuation. The section in any event requires a plaintiff to sustain the burden of proof that he relied upon the false or misleading statement and that he was damaged by such reliance. Where a plaintiff has relied upon a false or misleading statement and has been damaged thereby, the Commission believes that it is extremely unfair to require him to prove the totally irrelevant factor that the price was affected by the statement. The Commission, therefore, urges that section 18 (a) be amended by striking out the words "at a price which was affected by such statement." Representatives of the securities industry oppose the suggestion.

O. ENFORCEMENT OF RULES OF NATIONAL SECURITIES EXCHANGES

Section 6 (b) of the act provides that no registration of a national securities exchange shall be granted or remain in force unless its rules make adequate provision for disciplining members for conduct inconsistent with just and equitable principles of trade. Section 19 (b) also authorizes the Commission to alter or supplement rules of exchanges with respect to certain matters where the public interest so requires.

By enacting these provisions, the Congress clearly recognized that the rules of national securities exchanges do not concern their members alone, but that they directly affect the interests and safety of the investing public. Accordingly, the Congress charged the Commission with the duty of requiring that the rules of exchanges meet standards appropriate for institutions affected with a public interest. Nevertheless, there appears to be a loophole in the section. Nowhere is it made clear that the Commission has authority to require exchanges to enforce these rules. Thus, by adopting rules without doing anything to carry them out, an exchange may pay mere lip service to the congressional mandate. This leaves the Commission in the anomalous position of having responsibility under the statute with respect to certain exchange rules without any clear power to see to it that they do not become dead letters. The Commission, therefore, recommends that section 19 (a) (1) be amended to authorize the suspension or

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