**Seminar on Current Developments in Monetary and Financial Law**
**Washington, D.C., October 23-27, 2006**



PRESENTATION AT IMF SEMINAR
CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW
LAW AND FINANCIAL STABILITY

# ACHIEVING FINANCIAL STABILITY THROUGH DISCLOSURE

OCTOBER 25, 2006
ROBERTA S. KARMEL[1]

## I. Introduction

Effective securities regulation contributes to financial stability because it establishes a sound environment for capital formation. It fosters the efficient allocation of resources within an economy, without the need for government direction of those resources. In the United States, the federal securities laws are predicated on the theory that full disclosure by companies will cause the public securities markets to efficiently price securities, and this pricing mechanism will then foster the efficient allocation of resources among businesses competing for capital. Such efficient pricing should reduce speculation and undue price volatility. In order for full disclosure to be an effective basis for regulation, however, the disclosure must be free from fraud.

I will first discuss the objectives of securities regulation, then the choice of regulatory strategies that governments can make, and then the full disclosure system of the U.S. federal

[1] Centennial Professor, Chairman of the Steering Committee, and Co-Director, Center for the Study of International Business Law at Brooklyn Law School. The assistance of William Leahey, Brooklyn Law School student, is gratefully acknowledged.

securities laws. In this discussion I will outline the reforms to the disclosure system since the bursting of the technology bubble in 2000-2001. These reforms have been accomplished by the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"),[2] rulemaking by the Securities and Exchange Commission ("SEC") and the courts.

[2] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified in scattered sections of 11, 15, 18, 28 and 29 U.S.C.); *see* the author's interpretation of the background for this statute in Roberta S. Karmel, *Realizing the Dream of William O. Douglas–The Securities and Exchange Commission Takes Charge of Corporate Governance,* 30 Del. J. Corp. L. 79 (2005) [hereinafter *Realizing the Dream*].

## II. Objectives of Securities Regulation

### A. Capital formation

The United States, the United Kingdom and some other countries utilize the securities markets as a primary mechanism for capital formation.[3] By contrast, Germany, Japan and some other countries depend upon banks and internally generated profits for capital.[4] Such different systems of corporate finance have led to different corporate structures as well as different regulatory systems. In countries where the stock market provides the basis for capital formation, investor confidence is of great importance, and a primary purpose of securities regulation is to foster such confidence. In recent years many academics have attacked the proscriptive nature of securities regulation and argued for more market-based systems of regulation, but none of these alternative theories have displaced the idea that successful securities regulation must be based on investor trust in the markets.[5] Indeed, after the stock market scandals of 2001-2002, the United States Congress reacted to a perceived loss of investor confidence in the public securities markets by passing the highly regulatory Sarbanes-Oxley law.

According to the International Organization of Securities Commissions ("IOSCO"), the three core objectives of securities regulation are: protection of investors; ensuring that markets are fair, efficient and transparent; and the reduction of systemic risk.[6] The overarching purpose of securities regulation is investor protection. This is because investors entrust their capital to the management of professionals, and they are vulnerable to misconduct by intermediaries. Even

---

[3] *See* Lawrence A. Cunningham, *Commonalities and Prescriptions in the Vertical Dimension of Global Corporate Governance,* 84 CORNELL L. REV.1133, 1136-48 (1999) [hereinafter *Commonalities and Perceptions*]. In some transitional economies this has also been true. *See* J. Robert Brown, Jr., *Of Brokers, Banks and the Case for Regulatory Intervention in Russian Securities Markets,* 32 STAN. J. INT'L L. REV. 185 (1996).

[4] *See Commonalities and Perceptions, supra* note 3 at 1139-43 (explaining the bank/labor model).

[5] *See* Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals For Its Future,* 51 DUKE L. J. 1397, 1500-02 (2002).

[6] International Organization of Securities Commissions, Objectives and Principles of Securities Regulation (Sept. 1998).

supposedly sophisticated investors are not always able to comprehend the complex nature of securities transactions and can be the victims of overreaching by public companies and securities industry intermediaries. Although much of securities regulation today is by government agencies, most jurisdictions also rely on self-regulation to some extent.

B. Disclosure Regulation and Corporate Governance Standards

Although some systems of securities regulation depend upon merit regulation to a greater or lesser degree, the United States has a disclosure-based system. Disclosure is a keystone of most other securities regulatory systems as well. In the United States, the securities laws generally regulate disclosure by public companies, both when such companies engage in capital raising transactions and on an annual and periodic basis, and the fiduciary obligations of corporate officers and directors is generally covered by state corporation law. Even in jurisdictions where there is not a similar federal legal system, there generally is a separation between securities regulation and corporate law. In the European Union, for example, securities laws directives are covered by the Financial Services Action Plan and the Lamfalussy process, whereas corporate law is covered by the Corporate Law Action Plan.[7]

Stock exchange listing requirements have acted as a bridge between these two disciplines in the United States and also in other countries.[8] Many of the shareholder protections now embodied in the Securities Exchange Act of 1934 ("Exchange Act"), such as the need to provide shareholders with annual financial reports and to hold annual meetings, originated in listing standards of the NYSE.[9] Sarbanes-Oxley specifically required stock exchanges to impose corporate governance standards on listed companies with regard to director independence and

[7] *See* Roberta S. Karmel, *Reform of Public Company Disclosure in Europe,* 26 U. PA. J. INT'L ECON. L. 379 (2005).
[8] *See* Special Study Group on Federal Regulation of Securities, American Bar Association, Section of Business Law, *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 BUS. LAW 1487 (2002).
[9] *Id.* at 1496-1500.

committee structure.[10] In jurisdictions where offerings are conducted over a stock exchange, the exchanges traditionally judged whether an issuer was fit to go public and, in addition, vetted prospectuses used in the offering process. Further, exchanges sometimes demanded changes in a company's board before a public offering could occur, or other merit based or corporate governance changes in a company's structure.

In regulating broker-dealers, the SEC, like other financial regulators, has adopted capital adequacy rules, but unlike bank regulators, for example, it does not believe its mission is to prevent financial failures, but rather, only to protect customers who have property on deposit with broker-dealers. Accordingly, the SEC has utilized disclosure, as well as substantive capital adequacy regulation, to protect broker-dealers customers in connection with safeguarding customer funds and securities.

## III. Choices of regulatory strategies

### A. Command and Control Regulation by Government

An increasing amount of securities regulation operates by way of command and control regulation imposed by securities regulatory agencies. The entire panoply of national market system regulation by the SEC and the Financial Service Action Plan initiatives by the EU are examples of this type of regulation. Another example of command and control regulation is capital adequacy requirements for financial institutions, although the trend is toward risk assessment requirements rather than arbitrary ratios of obligations to capital. Where consolidated regulation has been put in place, such as in the United Kingdom, regulation is imposed by an agency which, for all practical purposes, operates as a monopoly. In other countries, such as the United States, where functional regulation and federal-state regulation prevail, there is a certain

[10] *See Realizing the Dream, supra* note 2, at 121-23.

amount of competition between regulators. Some have argued that such regulatory competition is healthy; others are more skeptical.[11]

Although there have been some deregulatory initiatives with respect to securities exchange regulation,[12] the world wide trend seems to be to impose an increasing amount of complex rules that are being developed and imposed upon market participants. Although disclosure frequently has been a substitute for regulation in the past, proscriptive rules have in many areas replaced disclosure.[13] Similarly, competition is not frequently utilized as a substitute for government regulation.

Since the bursting of the technology bubble, regulations by government agencies and self-regulatory organizations ("SROs") covering the securities markets and regulated entities in those markets have been proliferating. This outbreak of regulatory fervor has been justified as

---

[11] U. S. Gen. Accounting Office, Securities Markets: Competition and Multiple Regulators Heighten Concerns about Self-Regulation, GAO-02-263, May 3, 2003 (discussing regulatory inefficiencies resulting from broker-dealer membership in multiple SROs, and conflicts that SROs face in their dual roles as market operators and regulators); Securities Industry Association, Reinventing Self-Regulation pt. III.D.2 (2000) (recognizing a need to minimize duplicative and inconsistent regulations, and reduce regulatory competition among SROs) available at http://www.sia.com/market_structure/html/siawhitepaperfinal.htm ; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. 2359 (1998) (proposing the extension of competition among states for corporate charters to two of the three principal components of federal securities regulation); Paul G. Mahoney, The Exchange as Regulator, 83 Va. L. Rev. 1453 (1997) (arguing that a system of competing regulators furthers investor welfare).

[12] *See e.g.* Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000) (amendments in scattered sections of 7 U.S.C.).

[13] *See* Sarbanes-Oxley § 301, 116 Stat. 745 (codified at 15 U.S.C. § 78j-1 (Supp. II 2002)) (requiring an audit committee comprised solely of independent directors); Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Release No. 8,124, 17 C.F.R. Pts. 228, 229, 232, 240, 249, 270 and 274 (August 29, 2002); NYSE Corporate Governance Rule Proposals as Approved by the NYSE Board of Directors August 1, 2002 *available at* http://www.nyse.com/pdfs/corp_gov_pro_b.pdf . *Compare* to European corporate governance codes which lay down rules or recommendations that are not of mandatory application, but companies must either comply with them or explain publicly why they are not complying with some of their provisions. EUROPEAN CORPORATE GOVERNANCE FORUM, STATEMENT OF THE EUROPEAN CORPORATE GOVERNANCE FORUM ON THE COMPLY-OR-EXPLAIN PRINCIPLE (2005) *available at* http://europa.eu.int/comm/internal_market/company/docs/ecgforum/ecgf-comply-explain_en.pdf .

needed to correct the abuses of the late 1990s stock market bubbles, but it may also be the result of competing regulators trying to outdo one another in cracking down on malefactors.[14]

B. Recourse to Courts or Arbitration

After the fact regulatory standards frequently are imposed by way of securities litigation, at least in the United States. Such adjudications establish norms for future conduct. This litigation can be instituted by the SEC or private parties, and the standards developed tend to be more flexible than rules. In the United States and elsewhere there is also a considerable amount of arbitration between customers and securities firms and between securities firms or members of infrastructure institutions. Since arbitrators are not required to adhere to precedent, this type of adjudication leads to standards that are less clear than SEC or judicial opinions.

C. Competition

Competition is a recognized alternative to government regulation, and was utilized in the 1970s to eliminate rate regulation in securities regulation and other regulatory areas.[15] The SEC is required to take competition into account in determining market structure issues, [16] and clearing agent issues, [17] but generally opts for regulation rather than competition.[18] In many jurisdictions, there is a single national exchange and clearing agency, and a single government regulator. Accordingly, intra-country competition may not be a consideration in promulgating

---

[14] *See* Roberta S. Karmel, *Reconciling Federal and State Interests In Securities Regulation in the United States and Europe,* 28 BROOK. J. INT'L L. 495, 519-24 (2003).

[15] In 1975, Section 6 of the Exchange Act was amended to prohibit fixed commission rates. Pub. L. No. 94-29, §4, 89 Stat. 976 (codified as amended at 15 U.S.C. § 78f(e) (1994)). Similarly, the Airline Deregulation Act of 1978 abolished the Civil Aeronautics Board, which fixed prices and limited the entry of new airlines. Pub. L. No. 95-504, 92 Stat. 1705 (codified as amended in scattered sections of 49 U.S.C.); see also Alfred E. Khan, *Deregulation: Looking Backward and Looking Forward*, 7 YALE J. ON REG. 325 (1990).

[16] Exchange Act, Section 11A(a)(1)(C)(ii),15 U.S.C. § 78k-1(a)(1)(C)(ii) (2000).

[17] Exchange Act, Section § 17A(b), 15 U.S.C. §§ 78q-1(2002); Bradford Nat. Clearing Corp. v. Securities and Exchange Commission, 590 F.2d 1085 (D.C. Cir. 1978).

[18] When Regulation NMS was recently adopted, there were two vigorous dissenters who expressed their view that the SEC did not take competition as an alternative to regulation sufficiently into account. Dissent of Commissioners Cynthia A. Glassman and Paul S. Atkins to the Adoption of Regulation NMS, Regulation NMS, Exchange Act Release No. 51,808, 70 Fed. Reg. 37,496, 37,632-44 (June 29, 2005).

regulation, but global competition may become an important influence on regulators in all countries.

D. Self-regulation

Much market and other regulation have traditionally been imposed on markets and market participants by SROs. Although in some economic areas, governments have been privatizing former state own enterprises, in the securities field government has been seizing power from SROs. Some regulation formerly conducted by exchanges, such as the vetting of prospectuses, is now generally conducted by government securities regulators. Listing standards are likewise becoming government mandated standards.[19] When the Financial Services Authority ("FSA") was created in London, a variety of SROs were eliminated in favor of government regulation.

Although self-regulation continues to be a popular way for governments to impose controls on the securities industry, it has also become suspect. When the Public Company Accounting Oversight Board was created to regulate auditing by accountants for public companies, it was established as neither a government agency nor an SRO, but the claim that this agency is not a state actor can be challenged.[20] If such an agency is not, as a legal or practical matter, an SRO, then its advantages over a government regulator are questionable. Further, its constitutionality is currently being challenged.[21]

[19] Sarbanes-Oxley § 301, 116 Stat. 745 (codified at 15 U.S.C. § 78j-1 (Supp. II 2002)).
[20] *See* Donna M. Nagy, *Playing Peekaboo with Constitutional Law: The PCAOB and Its Public/Private Status*, 80 NOTRE DAME L. REV. 975 (2005).
[21] *See* Free Enterprise Fund v. The Public Company Accounting Oversight Board, Case No. 1:06CV00217-JR (D.C.D.C.).

## IV. The Full Disclosure System of the Federal Securities Laws

### A. Introduction

When the first of the federal securities laws, the Securities Act of 1933 ("Securities Act"), [22] was passed there was a debate between advocates of controlling the sale of securities by issuers which were dishonest or in unsound condition[23] and advocates of disclosure as a means to prevent the sale of poorly capitalized companies.[24] State blue sky laws, which preceded the federal securities laws, generally prevented a corporation from making a public offering unless it was fair, just and equitable, as determined by a state official.[25] The Securities Act permitted any corporation to go public if it made full disclosure of its business and affairs to investors.[26]

Shortly after the Securities Act was passed, William O. Douglas ("Douglas"), who was to exert considerable influence on the SEC as an early Chairman, criticized the full disclosure philosophy of the statute. In his view, it was a failure because it "presupposes that the glaring light of publicity will give the investors needed protection," but investors "either lack the training or intelligence to assimilate . . . and find . . . useful [the balance sheets, contracts or other data in the registration statement] or are so concerned with a speculative profit as to consider them irrelevant."[27] Douglas espoused a regulatory theory that was an integral part of a whole

---

[22] 15 U.S.C. § 77a-z (2000).

[23] An early draft of the Securities Act would have allowed a government agency to determine whether issuers were of unsound condition or insolvent. *See* DONALD A. RITCHIE, JAMES M. LANDIS DEAN OF THE REGULATORS 45 (1980) [hereinafter RITCHIE]. Such authority would have been similar to the ability of state blue sky merit regulators to prevent a public offering of securities if an issuer's capital structure is substantively unfair or presents excessive risks to investors. *See Ad Hoc Subcommittee on Merit Regulation of the State Regulation of Securities Committee, Report on State Merit Regulation of Securities Offerings,* 41 BUS. LAW. 785, 787 (1986) [hereinafter ABA Blue Sky Report].

[24] Full disclosure regulation is based on the often quoted theory that "[p]ublicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT at 92 (1914).

[25] *See* ABA Blue Sky Report, *supra* note 23.

[26] A specified list of disclosure items, including the provision of a profit and loss statement and balance sheet, was attached to the Securities Act as Schedule A to avoid Congressional tinkering although this list was the "guts of the bill" according to one of its drafters. *See* RITCHIE, *supra* note 23, at 47.

[27] William O. Douglas, *Protecting the Investor,* 23 YALE REV. 521, 523-24 (1934).

program of industrial regulation and organization for a modern and complex economy. Control over access to the market "would be an administrative control lodged not only in the hands of the new self-disciplined business groups but also in the hands of governmental agencies whose function would be to articulate the public interest with the profit motive."[28] Regulation of corporate governance by the SEC was injected into statutes passed after the Securities Act and intended to curb abuses by specific industries,[29] but the SEC was not given authority to regulate the structure of corporate boards generally, even when major amendments to the Exchange Act in 1964 gave the SEC power to direct a continuous disclosure system for all public companies, as opposed to its previous authority over only exchange listed companies.[30] One possible exception, the proxy provisions of the Exchange Act,[31] generally has been regarded primarily as disclosure rather than regulatory provisions.[32] Similarly, the SEC's regulatory authority over tender offers[33] has been interpreted as giving the SEC little authority to determine the outcome of contests for corporate control.[34]

The Securities Act regulates the distribution or underwriting of securities and is based on the premise that if companies going public make full disclosure, this disclosure can be evaluated

---

[28] *Id.* at 231.
[29] The Public Utility Holding Company Act of 1935, 15 U.S.C. §§ 79 to 79z-6 (2000), imposed various substantive controls upon capital structure. The Investment Company Act of 1940 ("Investment Company Act"), 15 U.S.C. §§ 80a-1 to 80a-64(2000), created a corporate governance structure for mutual funds, and in particular, a requirement for control by independent directors. 15 U.S.C. § 80a-10(a) (2000). The Exchange Act required the registration of stock exchanges and broker-dealers but did not give the SEC any control over their governance. Similarly, when the Maloney Act authorized the creation and regulation of national securities associations, 15 U.S.C. §70o-3, the SEC was not authorized to regulate the corporate governance of the National Association of Securities Dealers ("NASD"). A limited power to affect the board structure of these self-regulatory organizations ("SROs") was contained in amendments to the Exchange Act passed in 1975. Exchange Act § 6(b)(3), 15 U.S.C. § 78f(b)(3) (2000), Exchange Act §15A(b)(4), 15 U.S.C. § 78o-3 (2000).
[30] Securities Acts Amendments of 1964, Pub. L. No. 88-467, 78 Stat. 565; *see* Exchange Act Release No. 7,425, 29 Fed. Reg. 13,455 (Sept. 30, 1964).
[31] Exchange Act, § 14(a), 15 U.S.C. § 78n(a)(2000).
[32] *See* J.I. Case Co. v. Borak, 377 U.S. 426, 431 (1964); Roosevelt v. E.I. Du Pont de Nemours & Co., 958 F.2d 416, 421-22 (D.C. Cir. 1992).
[33] Exchange Act, §§ 13(d)-(e), 14(d)-(f), 15 U.S.C. §§ 78m(d)-(e)(2000), 78n(d)-(f)(2000).
[34] *See* CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 94 (1987); Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985).

by investors who can then fend for themselves. In addition to authorizing the SEC to dictate the disclosures that need to be made in initial public offerings, and the financial statements that such companies must provide to investors, the Securities Act specifies private remedies for investors who suffer damages by reason of false or misleading information in prospectuses.[35] The Exchange Act requires all companies that have made a public offering, are listed on an exchange, or have $10 million in assets and 500 shareholders to register its securities with the SEC.[36] Thereafter, such companies must file and send to shareholders an annual report that includes year end audited financial statements,[37] file quarterly unaudited financial statements and make periodic disclosures of materially important events. In addition to these SEC requirements mandating full disclosure of an issuer's business, financial condition, management and other matters, the stock exchanges impose continuous disclosure requirements on listed companies. These obligations are enhanced by a ban against trading on non-public material corporate information and general anti-fraud provisions giving investors civil remedies against corporations that fail to fulfill their disclosure obligations.[38] In addition to the liability the Securities Act and the Exchange Act impose on public corporations, their principal officers, directors, and reputational gatekeepers such as auditors and underwriters are also at risk of liability if full disclosure is not provided to investors.[39]

---

[35] 15 U.S.C. §§ 77k, l (2000).

[36] 15 U.S.C. §§ 78l(b),(g),o(d) (2000).

[37] 15 U.S.C. § 78m (2000).

[38] SEC Rule 10b-5 provides:
It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security. 17 C.F.R. § 240.10b-5 (2000); *See generally* Roberta Karmel, *Outsider Trading On Confidential Information - A Breach In Search of a Duty*, 20 CARDOZO L. REV. 83 (1998) [hereinafter *Breach in Search of a Duty*].

[39] See In re WorldCom, Inc. Sec. Litig., 346 F. Supp. 2d 628, 662 (S.D.N.Y. 2004) (Stating that "Overall, no greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the

The SEC has articulated its ideas and policies concerning disclosure in a variety of regulations, including registration forms and detailed instructions on how to comply with those forms.[40] It has also promulgated numerous interpretations of the disclosure provisions[41] and enforced its views regarding disclosure in civil and criminal prosecutions against violators of the laws and regulations regarding disclosure.[42] In addition, the SEC staff gives comments to issuers on their disclosure documents, and this informal administrative process often informs regulated entities and their advisors of the staff's evolving views on disclosure policies.

Beginning in 1980, the SEC has endeavored to integrate the disclosure provisions of the Securities Act and the Exchange Act, to provide investors with a single disclosure template for transactional and periodic disclosures.[43] This policy culminated in 2005 in the Securities

---

underwriter. Underwriters function as "the first line of defense" with respect to material misrepresentations and omissions in registration statements. As a consequence, courts must be particularly scrupulous in examining their conduct.") (internal citations omitted); See Also In re Enron Corp. Securities, Derivative & ERISA Litigation, 235 F.Supp.2d 549, 589 (S.D. Tex. 2002) (Widening Section 10(b)'s net, the Enron Court concluded that "the statute's imposition of liability on "any person" that "directly or indirectly" uses or employs "any manipulative or deceptive device or contrivance" in connection with the purchase or sale of security should be construed 'not technically and restrictively, but flexibly to effectuate its remedial purposes.'") (citing Affiliated Ute Citizens of Utah v. United States, 406 U.S. 128, 151 (1972)).

[40] *E.g.* SEC Form S-1 ( instructing proper completion of this "long form" registration statement and explaining an "[e]stimated average burden hours per response [of] 1,162.00"); SEC form S-3 (instructing proper completion of this "short form" registration statement and explaining an "[e]stimated average burden hours per response [of] 459.00");SEC Form 10-K (asking a registered company to annually give a comprehensive overview of their business); Regulation S-K, 17 C.F.R. § 229 (2006) (explaining the general disclosure requirements under the Exchange and Securities Acts); Regulation S-X, 17 C.F.R. § 210 (2006) (outlining accounting rules for filings with the Commission).

[41] *See e.g.* Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations, Securities Act Release No. 8,350 (Dec. 19, 2003) (codified at 17 C.F.R. pts 211, 231 and 241) *available at* http://www.sec.gov/rules/interp/33-8350.htm .

[42] *See e.g.* SEC Brings Settled Charges Against Tyco International Ltd. Alleging Billion Dollar Accounting Fraud**,** SEC Litigation Release No. 19,657 (April 17, 2006) (settling with TYCO for a civil penalty of 50 million dollars) *available at* http://www.sec.gov/litigation/litreleases/2006/lr19657.htm ; Complaint, Securities and Exchange Commission v. TYCO International LTD (outlining TYCO's alleged disclosure violations) *available at* http://www.sec.gov/litigation/complaints/2006/comp19657.pdf**;** *see* SEC Charges HealthSouth Corp., CEO Richard Scrushy With $1.4 Billion Accounting Fraud, Litigation Release 18,044 (March 20, 2003) [hereinafter HealthSouth CEO], *available at* http://www.sec.gov/litigation/litreleases/lr18044.htm; *see also* Hot Topic: Probing Stock-Options Backdating*,* Wall Street Journal, May 27, 2006, at A5. For the status of investigations against the over 100 companies ensnared in the options backdating Scandal see Options Scorecard, Wall Street Journal Online, *available at* http://online.wsj.com/public/resources/documents/info-optionsscore06-full.html .

[43] *See* Richard F. Langan, *The Integrated Disclosure System, Registration and Periodic Disclosure Under the Exchange Act of 1934,* 1556 PLI/CORP 251 (2006).

Offering Reforms.[44] The SEC's integrated disclosure policy is based on the efficient market hypothesis—the doctrine that once an issuer has established itself in the public securities markets and is widely followed by analysts its stock market value reflects all publicly disclosed information about the issuer. Further, if the pricing mechanism for securities is efficient, securities prices should be less volatile and speculation should be kept at bay.

B. Changes to Public Company Disclosure After Sarbanes-Oxley

Unfortunately, the SEC's full disclosure regulations and other regulatory tools for dealing with speculation did not prevent the technology bubble of the late 1990s. One consequence was that in Sarbanes-Oxley the Congress directed certain reforms of the disclosure system. These changes included CEO and CFO certifications; auditor attestations as to internal controls; better disclosures as to non-GAAP financial measures; more rapid disclosures of material changes in the issuer's business and affairs; and disclosures regarding codes of ethics and board composition. In addition to passing regulations to implement these statutory amendments, the SEC embarked on an ambitious rule making proceeding to improve disclosures regarding executive compensation.[45]

Sarbanes-Oxley requires the SEC to adopt rules requiring the principal executive and financial officers of SEC registered issuers to certify annual and quarterly reports filed with the SEC. The signing officers must certify that he or she has reviewed the report; it does not contain untrue or misleading statements; it fairly presents in all material respects the financial condition and results of operations of the issuer; and the signing officers are responsible for establishing

---

[44] Securities Offering Reform, Securities Act Release No. 8591, 70 Fed. Reg. 44,722 (Aug. 3, 2005) (codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, & 274) (attempting to eliminate barriers to open communications outmoded by technological advances. Additionally, the new rules reflect the importance of electronic dissemination of information).

[45] Executive Compensation Disclosure, Securities Act Release No. 8,765, 71 Fed. Reg.78,338 (Dec. 29, 2006) (to be codified at 17 C.F.R. pt 228 and 229)[hereinafter Executive Compensation Release].

and maintaining internal controls, have designed such controls to ensure that material information is made known to such officers and others and have evaluated such controls.[46] Further, there are criminal penalties provided for false certifications.[47]

A related mandated disclosure is that companies include in their annual reports an explanation of their internal controls.[48] Under the SEC's final rules, an issuer's annual report must include: a statement of the management's responsibility over internal controls and reporting; a statement on the framework used to evaluate those controls over the past year; management's assessments of the effectiveness of these controls over the past year, with an identification of any material weaknesses; and a statement that the issuer's auditors have attested to the management's assessment of internal controls.[49]

The filing of false or misleading financial statements with the SEC has long been subject to a variety of sanctions in SEC proceedings, criminal cases, and private litigation. Whether a CEO or CFO could be held liable for such statements generally depended on an analysis of the particular facts of a case.[50] The new certification requirement probably will make it easier to prosecute these top executive officers in such situations, but they will not prevent the filing of fraudulent financial statements.[51] The legal requirement that corporations have adequate systems

---

[46] Sarbanes-Oxley Act, § 303, 116 Stat. at 778 (codified at 15 U.S.C. § 7242 (Supp. III 2003)). These provisions have been implemented by Rules 13a-14, 13a-15, 17 C.F.R. §§ 240.13a-14, 13a-15 (2006). *See* Certification of Disclosure in Companies' Quarterly and Annual Reports, Securities Act Release No. 8,124, 67 Fed. Reg. 57,276 (Sept. 9, 2002).
[47] Sarbanes-Oxley, § 906, 18 U.S.C. § 1350 (Supp. II 2002).
[48] This disclosure is required by Sarbanes-Oxley, § 404, 15 U.S.C. § 7241 (Supp. 2002).
[49] *See* Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Exchange Act Release No. 47,986, 68 Fed. Reg. 36,636 (June 5, 2003).
[50] Liability could have been predicated on the theory that the officer or director was a direct participant in an accounting fraud, an aider and abettor or a control person. *See, e.g.,* In re Medimmune, Inc., Sec. Litig., 873 F. Supp. 953 (D. Md. 1995); General Electric Co. v. Rowe, 1992 WL 277997 (E.D. Pa. 1992); In re Par Pharmaceutical, Inc. Sec. Litig., 733 F. Supp. 668 (S.D.N.Y. 1990).
[51] *See* HealthSouth CEO, *supra* note 42.

of internal controls dates back to the 1977 amendments to the Exchange Act discussed above.[52] Further, the need for directors to be concerned about internal control systems in fulfilling their duty of care responsibilities has been enunciated in Delaware case law.[53] Sarbanes-Oxley adds another layer of legal obligation to this standard by imposing direct responsibility on executive officers for the establishment and maintenance of internal control systems. There is no question that internal control systems are extremely important and are the predicate for accurate and reliable financial reporting in today's complex business environment. But there is a question as to whether the new certification requirements are appropriately ensuring the reliability of financial statements by adding layers of costly and time consuming bureaucratic review within public companies.

The internal controls attestation regulations have proved extremely controversial because of their enormous expense due to the manner in which auditors have interpreted their responsibilities in order to make such an attestation. Both smaller public companies and foreign issuers have protested the attestation requirement, and the SEC has postponed the implementation of attestation for such issuers.[54] Further, the SEC has embarked upon rule making to determine whether the requirement can be altered for such issuers.[55]

---

[52] Exchange Act § 13(b), 15 U.S.C. § 78 m(b) (2000), added by the Foreign Corrupt Practices Act, Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1978) (codified as amended at 15 U.S.C. §§ 78m(b), 78dd-1, 78dd-2, 78dd-3, 78ff (2000)).

[53] *See* In re Caremark Inter. Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996).

[54] Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports of Non-Accelerated Filers and Foreign Private Issuers, Securities Act Release No. 8,545, 70 Fed. Reg. 11,528 (March 2, 2005); Rachel McTague, *SEC May Delay Internal-Control Reporting by Non-U.S. Firms, Donaldson Says in London*, 37 SEC. REG. & L. REP. (BNA) 195 (Jan. 31, 2005); Rachel McTague, *SEC Staff Likely to Recommend Rule to Ease Deregistration for Foreign Firms*, 36 SEC. REG. & L. REP. (BNA) 2050 (Nov. 22, 2004).

[55] See Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, Exchange Act Release No. 54,122, 71 Fed. Reg. 40,866 (July 18, 2006) (seeking comment on "special issues applicable to foreign private issuers that the Commission should consider in developing guidance to management on how to evaluate the effectiveness of a company's internal control over financial reporting").

Sarbanes-Oxley Section 401(b) instructed the SEC to adopt disclosure rules for financial information that is not calculated in accordance with GAAP. The SEC then adopted rules for the use of non-GAAP financial information in the preparation of an annual report.[56] These rules essentially require companies that report any non-GAAP financial measures to reconcile these figures to GAAP financial measures.

Section 409 of Sarbanes-Oxley requires that issuers disclose "on a rapid and current basis" such information concerning material changes in their financial conditions or operations as the SEC determines is necessary or useful for the protection of investors. This instruction to the SEC to move in the direction of a continuous rather than a periodic disclosure system led to new rules regarding the timing for the filing of annual and periodic reports and an amendment to the list of items requiring the filing of a special report.

Prior to the enactment of Sarbanes-Oxley, public companies were required to file their annual reports on Form 10-K with the SEC within 90 days of the end of a fiscal year and quarterly reports on Form 10Q within 45 days of the end of each quarter. Reports of material events were required to be filed on Form 8-K within 10 days at the end of the month in which the event occurred. The requirement that reports be filed on a rapid and current basis has changed these time frames. Currently, "accelerated filers"[57] must file annual reports within 60 days after the end of a fiscal year, and (beginning December 15, 2006) must file quarterly reports within 35

---

[56] *See* 17 C.F.R. §§ 244.100-102 (2006); Conditions for Use of Non-GAAP Financial Measures, Securities Act Release No. 8,176, 68 Fed. Reg. 4,820 (Jan. 22, 2003).

[57] Large accelerated filer defined by Exchange Act Rule 12b-2(2), 17 C.F.R. § 240.12b-2 (2006):
The term large accelerated filer means an issuer after it first meets the following conditions as of the end of its fiscal year:

> 1. The issuer had an aggregate worldwide market value of the voting and non-voting common equity held by its non-affiliates of $700 million or more, as of the last business day of the issuer s most recently completed second fiscal quarter;
> 2. The issuer has been subject to the requirements of section 13(a) or 15(d) of the Act for a period of at least twelve calendar months;
> 3. The issuer has filed at least one annual report pursuant to section 13(a) or 15(d) of the Act; and
> 4. The issuer is not eligible to use Forms 10 KSB and 10 QSB for its annual and quarterly reports.

days of the end of each quarter. For the time being, other filers are not required to file reports on this speedier schedule.

Important new events were added to the triggers for the filing of an 8-K by public companies.[58] These new disclosure requirements include the following occurrences:

(1) Entry into a material definitive agreement, not made in the ordinary course of business;

(2) Termination of a material definitive agreement;

(3) Creation of a direct financial obligation or an obligation under an off-balance sheet arrangement;

(4) Triggering events that accelerate or increase a direct financial obligation or an obligation under an off-balance sheet arrangement;

(5) Costs associated with exit or disposal activities, or other action that disposes of long-lived assets or terminates employees under certain plans;

(6) Material impairments;

(7) Notice of De-listing or failure to satisfy a listing rule or standard;

(8) A decision that previously issued financial statements are no longer reliable;

(9) Departure of Directors and Officers;

(10) Unregistered sales of equity securities of more than 1% of a company's shares;

(11) Material modifications to rights of security holders; and

(12) Amendments to Articles of Incorporation or Bylaws or changes in fiscal year.

[58] *See* Additional 8-K Disclosure Requirements and Acceleration of Filing Date, Securities Act Release No. 8,400, 69 Fed. Reg. 15,594 (March 25, 2004).

The last three items previously were reported in an issuer's quarterly reports. Further, the 8-K now has to be filed 4 days after an event as opposed to the previous 5 business day or 15 calendar day requirements.[59]

The provision with regard to the filing of a Form 8-K within 4 business days after a company's entry into a material definitive agreements outside its ordinary course of business has been further amended by the SEC's recent rule making on executive compensation and related party disclosure.[60] Disclosure of employment compensation arrangements for purposes of Form 8-K reporting now is limited to those compensation arrangements with executive officers and directors that are unquestionably or presumptively material. But material arrangements beyond employment agreements may have to be reported.[61]

It is interesting that Sarbanes-Oxley did not require and the SEC did not change the dates for the filing of insider transactions or accumulations of stock by potential tender offerors. Although there have been suggestions in the past for "closing the 10 day window" of the Williams Act, and change of control transactions do add volatility to securities prices, the SEC seems to be disinclined to put a damper on such transactions by requiring prompter announcements of stock accumulations.[62] Similarly, Sarbanes-Oxley did not require and the

---

[59] Wally Suphap, *Getting it Right Versus Getting it Quick: the Quality-Timeliness Tradeoff in Corporate Disclosure*, 2003 COLUM. BUS. L. REV. 662, 678 (2003) (explaining that "Since 1936, Form 8-K has undergone a series of substantive changes. In 1977, the SEC made significant amendments to create the general structure of the form that exists today, including filing deadlines that require reporting of some corporate events within five business or fifteen calendar days after their occurrence, depending on the nature of the event. In recent years, the SEC has amended Form 8-K at various times to add or delete items.") (internal citations omitted).

[60] *See* Executive Compensation Release, *supra* note 45.

[61] *See* Regulation S-K Item 404, Transactions with Related Persons, Promoters and Certain Control Persons, 17 C.F.R. pt. 229.404 (2006).

[62] *See generally A Breach In Search of a Duty*, *supra* note 38, at 124-33 (outlining the argument for closing the Williams Act's "ten day window," it's evolution, and SEC reluctance to "pursue this legislative initiative more aggressively before and after Congress abandoned takeover reform legislation.").

SEC did not change the timing for the filing of reports of purchases or sales of public company securities by officers, directors, and ten percent stockholders.[63]

One of the changes in the administration of SEC disclosure policy accomplished by Sarbanes-Oxley was a requirement that the agency to review every three years the periodic reports of all issuers listed on a stock exchange or traded on NASDAQ (which has since become an exchange).[64] During the bubble years, the SEC was not conducting such reviews, and for example, never reviewed any of Enron's filings. Since the SEC has long promoted the idea of integrated disclosure, based on the annual and periodic reporting requirements, this failure to review annual reports was a serious lapse. The SEC now gives issuer's comments on annual reports and in other ways has paid more attention to disclosure issues in documents in addition to prospectuses in initial public offerings.

The most important disclosure reform of the SEC since 2002 is its new regulation of executive compensation. Although the details of this rule making are beyond the scope of this paper, it is a good example of the use of disclosure by the SEC as a substitute for substantive regulation. The purpose of the regulation is compensation disclosure, rather than control or limitations on compensation. The theory of the new regulation is that enhanced transparency will enable investors to protect themselves. Although suggested by some, the SEC did not attempt to require an advisory shareholder vote on executive compensation.[65]

---

[63] Ownership Reports and Trading by Officers, Directors and Principal Security Holders, Exchange Act Release No. 46,421, 17 C.F.R. pts. 240, 249, 274 (Aug 27, 2002) ("adopting rule and form amendments to implement the accelerated filing deadline applicable to change of beneficial ownership reports required to be filed by officers, directors and principal security holders under Section 16(a) of the Securities Exchange Act of 1934, as amended by the Sarbanes-Oxley Act of 2002.").

[64] Sarbanes Oxley § 408, 15 U.S.C. § 7266 (Supp. 2002).

[65] Roel C. Campos, Commissioner, U.S. Securities and Exchange Comm'n, Remarks at the SEC Open Meeting (July 26, 2006) *available at* http://www.sec.gov/news/speech/2006/spch072606rcc.htm ; *see also* Protection Against Executive Compensation Abuse Act, H.R. 4291, 109th Congress (1st Sess. 2005) (introduced by Barney Frank of Massachusetts seeking federally mandated shareholder votes on executive compensation). For a discussion

C. Disclosure by SEC Regulated Financial Institutions

The SEC, like other financial regulators, imposes capital adequacy requirements on broker-dealers subject to its jurisdiction. But the SEC's mandate has never been to assure the safety and soundness of broker-dealers, or to prevent their financial collapse, but rather to safeguard customer funds in the possession of such firms. The Exchange Act requires broker-dealers to meet such operational and financial adequacy standards the SEC may establish.[66] In that connection, the SEC has promulgated the net capital rule, requiring a broker dealer to maintain a sufficient asset base for its operations.[67] The SEC also requires the segregation of customers' funds and securities from its proprietary accounts.[68]

Yet, after widespread broker-dealer failures as the result of the paperwork crisis of the late 1960s and early 1970s, and the insolvency of many broker-dealers at that time, Congress and the SEC broke with the general policy of bank regulators to maintain confidentiality with regard to the financial condition of banks in order to prevent bank runs, and required broker-dealers to publicly disclosure their financial condition to their customers. The Congress felt that during the period from 1967-70, "there was a notable absence of adequate disclosure of financial condition by broker-dealers to their customers."[69] At about this time, the SEC's Chief Accountant called for amending broker-dealer audit requirements to provide substantially greater disclosure to public customers. Although the SEC's rule making to accomplish this policy did not go as far as

---

of the federalism implications of national corporate governance proposals *see Federalism vs. Federalization: Preserving the Division of Responsibility in Corporation Law* 1543 PLI/CORP 221, 267 (2006).

[66] Exchange Act § 15(b)(7), Registration and Regulation of Brokers and Dealers, 15 U.S.C. § 78o (2000).

[67] Rule 15c3-1, Net Capital Rule, 17 C.F.R. § 240.15c3-1 (2005).

[68] Rule 15c3-3, Customer Protection – Reserves and Custody of Securities, 17 C.F.R. § 240.15c3-3 (2005).

[69] Securities Industry Study Report by the House Subcommittee on Commerce and Finance, H.R. rep. No. 92-1519, at 51, 92d Cong., 2d Sess. (1972).

the staff's recommendations, it did eliminate the broker-dealer's option of filing the auditor's letter on internal controls on a confidential basis.[70]

When the Exchange Act was amended in 1975, Section 17(e) was added to provide that every registered broker-dealer annually file with the SEC a balance sheet and income statement certified by an independent public accountant and such other financial statements and information as the SEC should require, and further, should send such information to its customers. The SEC implemented this provision by adopting a new regulation requiring the filing of certain reports with the SEC by broker-dealers, and furnishing to customers within 45 days thereafter an audited balance sheet with a footnote containing the firm's required net capital under the SEC's net capital rule.[71] Although other provisions of the Exchange Act and other SEC rules help assure the ability of broker-dealers to meet their obligations to customers and other broker-dealers, these disclosure provisions gave customers the necessary confidence to entrust their funds and securities to broker-dealers and probably avoided more stringent command and control regulations concerning capital adequacy.

Although the SEC does not regulate the capital adequacy of banks, it does require banks that are publicly held to make disclosures concerning their financial condition. The SEC developed a special template for such disclosures by banks[72] and some of the SEC's views concerning accounting matters brought the SEC into conflict with bank regulators. Such tensions have come to the fore with regard to the issue of capital adequacy requirements

---

[70] *Id.* at 52. *See* Reports to be Made by Certain Exchange Members, Brokers, and Dealers and Related Audit Requirements, Exchange Act Release No. 9,658, 37 Fed. Reg. 14,607 (June 30, 1972); Broker-Dealer Financial Disclosure Requirements to Each Customer, Exchange Act Releases No. 9,404, 35 Fed. Reg. 25,236 (Dec. 3, 1971).
[71] *See* Focus Broker-Dealer Reports, Exchange Act Release No. 11,935, 40 Fed. Reg. 59,706 (Dec. 30, 1975).
[72] Securities Act and Exchange Act Industry Guide 3, Statistical Disclosure by Bank Holding Companies, *available at* http://www.sec.gov/about/forms/industryguides.pdf .

regarding market risk as between banks and securities firms.[73] Very generally, bank regulators have frequently been reluctant to mandate the kind of full disclosure by banks that the SEC has required, in part because the SEC is concerned more about shareholders of banks and bank regulators are concerned more about bank depositors. Yet, it is unclear whether maintaining confidentiality concerning impaired assets merely postpones the inevitable collapse of a failing bank, thus increasing financial instability.

The regulation of capital adequacy of both broker-dealers and banks is fairly well settled in most jurisdictions, but recently there has been concern about the possible destabilizing effects of investments by hedge funds and other unregulated entities. A recent rule making proposal by the SEC to require the registration of hedge funds so that the SEC could obtain more information about them was struck down by the D.C. Court of Appeals.[74] The reaction of the SEC and the Congress to this decision and the future possible regulation of hedge funds are currently unclear, but in the event of problems in the capital markets due to the collapse of highly leveraged hedge funds more attention might be given to this issue. Regulators and hedge funds might well be advised to opt for disclosure of their activities rather than more prescriptive regulation.

D. Court Actions

The articulation of disclosure policy in U.S. securities regulation is often found in both private civil actions and civil and criminal prosecution by the Government. In the aftermath of the bursting of the technology bubble in 2000-2001, hundreds of cases were filed in the federal courts against companies, officers, directors and reputational gatekeepers charging violations of

---

[73] HAL S. SCOTT, INTERNATIONAL FINANCE: TRANSACTIONS, POLICY, AND REGULATIONS, THIRTEENTH EDITION 342-43 (Foundation Press) (2006) (explaining "market risk" and capital adequacy requirements).
[74] Goldstein v. Securities and Exchange Commission, 451 F.3d 873 (D.C. Cir. 2006) (holding that a rule, promulgated by the SEC, requiring investors in a hedge fund be counted as clients of the fund's adviser for purposes of fewer-than-fifteen-clients exemption from registration under IAA invalid because it conflicts with purposes underlying the statute).

the anti-fraud provisions of the federal securities laws. These cases influence the drafting of prospectuses in public offerings, annual report filings by public companies, proxy solicitations and other disclosures. Since many of these cases are brought by private litigants, who are sometimes likened to private attorney generals, they serve to correct distortions in the securities markets caused by faulty disclosure.

## V. Conclusion

The securities laws have attempted to substitute disclosure for command and control prescriptive regulation to the extent the Congress and the SEC have considered effective. With regard to the regulation of public companies, the SEC historically has not attempted to control which issuers can tap the capital markets or regulate their internal affairs, but rather, has compelled full disclosure so that investors can choose where to invest their capital. Sarbanes-Oxley has imposed corporate governance structures on public companies and their boards where previously state law allowed greater freedom of choice in these matters, but even Sarbanes-Oxley instructed the SEC to require stock exchanges to change their listing standards to deal with these corporate governance issues, rather than act directly.

Sarbanes-Oxley also required certain changes in the SEC's disclosure regulations, including the timing of disclosures by public companies. In general, these changes move such disclosures to more current disclosure filings. In the past, many companies reached the same end goal of rapid and current disclosure by issuing press releases, but in today's Internet world, the SEC has mandated quicker filings and has also asked public companies to post their filings on their web sites. These changes are moving the U.S. disclosure system in the direction of a continuous reporting regime as opposed to a transactional reporting regime.

In the regulation of broker-dealers, the SEC also has used disclosure to customers as a means to avoid prescriptive regulation regarding safe and sound practices or capital adequacy, although the securities laws do contain the net capital rule and other rules safeguarding customers' property. A challenge for the future for financial regulators around the world will be determining what type of disclosures hedge funds and other unregulated investors should be required to make in order to avoid undue speculation and volatility in the markets.