May 4, 1984

Mr. Paul Gonson
Mr. Irving M. Pollack
Mr. A.A. Sommer, Jr.

Gentlemen:

I am sorry that I missed your lunch on April 25. I am particularly interested in the concept that our session of the Major Issues Conference is to be a Panel. If this means that it is supposed to be a more general discussion than the usual series of lectures followed by a few minutes of give-and-take discussion someone must enlighten me how that is going to occur. I assume that it will be by Paul Gonson or Commissioner Cox acting as an interlocutor and master of ceremonies to keep the discussion going.

On this 50 year occasion we should minimize minor criticisms and suggestions for minor ameliorations and limit ourselves to really basic points. There are others, such as the restructuring of the financial markets, but I limit myself here to those on which I think I may know something.

Without going into detail, I think that the Commission went much too far in the 1970's in taking the position that all Act exemptions were to be strictly construed., in requiring information in Rule 146 essentially equivalent to a registration statement (which still continues in Rules 505 and 506) and in imposing tremendously rigid restrictions on resales under Rule 144. The subsequent steady relaxation of the latter rule with no perceived had consequences justifies my view that the Rule was bad in the beginning. But the latest change opens up a whole question of policy. Last fall the rule was amended to permit a non-affiliate to resell after 3 years with no limitation of amount and even though the issuer is not a reporting company, i.e. with no information available to the members of the public who may be buying the issue. This can happen even though the reseller had a specific intention to resell after the three years., i e. even though he meets the statutory definition of underwriter. (This result is not precluded by the provision of Rule 503(d) that the issuer in a private placement must make sure that the buyer is not an underwriter, for that paragraph certainly means that the buyer's compliance with Rule 144 will satisfy the issuer's obligation.)

Thus the first, and least important point that comes out of this, is that the Commission has done so much patching in the exemption rules lately that they need a general coordination.

A more important point is that the Commission must pay attention to the point I made in my "Dead Wood" article, 38 Bus. Law. 833, 836-837 (1983), that it makes no sense to impose all of the requirements about ability to fend for himself that it does impose on a private placee under Rule 506, but then not let him fend for himself but require him to be furnished with all of the information in a registration statement. Still less does it make sense for the Commission to continue to impose all of these restrictions on an issuer

selling to private placees who can fend for themselves, while at the same time it is permitting the private placees after three years to dump the stock in a public offering to buyers who have no access to information from a company which is not even a reporting company.

The final point is that the recent change in Rule 144 makes it imperative to have some basic reconsideration of the circumstances under which the '33 Act procedure should continue to be necessary. I do not mean within the present statutory framework, but through additional legislation, if necessary. Lou Loss had a better structure than the present hodgepodge, which the Commission was prepared to support a few years ago. But even that took too limited a view, because Lou's approach was primarily that of a codifier with some effort at rationalization. But I am suggesting opening up the subject more fundamentally. If the Commission had gone as far as it has under Rule 144 when no information is available to the public, what are the proper bounds of the registration requirement?

A second topic for consideration is whether the information requirements in the tender offer rules serve any useful purpose. I have yet to find anyone practicing in that field who thinks that stockholders pay any attention to anything other than a comparison between market price and the bids. In any event., disclosure could do no more than to support management's contention that the bid is inadequate, and certainly the disclosure rules and the accounting system which it supports do nothing to help the stockholder measure going concern value.

Another point, one on which Mr. Huber made a speech recently, is on the proper scope of the business judgment rule, I doubt that this is directly within the Commission's purview, hut I have grave doubts myself about applying the business judgment rule to management's actions blocking derivative actions and opposing u-friendly tender offers. I tried to get one recent writer in the field to take the position that the business judgment rule does not properly apply to matters relating to the fundamental governance structure of the corporation such as breach of duty of care or of loyalty by officers and directors and matters relating to control of the corporation

Several other points relate to financial disclosure, one of my old songs. I was astonished last summer at a symposium on Ten Years of the FASB at New York University, instead of being the severest critic as I expected to be, the professional and academic accountants were more critical that I toward FASB's accomplishments, and particularly its inability to make up its mind. A lead article on the front page of the Wall Street Journal this week shows that the feeling is widespread and deep-seated. I don't want to repeat some old arguments which Commissioner Longstreth has recently attempted to rebut. My present point is that self-regulation of a profession does not work, unless the SEC is known to have a firm hand behind the scenes, which will be felt if the self-regulators get-tied up in intra-industry arguments and the pressures of particular interests. That is what is happening at the FASB, and the Commission's hand is too light behind the scenes if it insists on the present set-up. At the Securities Institute in Coronado in January, 1983, I

criticized the Commission for not supporting the FASB against the bankers and the banking agencies on SFAS 15, relating to Restructuring of Debt of Troubled Companies. Commissioner John Evans answered me from the platform, and said that the Commission did not want to interfere with the FASB. But this was a literally crucial point. In 1977 in my Accounting book I wrote the passage that said that this argument about unjustifiable accounting hiding losses, which occurred in the context of bad real estate loans, was just the prelude to the same problem when the foreign loans came home to roost. We might he better off today if the SEC had fought the battle. Others in a position to know have told me that the SEC encouraged the FASB to stay with its original correct position, but that the SEC backed off against the onslaught of the banking agencies, and the FASB then changed its original view, and came up with an indefensible position.

There are several other basic aspects of financial disclosure on which the SEC ought to be pushing the accountants hard the way Sandy Burton did on inflation accounting and on accounting for leases. One of these is recognition of the time value of money in several areas, including deferred taxes and depreciation.

Another might be putting a stop to the FASB's is recent tendency to nullify the restrictions on the classification of Extraordinary Items in the income account by abandoning a fifty year old rule and permitting direct charges and credits to the equity accounts, short-circuiting the income account entirely.

But that point re-opens the fundamental question as to how important is correct accounting if there is full disclosure of what the company is doing, especially in the light of the recognition of the fact from Al Sommer's Committee, namely, that securities decisions are made by professionals, not by the layman in the street.

And that brings us back to the fundamental question of the proper role of government-mandated disclosure. I am by no means an enthusiast for the reigning political philosophy; but in this era of necessary budget-cutting, it is hard to classify the securities investor as among the truly needy, for whom government must provide a safety net. The securities investor pays for all kinds of investment advice and services, directly and indirectly. The securities legislation has played a useful role in conditioning the public and professionals to demand information and the issuers to furnish it. When it suited the purposes of the Commission to do so, it found, contrary to Al's Committee, that corporate annual reports were pretty good, and used this finding as one of the bases of the integrated disclosure system. Maybe the time has come again to examine the proper role of government in the area, but not to do so by repeating the work of Al's Committee, but by a fundamental legislative study. This is not any nefarious scheme of mine to attack the SEC through Congress because, as I read the papers, Congressman Worth and others are more supportive of the SEC's jurisdiction than I think is necessary at this stage of history.

I look forward to seeing all of you. I will probably arrive in Washington on Monday, June 25, and could meet with you before the Conference if seems to be advisable, but let me know comfortably in advance, because I will probably leave home as early as June 14.

Cordially yours,
Homer Kripke

P.S. I am asking Paul Gonson to copy this and distribute it to the addressees. I have typed this myself on Friday night, and do not have any ready access to copying facilities. If Paul will send me Irv Pollack's address, I will send Irv a copy of my recent article on Fifty Year's of the SEC. Copies have been sent to the others.