A Rejoinder To Mr. Ferber

Henry G. Manne

upon whether law professors have a duty to attempt to bring about what Professor Manne refers to as "moral escalation". I do think that in the securities market this is precisely what Congress formed the Securities and Exchange Commission to attempt to bring about.

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A fundamental difference between my approach to this problem and Mr. Ferber's is shown by his intimation that for him and the SEC Congress ordains what is moral and what is not. That, however, is not the appropriate posture for scholars seeking objective resolution of a complex issue. I for one am not willing to have Congress decree my attitudes on what is moral. But frankly I find unconvincing Mr. Ferber's suggestion that notions of morality and honesty as indicated by Congress have had anything to do with the development of Rule 10b-5. After all that is the same Congress that refused to adopt an express provision outlawing all insider trading.

No one questions that Congress wanted securities markets honestly conducted when they adopted the federal securities laws. But that hardly explains the creation of the Securities and Exchange Commission. Congress certainly did not say to an unknown commission "Here is 'the word." Go forth and do good!" What Congress indicated was that this area was too complicated and too dynamic for specific legislation on every issue that might arise. Therefore they created a commission which, through its staff of experts, was supposed to learn and then do what was in the interest of the public.

Furthermore I should surmise—and I would be very curious to know whether the Commissioners themselves agree with Mr. Ferber or me on this—that most of Congress wanted the securities markets of the country regulated in the *economic* interest of the public. Indeed one could say that there is a moral obligation on the SEC to know that its regulations are not causing more harm than good to the public's financial interests.

And yet, we find the Solicitor of the SEC making the almost unbelievable statement that "economic effect is largely irrelevant." This is a terrible confession that the SEC and spokesmen for it do not comprehend the significance of what they are doing nor do they personally concern themselves about the impact of their regulation on millions of investors who do indeed think that they are receiving *economic, not moral, benefits* from the agency. No congressman would tell his constituents, "you may be losing money by SEC regulation, but that is irrelevant, since the men down there are serving a higher moral order."

The truth of the matter is that there need be no conflict between good economics and good morality. The confusion arises when the attempt is made to substitute superficial ideas of morality for fundamental economic doctrine. Clearly every decision has an economic impact just as it has moral implications. But how can one judge the moral content or desirability of an act of economic regulation without knowing the effects of it?

But this is all a charade, or some form of high comedy. The SEC does not consult theologians or philosophers in its policy making any more than it consults economists. The Commission plays a serious game of law and politics, though the real winners are not always announced. Securities regulation has probably been of greatest economic benefit to members of the securities industry and to the lawyers who practice in and before the SEC. The rest of the country, whose influence is not so easily felt, have to accept disingenuous palaver about the morality of government and the irrelevance of their own wealth position.

I shall comment on a few of Mr. Ferber's more egregious errors. In my article I never credited the SEC with making the argument that information is the property of shareholders. I addressed myself only to the academic critics of my book. As a matter of fact the SEC itself has said so little about the policy underlying their interpretation of Rule 10b-5 that they have never given me much to respond to. Of course that way they are free to dissociate themselves from positions of their supporters as they see fit.

Mr. Ferber finds "a natural tendency for insiders to prolong the period prior to disclosure" if insider trading is allowed. This statement is certainly contrary to the economic analysis and studies made on the same subject.

Mr. Ferber simply does not understand my discussion of the economics of partial enforcement of certain kinds of laws. The reason that prostitution, marijuana, pornography and insider trading are of one kind is because an organized market in the illicit goods will develop. But that is not true generally of fraud, murder or many other forms of crimes against which enforcement is also only partial. As illicit businesses organize, grow, and prosper, so does the danger of their corrupting government officials.

Mr. Ferber is absolutely correct when he says there are potential conflicts of interest from insider trading by a trustee of a corporation in reorganization. Since he did not read my book, however, he could not know that I made precisely and exactly that point. But Mr. Ferber goes on to say that the same possible conflict "may exist to some extent whenever there is trading by corporate officials." Unfortunately he does not supply us with the minor premise in this syllogism, the one equating all companies with insolvent ones. And, unfortunately for his logic, the position of trustees in reorganization is vastly different from that of corporate officials generally. His suggestion that this analogy explains the Commission's position in *Texas Gulf* will certainly come as a surprise to many people.

Lawyers interested in anticipating new directions by the SEC should notice what may be the most important single sentence in Mr. Ferber's reply. He states that "the Commission has objected [to insider trading] only where the person taking advantage of information owes a duty of loyalty to the person he is trading with and is breaching that duty or where some type of aiding and abetting in such a breach of trust occurs." This sentence sounds suspiciously more like *Cady, Roberts* than it does like *Texas Gulf.* It is difficult to conclude that the Commission in *Texas Gulf* was saying that the defendants had some special duty of loyalty to the individuals with whom they were trading, though that is perfectly consistent with the standards stated in the *Cady, Roberts* opinion. Does this represent backtracking by the SEC on the frighteningly broad holding of *Texas Gulf*? Does this statement mean that "tippees" are excluded from liability under Rule 10b-5, or are they aiders and abettors? What are the standards for establishing whether a duty of loyalty is owed? Or is this statement merely another question-begging explanation of why we have a rule against insider trading?

Many readers will be somewhat confused by the juxtaposition of the paragraph on accounting procedures in the midst of a discussion of insider trading. I do not understand that either, though I think I know what he is unhappy about. Mr. Ferber is actually complaining because in another article (Manne, Accounting and Administrative Law Aspects of *Gerstle v. Gamble-Skogmo, Inc.* 15 N.Y.L.F. 304 (1969)) I had not praised the Commission for what I consider a grotesque example of regulatory misbehavior. The reference is to the case of *Gerstle v. Gamble-Skogmo.* I hope that my readers will realize that in that case the SEC took an amicus position flatly contrary to a stern warning they earlier gave the defendants on the same point. Thus, in a civil suit for damages, which could go as high as five million dollars, the SEC announced its new approach *for this case*. The accounting rule in question dealt with evaluations of appreciated assets, and I can only say that it took a long time for the SEC, in Mr. Ferber's words, to "learn from its experience." The old rule had been (and may still be) blindly followed by the SEC almost from its inception, despite widespread criticism. They certainly picked an odd place, time, and way to display their new found learning. I find it incredible that Mr. Ferber would even mention so shameful a travesty on justice and morality as the SEC perpetrated in the *Gerstle* litigation. But I am glad he mentioned the case, and I strongly recommend an examination of the SEC behavior therein to anyone interested in morals in government.

If I understand it correctly, Mr. Ferber's footnote number 21 says that no private interest groups have gained strong influence with the Commission in its thirty-six years. How about the New York Stock Exchange as opposed to small regionals, Mr. Ferber, or the larger member firms of the New York Stock Exchange, or the NASD, or old line mutual funds, or entrenched corporate managers who pushed for the Williams Bill? This sounds like a claim that bootleggers had no influence with the Chicago police during prohibition, or that the railroads were never closer than a counsel's arm's length to the ICC.

Only one last point needs to be clarified. Did Professor Schotland know what he was talking about or not when he claimed that the SEC traced all New York City trades in Texas Gulf stock based on information originating in Washington, D.C.? Obviously if he meant no more than that a few Washingtonians were asked whom they had contacted in New York, he did not say anything of significance, and the SEC stands accused, as I stated in my main atticle, of not discovering all the insider trading it claims to detect—or of hiding what it knew. On the contrary, if Schotland was correct, then the SEC should tell exactly how they do get the information. I have not accused the SEC of wiretapping. I have said that information which Schotland claims to have gotten from the Commission strongly suggests government investigation into records probably better kept private. This raises a serious civil liberties question and it should not be shrugged off, obfuscated, or denied without explanation. Mr. Ferber's comments are too unresponsive to be significant or satisfying. And someone in the Commission should certainly explain carefully what procedures the Commission uses in its policing activities. There is no reason that SEC policemen should be freer of public surveillance than any other police force.