REVIEW


Edmund W. Kitch†

This witty, complex, sophisticated, and charming book sets forth an agenda for reform of the Securities and Exchange Commission ("SEC"). Destined to serve as a blueprint for restructuring the SEC's activities, it will surely be regarded as an important work in the decade to come.

The book has three major themes. The first of these follows the course of an intellectual autobiography: the young, idealist SEC staff professional becomes the older, more sophisticated, doggedly idealist, securities scholar and practitioner. The book, drawing generously upon earlier essays dealing with the same topic,1 is a personal summation of the author's career in securities law, a career that has contributed much serious thought to the field:

I have been an observer of federal securities regulation since its very beginning. . . . The Securities Act seemed then to be the New Deal's pre-eminent means of preventing a recurrence of the conditions that led to the Great Depression, and well-designed to prevent a recurrence of the securities abuses of the 1920s.

Now, as I wind up over 45 years of watching, it seems clear that as the regulation gets more and more detailed and pervasive, its effectiveness is rapidly diminishing. The usefulness of constantly added detail must be questioned, especially considering our greater knowledge of how securities decisions

† Professor of Law, The University of Chicago.
1 See particularly Kripke's dissent to a recent report by a special SEC advisory committee, Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong., 1st Sess., Report, D-49 to D-56 (Comm. Print 1977), whose other members concluded that the current disclosure system "is sound and does not need radical reform or renovation," id. at ii. Kripke expanded his dissent into an article that was published in two professional journals. Kripke, Where Are We on Securities Disclosure After the Advisory Committee Report?, 2 J. Accounting, Auditing & Finance 4 (1978), also published in 6 Sec. Reg. L. J. 99 (1978).
are made and the lack of decisive influence of the disclosure system in those decisions. The administration of the securities legislation, despite its reputation for efficiency, has proved to be a conspicuous example of over-regulation. . . .

This book is an attempt to outline my dissatisfaction with the present disclosure system, and to indicate what went wrong.2

The second and most amusing theme of the book delineates Homer Kripke’s role as an indefatigable and ineffective critic of the SEC. His criticism is laced with wit, sarcasm, and not a little pique, the last of which results less from the failure of his arguments to carry the day than from the refusal of the SEC and its well-disciplined phalanx of practitioner defenders3 to deign to begin a dialogue. Of the modern staff, the clearest villain of the piece, Kripke writes:

Beyond all the written material are the routine staff contacts with the public when processing filings with the Commission. From all of this has developed a vast interpretive maze, for which even a sympathetic reader trained under the Acts and sympathetic to their purposes can find little justification in the statutes. . . .

The correct way to understand the maze, having in mind the staff’s zealotry and apparent delight in spinning out these glosses on the statute and their lack of demonstrable basis, is as a “theology.”

. . . The attitude of the staff toward its disclosure functions is marked by an unquestioning faith that the mandatory disclosure system must be a good in itself, and must be useful, and the more of it the better. . . . [W]hen one is self-righteously sure that he or she is performing a valuable public service, one becomes impatient with disagreement or delay.4

The third theme of the book details Homer Kripke’s positive program for a better SEC. Kripke maintains that the SEC should

2 H. Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose xvii (1979) [hereinafter cited without cross-reference as Kripke].
3 "The practicing lawyer knows that he or she has to live with an SEC staff profoundly immersed in its own preconceptions and ideology. . . . [T]he practicing lawyer is loath overtly to challenge the SEC ideology and methods . . . ." Id. at xix.
4 Id. at 4-5.
turn to the new learning of financial economics for the guidance to reform its program. It should substitute economically relevant, value-informative, future-oriented information in place of accounting numbers generated by the dead hand of the past. The central intellectual interest of this book emerges from Kripke's relentless determination to wrest from the literature of financial economics a meaningful reform program for the SEC.

Kripke has a devout commitment to the SEC and the Securities Acts as means to serve the public interest. Accordingly, he briefly discusses, but quickly discredits, the capture hypothesis—the notion that the SEC was created or captured by elements of the securities industry to serve their own interests. He dismisses the hypothesis (quite correctly in my view) on the ground that throughout much of its history, the SEC has been so ineffective that capture has been unnecessary. He does not discuss two hypotheses that seem to me more plausible. The first is that the SEC has been captured by the members of its staff, who have an interest in increasing the value of their specialized knowledge by advocating ever-more pervasive and irrational regulation. The more pervasive their control, the more potential employees their activities will impinge on; and the more irrational their requirements, the less likely the regulations will be understood by outsiders. My second hypothesis is that the SEC was created to foster and maintain two important myths of contemporary society: that the Depression was caused by structural flaws of the private sector and that those flaws have not been corrected. The gradual erosion of those myths seems to explain why serious criticism of the SEC such as that offered by Kripke is now more widely entertained, discussed, and considered.

"The theory behind the formation of the SEC and other administrative agencies," writes Kripke, "was that a cross-disciplinary expertise in all the relevant fields of learning would permit more efficient government than that provided through the old separation of legislative, executive, and judicial powers." Kripke notes that "[i]t is well-known that . . . the hopes of the New Deal

---

* See Kripke at 32-36.
* See id. at 33, 35.
* See, e.g., M. Friedman & A. Schwartz, A Monetary History of the United States 299-419 (1963) (exhaustively documenting the central role of Federal Reserve Board actions in exacerbating the Great Depression).
* Kripke at 62.
have been disappointed," but he is not about to give up, for he has found the appropriate field for the SEC: financial economics.

Although the SEC has always been dominated by lawyer-commissioners and lawyers on the staff, the most stimulating insights into the operations of the securities markets in the last twenty-five years have come from specialists in finance and academic accountants. Nevertheless, their empirical research is reported less in English than in mathematics, with only occasional translations of the implications into everyday speech. . . . It is . . . desirable that a lawyer familiar with SEC language and modes of thought should point out the implications of the research and thinking from other disciplines.11

For a practitioner, the most valuable aspect of this book is Kripke's effort to extract from this specialized literature lessons relevant to the regulatory policy issues the SEC decides. It is likely that the style of argument that Kripke uses—analysis of the impact of policy alternatives on the efficiency of securities markets—will become increasingly common in the decade ahead. In this respect, securities practice will be catching up with many other fields of law in which this type of argument has become more common. The practitioner who, persuaded by Kripke's analysis of a wide range of issues of securities law from the standpoint of financial economics, wishes to enhance his ability to use the economic material, should not stop with Kripke's book. He should go on to the texts,12 and perhaps from there into the literature13 of financial economics itself. For the literature contains a rich body of theoretical and empirical material that advocates can deploy on different sides of many issues.

There is one central theme of the literature that Kripke exploits with great skill and persuasiveness: the unlikelihood that pervasive disclosure of the attributes of a firm can significantly benefit anyone. The development and empirical confirmation of the efficient-market hypothesis,14 with its important corollary that,

10 Id. at 63.
11 Id. at xv.
13 The texts contain extensive references to the original literature.
14 See Kripke at 100-03.
for most investors, the market price is the best indication of the value of a stock.\textsuperscript{15} devestates the model of the securities-purchase decision implicit in most SEC disclosure regulations.\textsuperscript{16} Even more telling, the research indicates that much of the informational content of the SEC-required disclosures is impounded in the market price before the disclosures are made.\textsuperscript{17} Once one decides that SEC disclosures are not central to the operation of securities markets, choices between requiring more detailed and more widely disseminated disclosure on the one hand and saving the costs of that disclosure on the other are quickly and easily decided in favor of saving costs. Kripke’s most compelling element on the agenda for reform is that the SEC reduce the amount and detail of required disclosure, since the disclosure is costly and there is no reason to think that information is of any practical benefit.\textsuperscript{18}

But Kripke does not stop there, for he has a grander vision. Kripke suggests that the SEC should reform his first love, accounting. Armed with the insights of the new literature, the SEC should lead the way toward more useful and meaningful accounting standards. The animating vision is that accounting should turn away from antique concepts of recording the historic acts of stewardship\textsuperscript{19} and turn instead toward meeting the needs of the modern investor by providing meaningful information as to the real value of the corporation.\textsuperscript{20} The stereotype of the green-eyeshade accountant is transformed into that of the all-knowing seer who provides the market with the information it needs to be efficient. Ironically, Kripke would assign the role of leading, indeed mandating, this revolution—designed to overcome the timid and vested interests of the accounting profession\textsuperscript{21}—to the SEC itself.

Kripke has so much intellectual difficulty with this vision, as he candidly and charmingly reveals, that he concludes with a quite

\textsuperscript{15} Id. at 104-05.
\textsuperscript{16} One example of regulation based on the assumption that all investors want to value their securities independently is the requirement that copies of the prospectus must be delivered to all purchasers. See 15 U.S.C. § 77e(b)(2) (1976). See also 17 C.F.R. §§ 230.153-153a, 230.174 (1979).
\textsuperscript{17} See Kripke at 97-98. See also P. Foster, supra note 12, at 361 (“Much of the market’s reaction to accounting earnings is anticipating; more timely information sources than the earnings announcement are used in the security price revaluation process.”).
\textsuperscript{18} See Kripke at 117-33.
\textsuperscript{19} Id. at 145-48, 166.
\textsuperscript{20} Id. at 190.
\textsuperscript{21} See id. at 153-54. Kripke recognizes the irony of his position in light of his general disapproval of the SEC’s performance in the field of disclosure. Id. at 157.
unassuming proposal: firms should supplement traditional accounting statements with additional statements disclosing future-oriented and value-related information such as earnings projections and asset-value changes. Thus, operatively, Kripke’s reform agenda becomes one of adding to accounting procedures (and to their costs) marginal information of an explicitly value-related and future-oriented nature.

Kripke never rigorously lays out the logic of his animating vision. In spite of a curious and inexplicable section that relies on a long, naïve quotation from Adolph Berle to the effect that securities markets have no effect on allocational efficiency, and his own conclusion that “[t]he SEC’s potential for having an influence is primarily with respect to public equity issues for new money, a very small portion of the total process of resource allocation,” Kripke appears to believe that the SEC could reform accounting standards to improve the efficiency of securities markets. Since improving efficiency means improving the correspondence between market prices and real economic value, Kripke also appears to suggest that accounting standards should be reformed to reveal economic values more accurately.

At this point, Kripke has cast himself into an area of finance economics and the theory of information that is beset by paradox and confusion. How can the efficiency of the markets be improved if the research shows that the markets already are efficient? Kripke’s answer is that “[a] strong case can be made for the uniformity on the basis—apart from theoretical correctness—of understandability, compatibility, and economy of use.” Since the issue involved in the dispute over regulation is not whether, but how much uniformity is desirable, this response is a non-answer. I would respond instead that the efficient-market hypothesis, as confirmed by research, states not that the market makes no errors, but that its errors are randomly distributed. I would identify the objective of accounting as the reduction of the amount of this random error in market prices, and thus the improvement of the correspondence between actual market prices and the Pareto standard of efficiency. The modern literature on property rights has demon-

22 See, e.g., id. at 165.
23 Id. at 134-39.
24 Id. at 137-39 (quoting Berle, Modern Functions of the Corporate System, 62 COLUM. L. REV. 433, 445-47 (1962)).
25 Kripke at 139.
26 Id. at 164.
strated that in a world where transaction costs are not zero, the optimum assignment of rights and duties can increase social welfare.\textsuperscript{27} I could thus restate Kripke's argument in more cogent terms by asserting that the appropriate assignment of duties to accountants can increase social welfare.

Yet the finance literature fails to provide guidance. The efficient-market hypothesis contains an inherent paradox: if the market price already impounds the best information on value available,\textsuperscript{28} then how does it pay anyone to invest in acquiring that information? But if it doesn't pay anyone to invest in acquiring that information, then how is the information transmitted to the market so that the price is efficient?\textsuperscript{29} The literature on the theory of information has undertaken some initial and promising attempts to explore this paradox,\textsuperscript{30} and it is likely that ten years from now these processes will be better understood. Since Kripke has no implicit model of market efficiency, he has no guides as to how accounting can be more or less efficient. Kripke reports that he has sampled the economics of information and has learned little from it. "Frankly, I think that this discipline suffers because the authors do not know what they are talking about."\textsuperscript{31} A more accurate observation would be that although the authors know what they are talking about, the puzzles have yet to be solved.

Kripke does not confront those studies that present the most serious challenge to his approach, studies that show that accounting conventions do not affect market-price valuation of companies.\textsuperscript{32} For instance, Shyam Sunder has shown that the shift from LIFO to FIFO inventory accounting raises rather than lowers the market's evaluation of companies, even though it lowers accounting earnings.\textsuperscript{33} If the market is efficient either way, what difference do the accounting conventions make? Why is not accounting like

\textsuperscript{27} See, e.g., R. Coase, The Problem of Social Cost, 3 J. L. & Econ. 1 (1960).
\textsuperscript{28} See text and note at note 17 supra.
\textsuperscript{29} See Kripke at 106.
\textsuperscript{31} Kripke at 118.
\textsuperscript{32} See, e.g., P. Foster, supra note 12, at 352-59.
\textsuperscript{33} The increase in value is due to deferred taxation. See Sunder, Relationship Between Accounting Changes and Stock Prices: Problems of Measurement and Some Empirical Evidence, in Empirical Research in Accounting: Selected Studies 27 (1973); Sunder, Stock Price and Risk Related to Accounting Changes in Inventory Valuation, 50 Accounting Rev. 305, 305 (1975).
language, with which it shares the important feature that its symbols must have shared meaning?

Both language and accounting conventions must change to adapt to new realities. We do not have a system for legally mandating the meaning of words, with fraud penalties imposed on those who use words in a nonofficial sense. This permits new usages to appear and compete in the communications marketplace. Kripke does not consider the possibility that the conservative bias of accounting has been strengthened by regulation, and that it will be still further strengthened by more activist SEC intervention. Nor does he explain how economically useful accounting conventions are to be developed and proven in a market where deviation from the prescribed norm is penalized. A regulatory solution would be to increase the range of options available to companies (not their accountants) in the selection of accounting principles. Kripke's emphasis on the value of uniformity keeps him from considering this approach. Kripke has no sense that the SEC's delegation of accounting standards to the accounting profession, which he repeatedly deplores, is one device for preserving adaptive flexibility in a system biased toward harmful rigidity.

Kripke argues for modification of accounting conventions in the same "let's decide on the right rule" spirit so common to modern advocates of legal reform; he devotes insufficient attention to the costs of the changes he proposes. Existing accounting conventions have generated large investments on both the producer side and the user side. Companies and their accountants have invested in personnel training and in systems to collect and retain the information in the form required. Users and their agents have invested time and resources in acquiring the skill to interpret the information thus provided. Any change in the conventions imposes costs on both the producer and the user, and thus carries a heavy burden of justification. New words are not lightly adopted in such an expensive language.

Consider, for instance, the subject of disclosure of earnings projections. One of Kripke's most effective rhetorical themes is his criticism of the SEC for suppressing disclosure of earnings projections. Such suppression provides an ideal opportunity for twitting the SEC, since it seems to cast the Commission in the role of suppressing, rather than disseminating information. But does that

---

34 See, e.g., Kripke at 150, 151, 153, 155.
35 See, e.g., id. at 147.
mean that the information contained in earnings projections never reaches the market? The finance literature strongly indicates that it does, either through the buy-and-sell decisions of management itself, or through intermediaries who learn of the projections orally from management or who reconstruct them from other data. If earnings projections appear in disclosure documents, the literature suggests that management and professional intermediaries would beat the user of the documentary information to the market. Even though the SEC's suppression of earnings projections places it in an unflattering perspective, there seems little to be gained by adding to the length and complexity of the disclosure document.

The intellectual thrust and power of Kripke's positions are undercut by a fundamental reverence for authorities, even when they conflict. He reports without rebuttal that "professors Gonedes and Dopuch assert that no structure of accounting is theoretically more warranted than an other," but argues that since "the FASB and the SEC believe otherwise . . . it is worthwhile to try to influence their views." This is a non sequitur of the first order. If there is no right case, then there are only two intellectually rigorous positions: either the SEC should leave its requirements intact so as to avoid the costs of change, or its should reduce its involvement in the prescribing of requirements. At one point Kripke appears to adopt the position that the SEC serves no useful function, but he abandons it throughout the rest of the book without explanation. Is that because the SEC and Congress believe otherwise?

36 Id. at 164.
37 Id. at 117-33.