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**Regulation and accounting practice: An evaluation of the
efficacy of SEC mandatory reporting requirements**

Okcabol, Fahrettin, Ph.D.

City University of New York, 1989

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A

REGULATION AND ACCOUNTING
PRACTICE:
AN EVALUATION OF THE EFFICACY OF
SEC MANDATORY REPORTING REQUIREMENTS

by

Fahrettin Okcabol

A dissertation submitted to the Graduate Faculty in
Business in partial fulfillment of the requirements
for the degree of Doctor of Philosophy, The City
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1989

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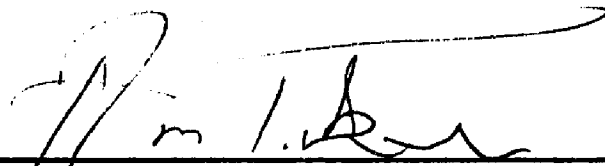
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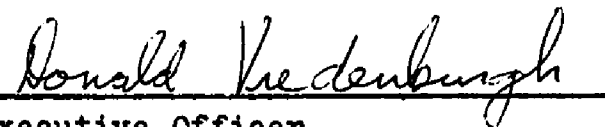
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ABSTRACT

REGULATION AND ACCOUNTING
PRACTICE:
AN EVALUATION OF THE EFFICACY OF
SEC MANDATORY REPORTING REQUIREMENTS

by
Fahrettin Okcabol

Adviser: Professor Tony Tinker

State regulation of capital markets in the US and the UK climaxed soon after WWII; thereafter, this "contested terrain" has been the site of a series of intense conflicts and struggles over the form and extent of regulation. Leading academic protagonists include George Benston and the Nobel Laureate George Stigler; both provided an intellectual spur for dismantling the apparatus regulating national capital markets. In essence, these theorists support market processes and oppose using the state's bureaucracy as a means of regulation. This thesis surveys literature that critically appraises Benston and Stigler's work and provides an empirical test of a number of hypotheses derivative of their work. Using evidence from court filings and other sources heretofore unexamined in the accounting literature,

this study shows significantly high levels of security law violations among firms currently exempt from SEC filing requirements; particularly where there is high information asymmetry between stockholders and management, and where management are subject to profit pressures. The thesis concludes that, in circumstances where Stigler and Benston's assumptions fail to hold, market processes are ineffective in preventing securities law violations.

To my parents, my brother, and my sister

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I have been fortunate during my whole educational life. I have received so much support that venturing into higher education has seemed almost riskless. Because of this, I am deeply indebted to many people and I would like to acknowledge a few here.

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INTRODUCTION

In a much quoted article, George Stigler (1964a, 1964b) questioned the necessity for any mandatory corporate disclosure system, and thereby inaugurated the most serious wave of academic criticism to be directed at the SEC's mandatory corporate disclosure system in the last 30 years.¹ Stigler, and subsequently Benston (1967, 1969a, 1969b, 1973, 1979-80, 1982a, 1982b) Manne (1966) and Merino and Neimark (1982) contended that the financial disclosure requirements mandated by the 1934 Securities Act had little relevance to dealing with the stock market crises of the period; that it was the regulation of security dealings in the 1933 Act (not the 1934 financial disclosure provisions) that should be credited with addressing the problems.

The above research has prompted considerable controversy in the accounting literature and more recently, the criticisms have begun to effect securities regulation.² For accountants, and important corollary of the criticisms is the proposition that SEC may safely deregulate financial disclosure without any deleterious consequences for capital market efficiency.

The SEC's Advisory Committee on Corporate Disclosure responded to Stigler and Benston's work by issuing a report in 1977 that largely rejected their criticisms of the mandatory corporate disclosure system. It concluded that disclosure system

established by Congress in the Securities Act of 1933 and the Securities Exchange Act of 1934, as implemented and developed by the Securities and Exchange Commission since its creation in 1934, "is sound and does not need radical reform or renovation."

Despite the SEC's 1977 Advisory Committee Report, criticism of mandatory financial disclosure has been renewed in works published by Kripke (1979), Phillips and Zecher (1981) Karmel³ (1982) Wolfson (1981) Scott (1980) and Jarrell (1981).

Moreover, since the publication of the 1977 Advisory Committee Report, Congress and the SEC have significantly broadened the small-issue exemptions under the 1933 Securities Act and have opposed attempts to extend the regulatory apparatus to other parts⁴ of the securities markets. While special circumstances were at work in each of these legislative cases, the widespread criticism of the SEC's mandatory corporate disclosure system during the last twenty years has probably diminished the political support for compulsory disclosure.

Developments in financial theory--particularly the efficient market hypothesis, portfolio theory, agency theory, and the theory of the firm--have provided additional academic stimulus for criticizing the SEC's mandatory disclosure system (Sharpe, 1970; Jensen and Meckling, 1976; Kripke 1979; Ross, 1979; Fama, 1980; Foster, 1980; Beaver, 1981; Dhaliwal, 1978).

This research contends that these critics have failed to account for historical evidence that led to the installation of

the mandatory corporate disclosure system. It argues that the interpretation of the historical record offered by Benston and Stigler is open to dispute and requires further empirical investigation. Additionally, it argues that because they overstate the distinction between securities regulation and disclosure regulation, their search for the benefits of compulsory disclosure was conceived too narrowly. That is, Benston and Stigler give insufficient accord to the fact that the obligation to maintain "proper books of account" and a system of internal control system that are critically reviewed by an independent auditor, imparts an integrity to corporate practices that extend beyond the financial statements that were primarily the subject of their empirical search. Thus Securities fraud, excessive underwriters' commissions, profiting from insider trading, and falling public confidence in the securities markets, were major factors in persuading Congress in 1933, 1934, and 1964 to create the legislative basis for the present mandatory corporate disclosure system.

Seligman (1983) posits that, in the absence of mandatory corporate disclosure systems, one or more of the following may ensue: First, some issuers of new securities will conceal or misrepresent information material to investment decisions; Second, underwriting costs and insider trading abuses will be excessive; Third, "public confidence" in the markets will decline leading to a higher cost of capital and a slowdown in economic growth; Fourth, neither state laws nor private

associations such as the FASB or the NYSE can ensure the optimal level of corporate disclosure; Fifth, civil or criminal actions will not ensure optimal levels of corporate disclosure.⁵ It is the aim of the empirical portion of the proposed study comment on the validity and status of the above five propositions.

The next section provides a review of the literature concerning mandatory corporate disclosure; this is followed by a summary of the principle hypothesis for investigation and an outline of the empirical model and data sources consulted to obtain data. The last section provides the result of the empirical study and some concluding remarks.

LITERATURE REVIEW:

CONTROVERSIES OVER THE NEED FOR A MANDATORY DISCLOSURE SYSTEM

The literature pertinent to assessing the validity of mandatory disclosure is voluminous and interrelated in a complex of ways. This complexity is simplified here by concentrating initially on the work of two of the most influential critics of mandatory disclosure (Stigler and Benston). Other perspectives are either subsumed into the discussions of Stigler and Benston's research, or are dealt with subsequently in a subsection dealing with extensions and complements to their work (including Signaling and Agency Theories). This design simplifies the line of argument without doing too much violence to the interconnections between the various theoretical perspectives.

1. STIGLER'S CRITIQUE

Stigler's 1964a study claims to show empirically that the 1933 Securities Act's new issue registration requirements "had no important effect on the quality of new securities sold to the public." He does this by examining how well investors fared before and after the SEC was empowered to regulate new issues. He compares the price history of all new industrial stocks, with a value exceeding \$2.5 million, introduced in the 1923-1928 period, with all new industrial stocks with a value exceeding \$5 million introduced in the 1949-1955 period. To allow for the effects of general market conditions, Stigler measured stock

prices relative to market averages.

In comparing the pre-SEC (1923-1928) period to the post-SEC (1949-1955) period, Stigler examined changes in two metrics of investor "well-offness": First, changes in the variance of the new issues relative to the variance of the overall market, where he assumed that if mandatory disclosure causes an early release of high quality accounting information (with good predictive value) then fewer surprises (and variance) in will be exhibited in post-issue price behavior.⁷ Second, changes in the new issue price relative to the market average, where he hypothesizes that, if disclosure requirements improved the quality of information, they would diminish security risk and, ceterus paribus, would raise the value of the average issue (and thus its price) relative to the average price in the secondary market.

Stigler's findings were, in fact, contrary to his theoretical priors: the variance of price ratios declined after the empowerment of the SEC. Stigler dismissed these results claiming that it was the result of SEC exclusion of risky companies rather than the benefits of disclosure (Stigler, 1964a).

Friend and Herman (1964), posit a counter-explanation of Stigler's data: "[w]ith full disclosure we would expect less drastic shifts in estimates of expected profitability of a given issue as a result of the greater initial level of economic information and, presumably, the reduction in the possibility of surprises from this source..." That fewer "risky" issues were

floated in the post-SEC period, Friend and Herman urged, "was a result of improved disclosure of the degree of risk and a consequent greater reluctance by investors to buy risky new issues." ⁸

†

Unfortunately, Stigler's research design suffered from some serious drawbacks. He did not control for differences between the two portfolio's degree of sensitivity to overall market price changes (the beta co-efficient). (A matched-pairs design would have rectified this, see Jarrell, 1981; Loss, 1961; Smith, 1981). Additionally, Stigler ignored dividend income and thus securities with a higher dividend payout ratio would, ceterus paribus, reveal a smaller long-term price appreciation than securities with a lower payout ratio. Thus, Stigler's findings could be attributed to these measurement errors rather than the empowerment of SEC to establishment mandatory disclosure requirements.

In addition to the deficiencies in Stigler's study design, there were a large number of computational errors which Stigler has subsequently acknowledged (Friend and Herman, 1964, 1965; Mendelson, 1978). There is a more serious difficulty with his study however: Stigler's conclusions are not supported by his results. Friend and Herman (1964) corrected the Nobel Laureate's calculational errors and found that, on average, common stock prices relative to the market in each of the five years after issue from the 1949-1955 period were superior to the comparable results from the 1923-1928 period. Stigler confirmed this

finding for four of the five post-SEC years (Stigler, 1964b). The directional changes in some of the post-SEC years were not always statistically significant, however the corrected results do suggest that mandatory disclosure for new issues had improved price performance.

2. BENSTON'S CRITIQUE

Benston (1967, 1969a, 1969b, 1973, 1979-80, 1982a, 1982b) has questioned the efficacy of the continuous disclosure requirements of the 1934 Securities Exchange Act. Benston's indictment of mandatory disclosure can be summarized under four headings: (1) that the evidence of fraudulent financial statements or misrepresentation prior to the Securities Acts is non-existent; (2) that adequate voluntary disclosure existed prior to 1933; (3) that the compulsory disclosure requirements of the acts were neither material nor timely, and (4) that adequate investor protection exists in competitive markets.

Benston's work is particularly significant in the corporate disclosure debate: it is an ambitious and wide-ranging exegesis involving a variety of arguments concerning the 1934 Act's disclosure provisions; additionally, several other eminent accounting scholars have relied on his findings (Beaver, 1981; Stan, 1977; Gonedes and Dopuch, 1974).

Generalizing from several of his writings Benston's major propositions are examined below:

a) Absence of Fraud and Misrepresentation

Benston contends that there was little evidence of fraud or misrepresentation in corporate financial statements before 1933 and concludes therefore, that the introduction of compulsory disclosure was unnecessary. Benston (1969a) observes:

It is difficult to believe that there was no deliberate misrepresentation in financial statements prepared by public accountants, given the existence of larceny among other (though lesser) men. However, a search of the available literature in several libraries revealed only anecdotal reports of fraudulent or misrepresentative accounting....

A thorough review of the United States court records to about 1929 by David L. Dodd lists almost 300 cases that are in some way related to watered stock. But most of the cases deal with non-fraudulent differences of opinion about the value of property....

Thus, the need for the financial disclosure requirements that are the "heart" of the Securities Act of 1933 appear to have had their genesis in the general folklore of turn-of-the-century finance rather than in the events of the 1920's that preceded the legislation, insofar as fraud and misrepresentation are concerned.

The qualifications in the above quotation caution us before accepting Benston's conclusion that there was little fraud or misrepresentation before 1933 (and ergo, there was little that needed to be remedied through disclosure regulation). Benston's "literature search" is explicitly directed at "deliberate misrepresentation in financial statements," and "fraudulent financial statements." That he found little evidence of fraud is not surprising. The Ultramares rule imposed severe qualifying restrictions on parties who were seeking legal redress as a result of losses due to fraud in financial statements.

Most important however is the issue of "external validity" of Benston's choice of data variable in his study. Ultimately, Benston aims to comment on the appropriateness of mandatory financial disclosure, and he seeks to do this by comparing conditions in the pre-SEC and post-SEC eras. Ideally, we should assess the contribution of the accounting "regime" in each era to capital market efficiency. Clearly measures of "capital market efficiency" are not easy to come by, and thus Benston chooses a data variable surrogate of the level of "fraud in financial statements" in the pre-SEC and post-SEC epoch.

The frequency of fraud in financial statements can hardly be said to "sum-up" the effect on capital market efficiency of mandatory disclosure provisions. Such a measure ignores fraud by omission (rather than by misrepresentation) and insider trading frauds committed on the basis of undisclosed material information. These were two types of fraud that, according to Seligman (1989) were much more prevalent in the post-World War II period than fraud by express misrepresentation. Similarly, by restricting his search to instances of fraud in financial statements, Benston apparently did not search for instances of fraud in the textual portions of prospectuses or shareholder reports. In order to generalize about the overall desirability of mandated disclosure, Benston needs to incorporate as set of data measures that more comprehensively reflects the impact on capital market efficiency.

The incompleteness of Benston's choice of surrogate

variables is further underscored by some of the glaring oversights in his literature search. While he claims to rely on "the available literature in several libraries," no mention is made of the extensive security legislation at the state level in the years preceeding the Securities Acts (it was the mail frauds that circumvented state legislation that, in part, impelled the passing of the 1933-34 legislation); to the House Hearings that preceded the 1933 Securities Act; or to the World War I Capital Issues Committee, which was the United States government's one earlier economy-wide securities regulation program.

Other citations by Benston also need to be interpreted with caution. For instance, he relies on "...a comprehensive study of the legal responsibilities of accountants, published in 1935 [by] Wiley D. Rich [i.e. In which the latter] stated that, 'An extensive search has revealed not a single American case in which a public accountant has been held liable in a criminal suit for fraud'" (Benston, 1969a, p.518; Seligman, 1983). This is a misleading conclusion however because, before 1933, civil rather than criminal lawsuits were much more likely in cases of securities fraud. Benston's writings show that he clearly appreciated this distinction and was well aware that civil actions against corporations or their promoters for fraud or unfairness were commonplace prior to 1933.

b) The Adequacy of Voluntary Disclosure Prior to 1933

Benston's second contention is that adequate corporate

disclosures existed before the 1934 Act became effective. He studied the 1934 financial accounting information disclosed by 508 companies listed on the NYSE in June 1935, the month before filing was required under the 1934 Act (Benston, 1969a). All firms provided a balance sheet and listed current assets and liabilities. Sixty-two percent of the firms published sales figures; 54 percent published the cost of goods sold; 93 percent published depreciation; and 99.6 percent published net income. By comparing the percentage of firms making voluntarily disclosures in 1934 with the percentage making comparable disclosures for the 1926 to 1933 period, he concluded that the percentage of firms listed on the NYSE making voluntary disclosures had risen (e.g., companies reporting sales rose from 55% to 62% during this period).

Benston's study was subject to a number of sample selection biases that restrict any conclusions that may be drawn from the research. Firms not listed on the NYSE were ignored by Benston, yet, in the period before the 1934 Act became effective, corporations listed on the New York Stock Exchange could avoid the NYSE's relatively stringent standards by delisting and seeking a quotation on another exchange or on the over-the-counter market. Thus, Benston's sample was restricted to firms which voluntarily observed the most stringent disclosure standards of the day. Excluded were all comparably-sized firms that had chosen to avoid observing these standards by trading
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elsewhere.

Furthermore, sample selection bias was operative in focusing on 1934 financial statements. By that time, some firms were beginning to follow the new disclosure requirements and thus, not all data disclosed by these firms can be regarded as "voluntary".

Finally, there is a great disparity between the primitive financial disclosure that Benston observed (sales data, depreciation data, etc.) and the kind of disclosure that would be adequate to "reduce the incidence of fraud, self-dealing and poor performance by managers." (Benston, 1976a,1976b). His study is silent on whether corporate managers voluntarily would disclose interested transactions, insider trading, executive perquisites, or, indeed, any information material to investors other than the few primitive accounting categories listed. Moreover, the results of this study, if anything, support the need for a compulsory disclosure system. The fact that only 62 percent of the firms were observing the most stringent voluntary disclosure standards for publishing sales data raises some questions about whether sufficient information would be voluntarily disclosed by even the most responsible firms.

c) Compulsory Disclosure is Neither Material nor Timely

The materiality and timeliness of disclosures compelled by the Securities Acts were examined in two ways by in Benston's research. First, after examining financial reports in the post-SEC period, he concluded that much of what was revealed was already publically available, and thus lacked information

content.

This conclusion has been challenged on two grounds: First: tests undertaken in subsequent studies (Friend and Westerfield, 1974; Friend, 1976; Beaver, 1968; May, 1971; Martin, 1971; Foster, 1978), have found that data in SEC disclosures did contain new information, and both Benston's study design and his interpretation of the results of this test have been subjected to considerable criticism. Second, even if SEC disclosure documents contained no new information, this would not prove that the requirements were valueless because they could still have had the affect of prompting an earlier disclosure (in press handouts, for instance).¹¹ It is irrelevant whether the Securities Acts induce disclosure in the financials or by other means, as long as it occurs.¹²

The second grounds for Benston's conclusions that disclosure promoted by the Acts were neither timely nor material was based on a study of, "a reduction in the variance of returns" for a sample of securities traded on the NYSE (Benston, 1973). If a reduction in variance was confirmed, the findings from this test would be of considerable consequence because they would suggest that the 1934 Act did not compel the disclosure of new information material to investors.

The results of this test do not support Benston's conclusion however. The 1934 Act required the publication of sales data; thus Benston compared the results before and after the Act's

passing for two samples of firms: one that disclosed sales data, and one that did not. For each sample, Benston computed various measures of relative value and portfolio risk. His sample included 290 "disclosure" companies and 176 "non-disclosure" companies listed on the NYSE before and after the passing of the Act. Benston reasoned that, if the legislation increased information value, the increased disclosure by the "non-disclosure" firms should have produced a greater improvement in the ability of investors to estimate the risk or value compared with the ability of investors to make such estimates for "disclosure" firms.

Benston's researches revealed that, in a 90 month period after the 1934 Act began to operate, there were no significant differences between "disclosure" and "nondisclosure" firms for various estimates of risk and value. Thus, Benston surmised that the 1934 Act's compulsion of sales data reporting "did not contribute to a reduction in the variance of returns from securities traded on the New York Stock Exchange ... and the standard deviation of the the residual on the securities."

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(Benston, 1973, p. 149).

In reviewing Benston's data, Friend and Westerfield (1974) found that, "the residuals from the market model in this second set of tests ... seem to indicate that both disclosure and non-disclosure firms performed better in the post-SEC than in the pre-SEC periods in the sense that residual risks were reduced for both groups of firms." (Benston, 1974). This result suggests

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that, if we consider all the data required by the 1934 Act, compulsory disclosure benefited investors by allowing them to more accurately estimate risk. This finding has been confirmed in other studies (Friend, 1972; Deakin, 1976).

d. Investors are Adequately Protected by Competitive Markets

Benston hypothesizes that management's abuse of its fiduciary responsibilities is restricted by the competitive environment. He identifies three markets that constrain managerial discretion: the market for the firm's final goods and services; the market for financial resources and corporate control, and the market for managerial services.

Market forces are augmented by the disciplining influence of internal and external monitoring systems (Benston, 1982a, 1982b). Benston posits that if corporate managers did not voluntarily provide material financial information, "a stockholder or potential investor ... is free to purchase it in the market much as other goods are purchased" (Benston, 1969a, p.516).¹⁴

Benston suggests that shareholders could exercise their rights of access in one of two ways: "Large shareholders generally have the right and small shareholders have some right to examine the books of corporations in which they own stock" (Op. Cit., p.516). But, as others have noted, it is not the case that either large or small shareholders have unlimited rights to inspect (Cary and Eisenberg, 1980 pp. 344-53).

Additionally, Benston asserts, "One would expect information-gathering services to spring up, if the economics of scale in gathering financial information result in saving that exceed the value to individual investors from not sharing information with others" (Benston, 1969a, p. 516; 1980, p. 60). But as Seligman (1983, p.15) has noted, it is hard to take this argument seriously. Moody's Investors Services and other financial information-gathering organizations were well established before the 1933 and 1934 Acts were adopted (TWENTIETH CENTURY FUND, THE SECURITY MARKETS, 1935, pp.610-15). The failure of these organizations to secure voluntary disclosure by American firms is evident from the pre-1933 publications of organizations such as Moody's, or by reviewing the post-1933 disclosure practices of firms not subject to the SEC mandatory corporate disclosure system. Neither examination sustains Benston's assertion that a free market in information makes adequate provision for the needs of stockholders or potential investors.

Regarding the discipline imposed on management by product market competition, Benston asserts that customers will not pay prices that are inflated by management appropriations when alternative products at lower prices are available. Additionally, managers who squander shareholder's funds (or who are otherwise inept) will be penalized, either when they attempt to raise new investment funds, or by attracting takeover bidders who feel that they can make more efficient use of the firm's

assets. The market for managerial services provides further restraint on misappropriations and ineptness because (it is argued) managers' long-run remuneration will depend on the adequacy of their "track records" (Ross, 1979). Although, as Pratt and Zeckhauser (1984) argue, if we assume management are rational economic actors and maximize expected values, they are unlikely to be deterred from self-aggrandizement because likelihood of getting caught (and thus the expected value of penalties for misdeeds) are minuscule (ibid., p.12).

Internal and external information systems reinforce the monitoring of management misbehavior at all levels in the organization according to Benston (op. cit.). Fama (1980) contends that the impact of such systems has been underestimated. He argues that: First, it is easy for shareholders whose management are acting dysfunctionally to dispose of their holdings and invest elsewhere rather than try to change the management; Second, that management have the greatest stake in effective monitoring systems because a manager's success and rewards depends on the performance of that person's peers, superiors and subordinates. Consequently, each manager's self-interest is best served if the performance of other managers is efficiently monitored. Perforce, mandatory regulation is regarded as an unnecessary interference; managerial self-interest is can be relied-on to instigate the optimal monitoring system for each case (something that a general fiat cannot possibly accomplish).

3. SIGNALING, AGENCY, AND RELATED PERSPECTIVES

Benston and Stigler's research on mandatory corporate disclosure has been paralleled by studies reported in the agency and signalling literature. These approaches share a twofold recognition that, first, "...the separation of ownership and control is the central feature of the modern corporation" (Ross, 1979, p.183), and second, that market pressures on management will (nevertheless) motivate management to disclose all or virtually all information that is material to investors.

a) Signaling Theory

Ross (1979) observes that, "in a competitive market (with no mandated disclosure) the managers of firms ... will have a strong self-interest in disclosing relevant information ..." (Ross, 1979, p. 184-85). Despite the separation of management and control, Ross posits that:

The economic fortunes of the management depend on those of the corporation....the performance of the company is affected by the actions of the management and serves as a measure of how well the members have performed. Compensation geared to firm performance, therefore serves as an incentive for managerial performance. Managerial compensation does not have to be tied directly by some specific formula to the earnings or overall performance of the firm. The effect of managerial activities on firm performance will still link the fortunes of the managers with those of the firm: If the firm does poorly, management will be thought to bear some responsibility, and the demand for services will be less. Conversely, if the firm prospers, management will share some of the credit, and the competitive market will drive their wages up" (Ross, 1979, p. 183-84).

Management compensation is regulated by labor market forces for Ross (Ross, 1979, p.184). Compensation, is all-inclusive in this view and includes compensation in the form of profits from insider trading: "Stockholders will not permit a \$100,000 a-year manager to have the freedom to trade in the firm for his own account and make million-dollar gains ... [s]uch activities would be a form of overcompensating managers for the services they supply....stockholders...will enter into contracts that penalize such activities." (Ross, 1979, p.184).

Ross's incentive-signaling theory explains how and why managers would be interested in voluntary disclosure. It would be in the interest of managers with good news to disclose it because it would raise the value of the firm and concomitantly, management compensation. "What of the firms whose news is bad or, alternatively, have no news at all. Just as the managers with good information have an incentive to signal this to the market to distinguish their firms from others, those with no information also have an incentive to signal" (Ross, 1979, p.186). That is, firms whose earnings are stable will have incentives to signal "no news" by publishing honest financial reports and maintaining stable dividend levels to avoid being confused with firms with bad news. "Firms with bad news are then left with no recourse. They cannot match the guarantees of the 'good news' and the 'no news' firms; hence they will be evaluated as having received bad news" (Ross, 1979, p.187).

Firm's would be discouraged from publishing false reports

because, to persuade a "wary public" that they are not falsely disseminating good news, managers with genuine "good news" will have to offer guarantees or warranties, such as entering into publicly known performance-related contracts, or hiring outside auditors. Managers of firms with poor news would be unable to match these guarantees or warranties. Thus, Ross asserts:

"In general, there is a hierarchy of firms best to worst, based on the relative change in their values that would occur if their inside information were made public. The incentive-signaling mechanism provides a structure that managers use to disclose their information in such a way that outsiders in the market believe it. Those with the best news distinguish their firms from those with the next best, and so on down the line. At the bottom of the hierarchy are those with the worst news, who would like to suppress it, but since it is not in their interest to offer the kinds of guarantees provided by those with better news, the worst news will also be effectively signaled."

Signaling theory assumes that managers of firms which previously have made disclosures know that failure to publish subsequently will be regarded by the market as a signal that the unpublished data are adverse. This, logically, would create a powerful incentive to disclose, even for firms with "really bad news".

b) Agency Theory

The incentives for voluntary disclosure--indeed, the reasons "why accounting reports would be provided voluntarily to creditors and stockholders, and why auditors would be engaged by management to testify to the accuracy and correctness of such

reports"--are articulated in the agency work of Jensen and Meckling (1976).

Jensen and Meckling argue that the smaller the fraction of a firm's equity owned by its managers, the greater will be their temptation "to appropriate larger amounts of the corporate resources in the form of perquisites." They surmise that a manager who owned 100% of his firm would directly receive all of its benefits; owning any lesser percentage would mean sharing benefits with "outside" shareholders. In circumstances where a manager owns anything less than 100% of the firm, there is an incentive to seek to appropriate the maximum amount of income by way of management compensation (perquisites, salaries, status rewards, etc.) rather than through increases in shareholder wealth that would be shared with the "outside" owners.

What restrains management in this regard are the rational expectations of the equity market. Outside shareholders would assume that management might resort to excessive personal compensation, and the share price would be lower as a result, i.e., the value of the firm's shares would be less than the value of shares in a firm managed entirely by its owner.¹⁵

Rather than suffer this penalty (Jensen and Meckling argue) management will resort to a range of contracting devices to assure shareholders that they are not appropriating the latter's income (op.cit., p.323). Thus:

"through monitoring and other control activities....it

is usually possible to alter the opportunities the owner-manager has for capturing non-pecuniary benefits. These methods include auditing, formal control systems, budget restrictions, and the establishment of incentive compensation systems which serve to more closely identify the manager's interests with those of the outside equity holders, etc.

Both the outside shareholders and the corporate managers have incentives to contract to restrict management compensation. Hence, the outside shareholders would enter into such a contract whenever the increase in the value of the firm exceeds the costs of the monitoring or incentive compensation systems. Similarly, "[t]he manager finds it is in his interest to incur these costs as long as the net increments in his wealth which they generate (by reducing the agency costs and therefore increasing the value of the firm) are more valuable than the perquisites given up." (Jensen and Meckling, 1976, p. 326).

As disclosure of material information would assure shareholders that managers are unable to trade on their own accounts at the expense of outside shareholders or otherwise exploit their fiduciary position, it follows that the monitoring contract between the manager and outside shareholders would provide for the publication of such data.

c) Counters to the Signaling and Agency Critique

Signaling and Agency theories go some way towards explaining why management might be motivated to disclose material information, but as will be shown, when evidence of management practice is examined, a large number of anomalies remain.

Specifically, these theories do not explain the historical incidence of securities fraud and its dramatic increase during certain periods. They do not adequately explain why small firms, not subject to the SEC's mandatory corporate disclosure system, seem to have been responsible for the majority of the fraud cases brought by the SEC (Seligman, 1982, 1983). Finally, these theories fail to account for the prevalence of the "window dressing" of financial statements to obscure "bad news".

Empirical tests of the "strong form" of efficient market hypothesis cast doubt on the proposition that market forces promote sufficient disclosure to deter insider trading and abuse of management's fiduciary responsibilities (Fama, 1970). The results of strong form tests show that corporate insiders and stock exchange specialists benefit because of informational advantages. Several strong form tests have focused on the trading records of corporate officers, directors or owners of 10% or more of a firm's common stock. These tests have a built-in bias against finding significance results because they rely on self-reported data (for trading by friends or relatives of persons required to report for instance). Such under-reporting is likely to bias test results toward findings that no difference exists between trading by corporate insiders and traders who rely on published data.

Despite these methodological shortcomings, Lorie and Niederhoffer (1968) found that "Insiders are superior forecasters of large [price] changes."; Pratt and Devere (1978); Jaffe

(1974); and Finnerty (1976), found that insiders were more successful than non-inside traders. Niederhoffer and Osborne (1966) demonstrated, with a small sample, that Exchange specialists, trading for their own behalf, are profitable over 80 percent of the time. Several studies found that corporate disclosure of line-of-business data permitted investors to make earnings forecasts superior to those which they would have made relying on consolidated data (Collins, 1975, 1976; Collins and Simonds, 1979). Collectively, these studies suggested that unpublished material investment information confers a distinct advantage on those who are privy to it.

Several assumptions underlying the signaling and agency explanations of management's propensity to undertake voluntary disclosure seem implausible. Typically, these theories assume that managers will take decisions concerning disclosure employing a long-term horizon. But as the SEC's 1977 Advisory Committee Report observed:

"Very often there are significant motives for at least temporary concealment of adverse information on the part of corporate executives. Often a sizeable part of management's total compensation, such as benefits from stock options or stock bonus plans, depend upon the price level of the company's securities. Frequently, their direct compensation--salary and bonuses--will depend upon the earnings of the company, thereby providing strong motivation to enlarge artificially the company's earnings. In addition, there is often simply the hope that news will be temporary and thus need not be disclosed."

The promoters of new securities have a similar incentive to conceal adverse material information during the relatively short

floatation period and then sell their interest in the firm.

Agency and signaling theorizing also fail to account for non-financial motivations for suppressing disclosure. Many firms are reluctant to disclose data for fear that will aid their competitors. Balance sheet and income statement data, line-of-business data, and earnings projections have all been cited by businesspeople as revealing potential useful data to competitors (Foster, 1980). If this is the case, then one of the key assumptions of the signaling literature becomes very questionable: non-disclosure cannot be taken by investors to mean "bad news"; non-disclosure might signal that the firm is protecting valuable secrets from competitors rather than hiding poor performance. Thus the meaning of the signal is ambiguous in that investors would have no way of telling whether the news is good or bad. It cannot be assumed that management have an unconditional incentive to disclose, whatever the news.

RESEARCH QUESTIONS AND HYPOTHESES

INTRODUCTION TO RESEARCH PROBLEMATIC

The empirical part of this study focuses on the prevalence of securities law violations by firms exempt from SEC filing requirements. With the level of popular rhetoric denouncing government waste and interference in recent years, it is not always appreciated that the vast majority of US corporations are exempt from the SEC's mandatory reporting requirements (the filing of annual reports). Section 12(g) of the Securities Exchange Act of 1934 (revised on July 8, 1986) exempts firms with assets of less than \$5 million and/or shareholders numbering less than 750 from the Acts filing requirements. Sec.3 and Sec.7 of the Securities Act of 1933 (As in Effect June 4, 1975--Public-No.22-73D Congress) provide a list of exempted securities and required information in registration of new issues if a security is not exempted. In addition, banks, insurance companies, transportation enterprises, and public utilities are exempted from the Acts provisions because they are regulated by other statutes and agencies. Appendix I includes a copy of Section 12(g) of 1934 Securities Act that specifies who is, and who is not, regulated by the SEC reporting requirements and a copy of Sec.3 and 7 of the Securities Act of 1933 for exempted securities and new issue disclosure requirements.

Whether exempt or not from the SEC filing requirements, a corporation may still be prosecuted by the SEC (as well as state authorities) if it makes statements in financial documents that "contravene the regulations of the Commission" (e.g., makes statements that are false and misleading with respect to a material fact, as per Section 12, subsection 1, of the 1934 Securities Act as well as Section 3 and 7 of the Securities Act of 1933). On receipt of a complaint from members of the public, the SEC may prosecute corporations even though the latter may not be required to register financial statements with the SEC (Appendix II is taken from the SEC Annual Report (1985) and describes the sources used by the SEC in identifying violators among non-filing firms.) Thus, all corporations are "regulated" in that they must abide by the SEC rules, notwithstanding the fact that most of them are "unregulated" in the sense that they are exempt from filing or reporting requirements.

Figure 1 shows that, using tax return data (Statistical Abstract of the US, 106th Edition, 1986, page 514-539), less than 1% of all US corporations are required to file with the SEC. The way in which this small number of corporations is "targeted" (defined and selected) for the SEC scrutiny, crucially affects the efficacy with which the SEC forfills its public mandate.

The improvement in "targeting" of corporations for the SEC surveillance (through filing requirements) is the *raison d'être* of this study. By revising and refining the list of "qualifying characteristics" (and exemptions) that define the firms required

to file, this study aims to improve the SEC's productivity relative to its purposes, as laid down in the 1933-34 Securities Acts.

In a nutshell, this research examines the proposition that, by redefining and/or extending the SEC's target group, it is possible to enhance the SEC's effectiveness. Two avenues are proposed for investigating this hypothesis: First, by examining firms that are exempt from the SEC filing requirements ("non-regulated" firms) who are nonetheless violators of the Securities Laws (Securities Act of 1933 and Securities Exchange Act of 1934): Second, to investigate the characteristics of the four major categories of firms in the study (regulated violators, regulated non-violators, unregulated violators, unregulated non-violators) with a view to improving predictions about their propensity to adhere, or violate, the Securities Laws. Having overviewed the research in a preliminary way, we can now proceed to questions about the population, the sample, data availability, etc.

THE POPULATION AND THE SAMPLE

In 1982, 2,926,000 corporations filed corporate tax returns (Statistical Abstract of the US, 106th Edition, 1986, page 517-39, Schedules 874- 897). Schedule 896 (Appendix III) shows the breakdown of these firms by asset size.

As Schedule 896 of Appendix III shows, only 38,000 firms (1.2987%) of all corporate tax filers had assets in excess of \$10 million. The Securities Laws impose an even "tighter" condition requiring a firm to file with the SEC. Figure 1 reveals that, of the 2,926,000 (1982 data) corporations filing tax returns, only 12,450 (0.425%) were required to file with the SEC (Directory of Companies Required to file Annual Reports with the Securities and Exchange Commission under the Exchange Act of 1934, September 30, 1986).

The economic efficiency of the capital markets--especially the effectiveness of the capital raising and accumulation process--is the prime concern of the SEC, according to the Securities Laws (see, for instance, Sec.11.A of the 1934 Act). Schedule 896 of Appendix III permits us to assess the scale of capital-raising by corporations that falls under the scrutiny of the SEC and, more importantly for the purposes of this study, the amount of capital raising that falls outside the SEC's bailiwick.

The schedules in Appendix III show that the total assets of all corporations in 1982 was an estimated \$9,358 billion; of which less than \$760 billion (8%) falls within the SEC jurisdiction for reporting purposes. Thus some \$8,598 billion (92%) is exempt from filing requirement scrutiny. The total assets of all capital raisers (including partnerships and sole traders) was estimated to be \$14,497 billion in 1982, of which an estimated 5% falls within the SEC's reporting requirement mandate.

The previous estimates as to the scope of capital raising activity are rough approximations, intended to provide some perspective of the context within which the SEC "targeting" takes place. They help underscore the importance of ensuring that the SEC's targeting processes are guided by selection criteria (such as minimum cut-offs as to asset size and number of stockholders) that are "efficient" with respect to the transcendent objectives of the agency.

Moody's records are an important data source for the study; Figure 1 places the Moody's list in the context of the larger universe of firms being sampled from. A detailed breakdown of the Moody's 1986 Manual is shown in table 1: it lists 5985 firms, divided into "Industrial," "OTC Industrial," "Public Utility," and "Transportation." The particular value of Moody's records to this work is that it gives information on non-regulated as well as regulated firms.

A sample was taken from Moody's records to estimate the proportion of firms required to register with the SEC (regulated firms) and those not required to register (unregulated firms). This sample was taken, from the Moody's Manuals and the SEC Directory of Firms Required to Register, 1986, and was based on all firm's, listed in the 1986 Moody's Manuals, whose name begins with the letter "A". The details of this sample are presented in Table 1. The sample of "A" firms permit us to estimate that, of the 5985 firms listed in the Moody's manuals in 1986, 4812 are

regulated, and 1173 are unregulated with regard to reporting or filing requirements. These results confirm that the data for non-regulated as well as regulated firms may be obtained from the Moody's manuals.

Figure 1 displays all the Moody's firms (1986) relative to the estimated population of capital raising corporations (1982). The figure divides firms into mutually exclusive subsets. The primary distinction is between firms regulated by the SEC and firms not regulated by the SEC. Within these primary groups are shown two subsets: Moody's firms regulated by the SEC, and the Moody's firms not regulated by the SEC.

THE DEPENDENT VARIABLE

The primary proposition of the research is that a significant level of violation of SEC rules will be found in the non-regulated group in Figure 1. In this regard, three important assumptions require elucidation: First, that "being cited for a violation" is equated with "being a violator" in this study. Second, in using Moody's as a data source, no "Moody's selection bias" is introduced. Third, what constitutes a violation. Each assumption is discussed below.

(a) Adequacy of The Proxy For Identifying Violators

A list of violators is published weekly in the SEC dockets giving the names of the firms that violate the Securities Laws. They also provide information about each type of violation.

(These records are filed by the SEC in Washington). Being cited by the SEC for violating the Securities Laws is taken as a proxy for actually being a violator in this study.

The representativeness of a data variable proxy--its internal validity--is measured by its correlation with the conceptual variable it stands-in for (Kirlinger, 1973; Firestone and Chadwick, 1975). In general such evidence is typically difficult to obtain as a data variable is usually the only means for observing its conceptual variable.

In this study, some indirect evidence is provided as to relationship between the proxy of "being cited" and the conceptual variable of "being a violator." The General Counsel represented the Commission in 289 litigation matters during 1985. During this fiscal year, 47 Court of Appeals and Supreme Court cases were concluded, all but 4 favorably to the Commission. There were 37 appeals to the Supreme Court and Federal courts of cases in which a party subject to a Commission injunctive action challenged the lower court's decision. Of the 18 appeals that have been concluded, only 2 outcomes were unfavorable to the Commission. The foregoing compares with 1984's when there were a total of 276 injunctions, of which 42 were appealed, 19 of which have been settled to-date, with only 2 outcomes unfavorable to the Commission (SEC's 51st Annual Report, 1985).

(b) **Moody's Selection Bias**

In the empirical study, a list of violator firms are

obtained from the SEC dockets. Four sources of financial data are available on these firms: the Moody's records, the SEC microfiches (for annual reports, 10-Ks, etc. for regulated firms), the SEC litigation files (these files are located in Washington), and the court files (for example; the file of a case that took place in Southern District of New York can be found in New York City's Court House's public reference room or in the archive of Bayonne). These various data sources offer a measure protection against selection biases associated with relying exclusively on the Moody's manuals.

A review of the SEC Docket Litigation Releases covering violations between January 1st and June 30th 1985 revealed 112 violator firms. "Violation" encapsulates a range of meanings which are summarized below in Table 2. (Appendix IV provides a copy of a SEC litigation release.)

(c) Types of Violations

Table 2 was constructed by reviewing the SEC Docket Litigation Releases covering violations between January 1st and June 30th 1985, and shows the main types of violation: "failing to register", "transgression of the anti-fraud provisions of the federal securities laws", "the disclosure of false and misleading information", "breach of the reporting provisions" (e.g., timely reporting), "statements that are false and misleading with regard a material statement", etc., (SEC Dockets, Vol.32, No.2, Jan.8, 1985 through Vol.33, No.6, June 25, 1985). In the empirical

study, these different types of violations/violators are treated as different states of a variable.

Below we to consider the research hypotheses and the data proxies to be used in testing the hypotheses. A brief rationale for each hypothesis is offered, however this is merely a restatement of the fuller theoretical justification provided in the literature review of the paper. In summary, this literature review concludes by arguing that complete reliance on competitive processes in regulating the market for accounting information would be unwise. A critical assessment of the work of leading scholars like Stigler and Benston--as well as that of other agency and signaling theorists--reveals serious shortcomings in the analysis supporting their conclusions that market regulation should displace state and professional regulation.

What the literature review suggests (and the hypotheses below seek to examine) is that violations may be more prevalent in the following circumstances: where state (the SEC) regulation is absent; where uncertainty is high (as in the case of a new issue by a new firm, where no track record exists); where competition is intense and managers are under pressure to represent a distorted picture of economic reality. These conditions are expressed in the form of research hypotheses below.

RESEARCH HYPOTHESES:

Introduction:

Hypothesis 1 (see below) is the primary proposition of this study. It problematizes extant SEC regulations by inquiring into the desirability of extending the target group of firms required to file. The hypothesis asserts that a high incidence of violation of the Securities Laws will be prevalent among firms exempt from the discipline of the SEC reporting requirements. But how are the empirical results from hypothesis 1 to be interpreted? When is the incidence of violation "high" and, particularly, what level of violation among unregulated firms would warrant requiring them to file with the SEC?

It should be noted at the outset that the evidence collected in this research can only partially contribute to a resolution of these questions. Ideally, what is needed is a measure of the net social costs and benefits arising from incremental revisions to the definition of the regulated target group. "Costs" are particularly interesting from an accounting perspective because they include the cost of auditing and information production, the burden of which falls on clients, and which becomes revenue to accounting firms. Costs are not limited to such tangible items, however, they also include the cost of stifling enterprise, initiative, creativity, and entrepreneurship through the

imposition of bureaucratic procedures and regulations.

With all the above factors summarized into a measure of "net social benefits" (a "figure of merit" to use Ijiri's phrase) it becomes possible to evaluate alternative re-definitions of the regulatory target group. For many analysts, this kind of neo-marginalist analysis permits an optimal (sic.) target group to be identified (Stigler, 1961, 1964a, and 1971; Peltzman, 1976).

But even if this information were available, it would still be insufficient for deciding the optimal regulatory system. Only by happenstance would the additional costs of new regulations be distributed to the same individuals, groups and classes as the benefits. Much more likely is the possibility that the costs and benefits will not coincide in their distributional impact, with the result that each new regulatory proposal would be distributionally "incommensurable" with every other scheme (Sraffa, 1960; Kregel, 1972, 1975, and 1976).

While it is common in economic research to ignore such distributional affects on the somewhat questionable grounds that they will be corrected by tax policy (c.f., Rowley, 1969; Arrow et al., 1961) this assumption is hardly adequate because it regards a tax correction of income back to the distributional status-quo to be a return to "optimality", without ever bothering to justify the optimality of the previous status-quo (Hunt and Schwartz, 1972; Nell, 1973).

In the research envisaged here, partial information--

relevant, but not determinate regarding social choice--is sought. An analysis of Hypothesis 1 would provide estimates of the probabilities of violation by regulated and non-regulated firms. Using IRS data, and the differences between the probabilities of violation for regulated and (different types of) non-regulated firms, we will estimate the total value of all assets in the economy held by non-regulated violators, who might not have violated if they had been subject to the SEC filing requirements (i.e., "regulated"). Finally, using the same data, we can make conditional estimates of the affect of changes in the threshold limits that exempt different classes of firms (i.e., those below \$5 million total asset value, below the stockholder minimum).

These "affects" of threshold changes may be calculated in terms of both the number of firms turned into non-violators, and the total value of assets in the economy transferred to the custody of non-violators. While these measure are not perfect proxies for the "net social benefits" of new regulatory proposals, by the standards of previous studies in the area, they are "interesting" and "relevant" (Stigler, 1961, 1964a, and 1964b; Benston, 1967, 1969a, 1969b, 1973, 1979-80, 1982a, and 1982b). Subject to the above qualification to the empirical analysis, the research hypotheses are as follows:

Hypothesis_1:

Violations (V) of the Securities Laws by SEC non-regulated firms is significantly higher than among SEC regulated firms. This may be expressed as follows:

$$V = f (R) ;$$

"Significant" in the above will be assessed using several indices: the probability of violating; the number of firms; the average size of firms (in terms of value of assets); and the value of assets in the economy at large estimated to be under violator-control. Williamson (1988, p575) points out that some constituencies bear a strategic relation to the firm and can disclose information pertinent to other constituencies selectively. The management of the firm is the obvious constituency to which to ascribe such a strategic informational advantage. Given its centrality in the contracting process (in a free market), the management will sometimes be in a position to realize advantages by striking mutually "inconsistent" contracts with other constituencies. Thus, undisclosed contractual hazards can arise in this way (Williamson, 1985, p318-319). SEC non-regulated firms have an incentive not to disclose information that may reveal this inconsistency, and thus, are more likely to violate SEC Laws than SEC regulated firms. As discussed previously, such information is necessary (although not sufficient) for appraising the net social benefits accruing from proposals for revising SEC thresholds.

This study defines "regulated firms" (and thus "non-regulated firms") as those listed according to the Directory of Companies Required to File Annual Reports with the Securities Exchange Commission (1986). The directory includes companies with securities listed on national securities exchanges, companies with securities traded over the counter which are registered under Section 12(g) of the Securities Exchange Act of 1934, and certain companies required to file pursuant to Section 15(d) of the Securities Exchange Act of 1934 as a result of having securities registered under the Securities Act of 1933. (see Appendix I for a copy of the relevant sections of the Securities Laws definition of firms required to file.)

The following groups are excluded (and are therefore non-regulated):

1. Firms with assets of less than \$5 million;
2. Firms with shareholders numbering less than 750;
3. Investment companies registered under the Investment Company Act of 1940;
4. Governments and political subdivisions thereof;
5. Issuers of voting trust certificates and stockholders and bondholders protective committees.

Firms falling under categories 4 and 5 (above) will be removed from the non-regulated sample. Non-regulated firms will be identified and classified so that "types" of violator will be highlighted by the analysis.

Hypothesis_2:

Benston hypothesizes that competitive forces restrain management in abusing of its fiduciary responsibilities. He identifies three markets that constrain managerial discretion: the market for the firm's final good and services, the market for financial resources and corporate control, and the market for managerial services. According to Benston, market forces are augmented by the disciplining influence of internal and external monitoring systems. Thus, from Benston's work we would expect that the violations are greater among firms subject to weak competitive pressures (C) than among those subject to severe competition. In this study, we test the counter-hypothesis that infringements are likely to increase with greater competitive pressures. This may be expressed as follows:

$$V = f (C) ;$$

The competitive pressures (C) will be measured using a weighted average of Tobin's Q and Palmer's Index. These measures will be described subsequently.

Hypothesis_3:

Ross (1979) observes that, "in a competitive market (with no mandated disclosure) the managers of firms ... will have a strong self-interest in disclosing relevant information ..." However, evidence refuting the "strong form" of the efficient market hypothesis' casts doubt on Ross' arguments. The prevalence of

"window dressing" to obscure "bad news," and the growth of large managerially controlled firms, raises further doubts about Ross' thesis. From the above, we can reason that violations are more likely to occur in conditions of high information asymmetry (A) between managers and investors. This hypothesis may be expressed as follows:

$$V = f (A) ;$$

New issues by the firms and the age of the firm (incorporation date to the violation date) will be used to measure this variable.

Hypothesis_4:

The users of financial statements form expectations about the firm's financial prospects from the previous year's performance, industry performance and contractual agreements. In order to accommodate user expectations, firms may bias the information in financial statements. Past literature suggests that management may manipulate measures of the firm's profitability (P) and debt covenants (D) (e.g., see Lambert (1984)). Thus, violations of the Securities Laws are likely to occur among firms that bias profitability and debt covenants. This may be expressed as follows:

$$V = f (P, D).$$

The variable, "P," (profit pressures to manipulate) is

measured in this study in terms of the ratio of rate of return on total assets to the average rate of return for the industry using Value Line data. The variable, "D," (pressure to manipulate because of the debt covenants) will be measured in terms of the proportion of total debts to equity (see Bowen, Noreen, and Lacey (1981), Collins, Rozell, and Dhaliwal (1981), Holthausen (1981), Lilien and Pastena (1981), Holthausen and Leftwich (1983), etc.).

A multivariate formulation of the above bivariate tests is expressed in conceptual variables as follows:

$$V = f \{R, C, A, P, D\} \quad [1] \quad .$$

STATISTICAL MODELS

The coefficients of Equation 1 are estimated using multiple linear regression. However, if the linearity and the homoscedasticity assumptions of multiple regression are violated, it can lead to least squares estimates that (a) have no known distributional properties, (b) are sensitive to the range of the data, (c) may grossly understate the magnitude of the true effects, and (d) systematically yield probability predictions outside the range of 0 to 1. To avoid these possible model specification problems, a logit model are used to estimate the coefficients.¹⁶ In addition, discriminant analysis are used to develop a model that attempts to elucidate "predictors" of violators of the Securities Laws. The models are estimated by using the SPSS-X (1988, 3rd. Ed.) computer packages.

The following statistical models are estimated:

Full sample model:

This includes firms that are regulated non-regulated, violators, and non-violators (see Tables 3 through 6).

$$V = f (R, C, A, P, D)$$

Previously, we identified five types of violations of the securities laws (see Table 2). These are represented, according

to the violator firms' regulatory status, as follows:

Violation_Type_1_model:

This includes firms that are regulated, non-regulated, and have violated registration provision of the Securities Laws (see Tables 7 through 10).

$$V(1.1) = f \{C, A, P, D\}$$

Since violation type 1 is a violation of registration of securities, the new issue/not new issue variable A(1) is not included in this model. registration of securities, the new issue/no new issue variable is not included in this model.)

Violation_Type_2_model:

This includes firms that are regulated, non-regulated, and have false statements (see Tables 11 through 14).

$$V(1.2) = f \{C, A, P, D\}$$

Violation_Type_3_model:

This includes firms that are regulated, non-regulated, and have violated the filing provision of the Securities Laws (see Tables 15 through 18).

$$V(1.3) = f \{C, A, P, D\}$$

Violation_Type_4_model:

This includes firms that are regulated, non-regulated, and have violated two or all three of the previous violations (see

Tables 19 through 22).

$$V(1.4) = f \{C, A, P, D\}$$

Violation_Type_5_model:

This includes firms that are regulated, non-regulated, and have violated other provisions of the Securities Laws. This model is not estimated in this study because of the insufficient sample size.

$$V(1.5) = f \{C, A, P, D\}$$

DATA VARIABLES

Conceptual variables are measured using one or more data variables to test the hypotheses. The data variables, corresponding to each conceptual variable, are as follows:

Conceptual Variables: $V = f \{R, C, A, P, D\}$

Data Variables: $V(1) = f \{R(1), C(1), A(1,2), P(1), D(1)\}$

Dependent Variable V(1):

Where $V(1) = 1$ violator of the Securities Laws,

$V(1) = 0$ non-violator of the Securities Laws.

and $V(1.X) = 1$ for regulated violators (where X represents the type of the violation),

$V(1.X) = 0$ for non-regulated violators for violation type X.

The "Introduction" and "Hypothesis 1" of the "Research Hypotheses Section" discusses the dependent variable.

Independent Variable R(1):

Where $R(1) = 1$ SEC regulated firm,

$R(1) = 0$ non-regulated firm.

Independent Variable C(1):

Where C(1) = weighted average of Tobin's Q and
Palmer's Index.

This continuous variable measures a firm's competitiveness in testing Hypothesis 2. Tobin's Q, which measures the degree of monopoly, is calculated as follows: Market value of common and preferred stock divided by replacement cost of the assets (Lindenberg and Ross, 1981). This is approximated by the following formula:

$$\frac{\text{M.V. of common stock (see below) + Book value of all other classes of stocks}}{\text{Total assets + Total accumulated depreciation}}$$

M.V. of common stock is equal to the market price multiplied by the number of outstanding shares. If no market price data is available (if, for example, the stock is a new issue) then the offer price will be used. This will be obtained from litigation files and/or in registration files.

The Palmer's monopoly index is a firm's sales as a percentage of its industry sales multiplied by its industry's barriers to entry index. The barrier to entry index is based on a three-part classification: "high," "substantial," and "moderate-to-low." These are coded as 1, 0.5, and .001 (Palmer, 1973). The Palmer's index score gives a measure on a monopoly-

competitiveness dimension for each firm.

The data variable C(1) is calculated below from Tobin's Q (TQ) and Palmer's Index (PI):

$$C(1) = \frac{TQ}{TQ + PI} \times TQ + \frac{PI}{TQ + PI} \times PI .$$

These measures have been used extensively in a variety of authoritative economic studies: see for instance, Bain (1965), Ciccolo (1975), Hall and Weiss (1967), Mann (1966 and 1970), Rhoades (1972), Sullivan (1977), Tobin (1969 and 1978), and Tobin and Brainard (1968 and 1977) .

Independent Variable A(1):

Where A(1) = 1 firms engaging in new issues of stock,
A(1) = 0 firms not engaging in new issues.

To determine whether a violator firm is engaged in new issues, the SEC News Digests in the three-month-period prior to the violation date (see the Data Sources section of the thesis) and the litigation releases were examined. For the non-violator firm, the SEC News Digests in the three-month-period prior to the end of their fiscal year were examined.

Independent Variable A(2):

Where A(2) = age of the firm (incorporation date to the violation date).

The importance of the A(2) variable is to assess the level of information asymmetry between managers and investors for new and existing firms.

Independent_Variable_P(1):

Where $P(1)$ = a rate of return on owners' equity (net income or net loss/owners' equity) divided by the average rate of return for the industry using the Value Line data.

The variable is assigned a negative value when ever firms have net loss. In addition, the variable is adjusted according to the following criteria:

- if a firm has net loss with positive owners' equity or positive industry return ADD 1,
- if a firm has net loss with negative owners' equity or negative industry return SUBTRACT 1,
- if a firm has net income with positive owners' equity or positive industry return SUBTRACT 1,
- if a firm has net income with negative owners' equity or negative industry return ADD 1.

This variable measures the link between the pressure to manipulate profits and the propensity to violate the Securities Laws.

Independent_Variable_D(1):

Where $D(1)$ = debt to equity ratio. (This variable always takes a positive sign, but it must be increased by 1 if a firm has a negative owners' equity.)

This proposition reflects the influence of debt covenant constraints on the propensity to violate the Securities Laws.

In summary, the conceptual variables and their data variable surrogates are related as follows:

		CONCEPTUAL VARIABLES				
		R	C	A	P	D
DATA VARIABLES	R(1)	x				
	C(1)		x			
	A(1)			x		
	A(2)			x		
	P(1)				x	
	D(1)					x

DATA_SOURCES

As indicated previously in Figure 1, the Moody's manuals were selected as a primary data source for data on firms active in social wealth accumulation. The SEC Dockets together with the SEC litigation files served as supplementary data sources for firm's violating of the Securities Laws. It should be noted that these sources bias downwards the estimate of the number of violators insofar as "not all crooks get caught!" Thus the evidence is a conservative test of the propositions.

A two-stage random procedure sampling is used. The first sample for violators is selected from the SEC Dockets (using January 1, 1980 - December 31, 1987). Each firm is then investigated to ascertain its SEC regulatory status (regulated or non-regulated). The second stage extends the original sample by using stratified random sampling to obtain a sufficient cell size for all types of firms (regulated violators, regulated non-violators, non-regulated violators, non-regulated non-violators). Stratified random sampling involves taken random selections, to pre-set limits, from two or more sub-populations. Thus, for instance, random selections from female and male student populations may be pre-set at limits of 40 and 50 respectively, reflecting known proportions of the population-at-large. While endeavoring to obtain a sufficient cell size, a comparable number of violators for regulated and non-regulated firms were picked for each year. In addition, an attempt was made to match the

violators with non-violators (regulated as well as non-regulated) by industry and year of violation.

The following data sources were employed in addition to the Moody's manuals: the SEC microfiches (for annual reports, 10-K's, etc.), the SEC News Digests (published daily by the SEC and lists firms (new or existing) that sell new securities), the SEC registration files (in Washington), the SEC litigation release files (in Washington), and the Court files for a given litigation (especially in Southern District of New York cases of litigations -- in New York City or Bayonne, New Jersey).

EMPIRICAL RESULTS

Tables 3 through 22 represent the results of the multiple regression, logit, probit, and discriminant analysis for five different models with different sample of firms. The breakdown of the sample of firms into violation and regulatory status is shown at the bottom of each table.

In summary, the tables showing the empirical results are related to the statistical models as follows:

	STATISTICAL MODELS			
	Multiple regression	Logit	Probit	Discriminant analysis
EMPIRICAL TEST				
Full sample (154 firms)	Table 3	Table 4	Table 5	Table 6
Violation Type 1 (34 firms)	Table 7	Table 8	Table 9	Table 10
Violation Type 2 (40 firms)	Table 11	Table 12	Table 13	Table 14
Violation Type 3 (25 firms)	Table 15	Table 16	Table 17	Table 18
Violation Type 4 (26 firms)	Table 19	Table 20	Table 21	Table 22
Sample of 124 firms (154 - 30 hold out sample)	Table 23	Table 24	Table 25	Table 26

Logit and Probit coefficient estimates (Tables 4, 8, 12, 16, and 20 and Tables 5, 9, 13, 17, and 21, respectively) cannot be

compared to each other directly. According to Aldrich and Nelson (1984, pp. 64-65), there is a scale difference between the two, such that logit coefficients are about 1.8 times the size of otherwise comparable probit results. They claim that making this (approximate) correction indicates that the two sets of coefficients differ very little. In Table 4 (sample of 154 firms for Logit) and Table 5 (sample of 154 firms for Probit), one can observe that even though signs and the values of the coefficients of the two models differ, the significance levels are almost the same. However, in Tables 20 and 21 the significance levels are also slightly differ because of the smaller sample size (26 firms only).

The evidence suggests that there is little difference between the results for the two procedures (logit and probit). Thus, for instance the goodness of fit Chi-Square values for Logit and Probit are $8.817E-30$ (Table 3) and $7.177E-31$ (Table 4) respectively. For a smaller sample size, the Chi-Square results for Logit and Probit are $5.007E-35$ (Table 20) and $2.006E-33$ (Table 21) respectively. Similarly there is little difference between the two procedures in terms of individual parameter estimate comparisons (see Tables 4 and 5). The differences get smaller with the increases in sample size as noted in our results.

Comparison of the size of coefficients between multiple regression results and logit or probit is more difficult. Casual inspection indicates that the coefficients for the

independent variables show the same signs and are approximately the same size.

Of particular interest are the coefficients in the full sample as they facilitate prediction of the value of the dependent variable. Using the multiple regression results of the full sample of 154 firms (Table 3), a firm having a new issue, a 50% debt/equity ratio, a 10% return on equity relative to the industry return, a .20 competitiveness, being established 10 years ago, and being regulated, has a probability of violating the SEC Laws about 78%.

No such easy conclusion is possible for logit and probit, since the impact of any variable is nonlinear. Tables 4 and 5 show for Logit and Probit, predicted probabilities for the values of the dependent variables around 10 and 8 respectively-- a meaningless result. This is possibly due to the linear relations in the data.

Discriminant analysis (Tables 6, 10, 14, 18, and 22) provide the standardized discriminant function. Since the discriminant variables are not normally coded in standard form (such as multiple regression coefficients), the standardized discriminant function coefficients may not be useful for computational purposes. However, the standardized discriminant function coefficients are of a great analytic importance in and of themselves. When the sign is ignored, each coefficient represents the relative contribution of its associated variable to that function. The sign merely denotes whether the variable

is making a positive or negative contribution. The interpretation is analogous to the interpretation of beta weight in multiple regression.

In Table 3 (full sample--154 firms), one can see that independent variables vary, in order of importance, as follows: new issue, return on equity relative to the industry return, debt to equity, firm's age, competitiveness, and whether a firm is regulated or not. Discriminant analysis results of Tables 10, 14, 18, and 22 confirm these results.

The signs of coefficients for all the independent variables for the full sample (Table 3: the multiple regression test) are in the predicted direction and the discriminant analysis for the same sample (see Table 6) provides exactly the same results in terms of the significance level and importance of the independent variables. Namely:

	Multiple Regression Results --significant at-- (high to low)	Discriminant Analysis --importance-- (more to less) (signs are ignored)
	-----	-----
A(1)	.0001%	.94096
P(1)	5%	.26794
D(1)	5%	.26207
A(2)	10%	.20160
C(1)	20%	.14416
R(1)	28%	.09420

The results of multiple regression (Table 3) for independent

variable A(1), significant at .0001%, indicate that, during the issue of new shares, there is a propensity to violate securities laws because management abuse their asymmetric information advantage over investors. This result is supported, albeit less strongly, by variable A(2) (age of the firm) which indicates that new firms, with little track record, are more likely to violate than older firms. The sign for this variable is in the correct direction although the coefficient is only significant at the 10% level.

Table 3 shows that the propensity of management to violate because of pressures to bias profit measures P(1) and to meet covenant restrictions D(1) are significant at the 5% level.

The degree of competition C(1) increases the proclivity to violate. This result is in the opposite direction from that posited by Benston. While the coefficient's sign is in the correct direction, it registers a type 1 error 20% of the time. Similarly, the obligation to file (being regulated) with the SEC R(1) does dampen the tendency to violate, however the significance of this coefficient is a low 28%.

30 firms were held out, randomly, from 154 firms in order to predict these 30 firms' violator/non-violator status and check the results of the multiple regression model(s) (see Table 23). Table 23 (multiple regression model of 124 firms) shows that, overall, 80% of the firms (namely 24 of 30 hold out sample) were correctly predicted by using the multiple regression results of

124 firms. The comparison of Table 3 (154 firms) and Table 23 (124 firms) reveals that all variables in both tables have the expected signs. In general, the significance level increases when the sample size is increases from 124 to 154 firms. The full sample (154 firms) would give a prediction accuracy rate of more than 80% (Table 3).

The above findings are confirmed by the results of discriminant analyses in Tables 6 and 26. The classification results of the discriminant functions show that, overall, 75.32% of the 154 firms and 75% of the 124 firms are correctly classified in Tables 6 and 26, respectively. There is a slight improvement in classification accuracy with the increase of the sample size. Tables 6 and 26 of discriminant analysis show that the variables have the same sign and relative magnitude.

Matrices of Pearson Correlation coefficients are provided for each multiple regression model. When properly employed, the correlation matrix becomes an excellent technique for uncovering spurious ¹⁸ relationships, locating intervening variables, and can even be used to help the researchers make certain types of casual inferences (SPSS, 1975).

It is clear from the correlation matrix of the Full sample (Table 3) that the relationship between the dependent variable and the independent variables are in the following order (disregarding the signs), from the most important to the least important one; new issues A(1), age of a firm A(2), debt to

equity ratio D(1), rate of return on equity relative to the industry return P(1), competition C(1), and regulated/non-regulated R(1). Table 23, also, provides similar results, namely new issues A(1) having the highest correlation and regulated/non-regulated R(1) having the lowest correlation to the dependent variable V(1). The correlations of tables 3 and 23 indicate that approximately 23.55 of the variances in violation of SEC Laws are determined by the new issues A(1).

Further examination of the correlation matrices (in Tables 3 and 23) shows that new issues A(1) is highly correlated with the dependent variable V(1) without being effected by any other independent variables. This can be observed by the following correlations results:

	V(1)	R(1)	C(1)	A(2)	P(1)	D(1)
Table 3: A(1)	.4887	.0123	-.0385	-.0791	-.0619	.0226

Correlation of the age of the firm A(2) with the dependent variable V(1) is, also, standing alone without being effected by any other independent variables in the functions. This can be observed by the following correlation results:

	V(1)	R(1)	C(1)	A(1)	P(1)	D(1)
Table 3: A(2)	-.1429	.1069	-.0628	-.0791	.1002	-.0051

The same interpretation applies for debt to equity ratio D(1).

The results of Tables 7, 11, 15, and 19 (multiple regression

models) and Tables 10, 14, 18, and 22 (discriminant analysis) reveal similar results to the results of Tables 3 and 6. Some differences are observed for the signs, significance levels, and importance of the variables based on different type of violations and the sample size. The low significance levels maybe due to the small sample size of 33, 40, 25, and 25 for violation type 1, 2, 3, and 4 respectively.

A closer look at the correlation matrices' results of Tables 7, 11, 15, and 19 (multiple regression models) reveals that almost all independent variables have notable correlation with the dependent variable. This can be observed in the following examples:

		C(1)	A(2)	P(1)	D(1)
Table 3:	R(1)	-.1241	.1069	-.1551	.0910
Table 7:	R(1)	-.2591	.3010	-.3465	.2186

In addition to the multiple regression results, a closer look at the discriminant clasification results of Tables 10, 14, 18, and 22 reveals a successful prediction rate of 75.76% of the firms for type 1 violation, 70% of the firms for type 2 violation, 72% of the firms for type 3 violation, and 76% of the firms for type 4 violation.

In interpreting the results concerning the impact of filing, it is important to remember that study period spans the tenure of SEC chairman John Shad who relentlessly pursued a policy of staff and service cutbacks to produce a "leaner" SEC. Insofar as the

disciplining influence of SEC surveillance and filing was blunted by Shad's policies, it would account for a "leaner" SEC and the low significance of the empirical results.

Overall, the results cast doubt on the wisdom of an unconditional reliance on market regulation. The study targets specific areas of "market failure" where violations become more prevalent. With varying degrees of significance, the intensity of competition C(1), information asymmetry A(1) and A(2), pressures to meet profit targets and debt covenants P(1) and D(1), and the obligation to file (being regulated) R(1), all influence the level and type of violation.

CONCLUSION

The capital market is a cockpit where social struggles most germane to financial accounting are worked out. Securities disclosure legislation, such as the US's 1934 Glass-Steagall Act and the UK's 1948 Companies Act, were part of a more general, Keynesian-inspired post-depression movement to temper the excesses of unregulated markets. In the US, securities legislation sought to restore "confidence" by restricting the involvement of banks in securities trading and by requiring financial disclosure by large corporations (Merino and Neimark, 1982; Cooper, 1984).

National legislation provided only temporary respite however as material conditions changed and ideological challenges to legal restrictions emerged. The partial internationalization of capital markets (especially the Eurodollar market) permitted banks to circumvent minimum capital requirements and corporations to avoid their own national disclosure regulations. Thus "stateless" capital markets compete, in terms of both supply and demand, with their regulated (socialized) counterparts in New York, London, and other money centers, presenting a fait accompli to regulators of national markets: if the capital market business is to remain in their bailiwick, they must be liberated from the burdens of regulation.

These "objective" changes in the material conditions of

capital accumulation have been accompanied by a virulent ideological, cultural, and intellectual counter attack to secure recognition of the "realities" of the new international economic order and popular support for cutbacks in state intervention, expenditure and taxation (Lehman and Tinker, 1987). In the forefront of recidivist theorizing has been George Benston and the Nobel Laureate George Stigler who have provided the intellectual spur for dismantling the apparatus regulating national capital markets. In essence, these theorists promote market processes, and denigrate the state's apparatus as an efficacious means of social regulation.

The empirical results raise questions about the desirability of unqualified deregulation by pointing to specific circumstances where abuses of securities laws tend to proliferate. Even stronger support for the hypotheses might have been forthcoming but for two handicaps specific to the empirical situation: First, that data is only available for that small percentage of violators who are detected and prosecuted (less than 1% according to some estimates (Tinker, 1987A)) and Second, that this study was conducted in a period in which the Executive Branch of the US Government was extremely hostile to SEC enforcement action and accordingly starved the agency of resources.

Notwithstanding its impediments, this research puts into question the conventional empirical methods that have been used by accounting researchers to endorse market regulation and oppose mandatory disclosure. Nowhere in science has the practice of

"making assumptions" been more abused than in economics and its theoretical dependents in accounting and finance (Blaug, 1980; Caldwell, 1982, 1984). Traditionally, assumptions are invoked in a spirit of precaution: they refer to extant conditions that are thought to prevail, but for which incontrovertible proof has not been secured. Assumptions serve only to affirm what is widely believed to be the case; they represent a modest caveat or caution against eventualities that are thought unlikely to materialize.

Assumptions that predicate theorizing in contemporary financial economics and accounting bear little resemblance to a mild precaution. "Pure competition," "homogeneous expectations," "diminishing returns to scale" etc., are not assumptions about extant conditions that can be reasonably assumed to exist, rather they refer to the highly restrictive and often unrealistic conditions to which a theory applies.

Two additional considerations contribute to the misuse of assumptions in accounting and economics. First, assumptions are frequently constructed in a manner that makes them empirically untestable (unprovable or irrefutable). Probabilistic (or "fuzzy") statements are particularly impervious to evaluation: "The 'typical' firm maximizes 'long run' profits" (for instance). Second, universal applicability is usually claimed for an assumption, leaving the burden of finding the limits of applicability unhindered by guidance as to what would constitute a refutation (Popper, 1959).

The combined impact is a total transformation in the use of assumptions: from statements about what is truly thought to exist, to ideological proclamations about a sometimes monstrous fantasy world, used to support self-serving policies. The patina of scientific legitimacy offered by "stating one's assumptions" masks an outrageous violation of the integrity of the practice. This perversion of a scientific practice allows assertions, as untestable as anything found in alchemy, astrology, and mysticism, to be dressed in the ritualistic garb of science, and used as a conduit for promoting sectarian social policies.

What motivates the proffering of often implausible assumptions? From a deconstructionist perspective, it is the reality that is promoted as well as the reality that is denied and the possibilities that are precluded, that prompts a particular construction of events. The more outrageous the assumptions, the more they transgress our sense of what we know to be true, and thus the more severe the censorship and mystification perpetrated by the theory.

Assumptions about the prevalence of perfect competition exemplify the ideological role of assumptions. Perfect competition is typically defined by five critical assumptions (Cohen and Cyert, 1975; Mansfield, 1975, 1979):

1. That all firms in an industry produce a homogeneous product. Thus, the properties of any one firm's product are neither superior nor inferior to the products

made by other firms in the same industry.

2. That business firms and consumers possess perfect knowledge of relevant alternatives. It follows that all firms have access to the same types of production technology, and that potential buyers and sellers are familiar with prevailing market prices.

3. That firms attempt to maximize their profit and consumers try to maximize their utilities (i.e., their satisfaction from spending their money as they choose).

4. That atomistic competition prevails, implying that the number of buyers and sellers in each market is so large that any one individual firm or household has only a negligible effect on market price.

5. That there is free entry and exit in every market.

Few realities would meet the stringent conditions imposed by the above assumptions in their undiluted form. Attempts to make the assumptions "realistic" usually involve adding qualifiers, such as "most" firms, or "a large number" (of buyers and sellers). However, this merely compounds the problem as what constitutes "most," "typical," or the "long run" is never theoretically defined, and thus the theory is not empirically testable (Popper, 1959; Caldwell, 1982, 1984).

The assumptions constituting perfect competition may be further deconstructed by noting importance of asserting the existence of equilibrium levels of price and output. Equilibrium analysis permits economists to asserts the functionality of prices found in the market place--that the wage rate paid, and the prices charged, for goods and services can be justified and

are rational in an economic productivity sense. If equilibrating tendencies are put into question, so is the legitimacy-of and justification-for a specific price structure. The implication is that the process of wealth distribution is a Hobbesian brawl--not on a fair and rational allocative mechanism that values "need," "effort," and "worth."

Disequilibrium--rather than equilibrium--is a more plausible assumption regarding the usual state of most real-life markets (mansfield, 1979). Demand curves are constantly shifting in response to changes in tastes, preferences and incomes, etc. Supply curves are also constantly shifting in response to changes in technology, resource limitations, etc. Thus, the equilibrium levels of prices are constantly in a state of flux.

The severity of the above functionality assumptions is indicated by Cohen and Cyert (1975) who detail the necessary conditions to support statements and conclusions about economic efficiency as: (a) the marginal rates of substitution between any two commodities should be the same for any two consumer, (b) the marginal rates of transformation between any two products should be the same for any pair of producers, (c) the marginal physical products of a given factor for a given product should be the same for any pair of producers, (d) the marginal rates of technical substitution between any two factors should be the same for any pair of producers, and (e) the marginal rate of substitution between any two commodities should be the same as the marginal

rate of transformation between these two commodities for any producers.

The Oxford price studies was the early authoritative empirical source to rebut the diminishing returns to scale assumption included above. The Oxford studies showed that cost-plus (rather than a supply and demand) provides a better empirical foundation for price theory (Nell, 1972).

The power of business firms or households to modify market prices stems from their ability to regard price as a decision variable rather than as a constant given by the market. Price making indicates a degree for economic power for private decision-making units is a market imperfection. Governments also override markets (often on behalf of other market participants) by establishing quotas, granting subsidies, imposing sales taxes and import duties.

What is repressed by the functional assumptions is the latent agenda of market regulation: that passivity and compliance are the best postures under capitalism; that political, social, and industrial interventions serve only to impede the efficient workings of the equilibrating processes; that the present distribution of income and wealth accords with criteria of marginal productivity and global economic efficiency. If the functional assumptions are put into question, so are the politics of political quietism that these assumptions promote (Tinker et. al., 1988).

Increasingly, accounting research is being conducted that begins with an alternative set of assumptions to those of neoclassical thought: that markets, corporations, and the state are terrains of social conflict, and that accounting--and accounting research--inevitably "takes sides" in such conflicts. This new research interrogates two prior questions: "what are the sides in conflictual situations?" and "how do--and should--accountants choose which side to support?"

This emerging viewpoint is advanced by a mushrooming new journal market in accounting. Publications such as *Accounting, Organizations and Society*, *Advances in Public Interest Accounting*, *Journal of Accounting and Public Policy*, and *Critical Perspectives on Accounting*, all take social conflict and disequilibrium (rather than efficiency and equilibrium) as the basic characteristic of accounting situations. Thus, the third world debt, pension accounting, public utility accounting, management buyouts, and the saving and loans crisis are all examples of current research undertaken from a social conflictual viewpoint.

Research into mandatory financial reporting has a long-time affiliation with legal studies. In this research tradition, the efficiency perspective has never totally dominated the social conflict orientation and its focus on social equity. In the long span of financial accounting research, the last fifteen years of market studies are a mere blink in the subject's research history.

This thesis may be seen as a revival of the conflict-based tradition in mandatory financial reporting: First, it rejects "take-spinning" as the only source of evidence for accounting research and employees evidential sources hitherto neglected by accounting research and Second, it focuses on deviant cases (the violators who are the phenomenon of interest). The latter is more likely to provide insights for targeting new regulation and disclosure policy than research that confines its examination to the "typical" or "mythical average" case.

In accounting, there are two basic issues: First, the standards for preparing an accounting information (such as LIFO, FIFO inventory methods) that is set by Financial Accounting Standards Board (FASB) and SEC. Second, the standards for providing accounting information to the public (such as filing requirements by SEC which is the subject of this thesis). The availability characteristics of accounting information makes it as a public good. If users of accounting information were required to pay, and if free riders exist, the market of accounting information would not be the social optimum. Regulation for availability of accounting information corrects for this market imperfection (Solomons, 1986, p184).

It is a necessity that there should be regulatory agency to correct the market imperfection and this agency must have a power to enforce the regulations. However, it is not important whether it should be a government organization (such as SEC) or a private organization (such as FASB). The agency must, eventually,

achieve the public's acceptance and trust and must have adequate financial resources to be able to function effectively.

Concretely, the research suggests that Section 12(g) of the Securities Exchange Act of 1934 (revised, July 8, 1986) be modified in order to expand the scope of corporations required to comply with disclosure laws. In addition to the Treadway Commissions general recommendations, the SEC should expand its enforcement remedies to impose severe penalties and tailor such penalties to individual cases. Finally, the agency should start educating the users as well as the issuers about the economic importance of accounting information.

This research is not an unreserved endorsement of all forms state regulation (Berry et.al., 1987). Clearly state regulation, in-and-of-itself, does not render capitalism's dialectic obsolete; state bureaucracies continue to be progressive, captive, repressive, and, most of all, contested, even under the rhetorical guise of "The National Interest" (Burchell et.al., 1980 and 1985; Tinker, 1987B). The point is that the state's apparatus for accounting disclosure and securities regulation is a disputed territory in the social conflicts endemic to capitalism, and theories sponsoring deregulation (or greater regulation) should be interpreted and interrogated in that light.

FOOTNOTES

1. The phrases "mandatory corporate disclosure system" or "the SEC's mandatory corporate disclosure system" are used here to denote the data business firms must disseminate when issuing new securities under the Securities Act of 1933 and when making annual and periodic reports to shareholders as required by the Securities Exchange Act of 1934. This definition excludes the mandatory disclosure required by any other statute.

2. An indication of the economic issues at stake here is provided by data as to the growth in securities markets. In the 1935-1944 decade, a total of \$24 billion worth of securities were registered with the SEC. In the 1945-1954 decade, \$67 billion of securities were registered. In the 1955-1964 decade, \$155 billion of securities were registered. In the 1965-1974 period, \$543 billion of securities were registered (46 SEC ANN. REP. 132, 1980). Thus, the annual average of registered securities increased from \$2.4 billion in the 1935-1944 decade; to \$6.7 billion in 1945-1954; to \$15.5 billion in 1955-1964; to \$53.2 billion in 1965-1974; and to \$83.2 billion in the six and one-quarter years, 1975-1980 (Seligman, 1983).

3. These criticisms of the SEC's mandatory corporate disclosure system have added significance because several of the authors (including Kripke, Phillips, Zecher and Karmel, and Wolfson) are former SEC employees.

4. In the deregulatory spirit of recent times, Congress has rejected an SEC legislative initiative concerning municipal bonds (Final Report in the Matter of Transactions in the Securities of the City of New York (1979)) and an FTC request that something analogous to the 1933 Act prospectus accompany the sale of each life insurance policy (see FTC, Life Insurance Cost Disclosure, 1979).

5. Supporters of mandatory disclosure typically appeal to such work as that of Peltzman (1976) and Stigler (1971) to argue that the political "market" for voting (with lobbying and sidepayments) is an adequate democratic process.

6. "Thus if from 1926 to 1928 a common stock rose from \$20 to \$30, the price ratio is 150 (percent) or an increase of 50 percent, but relative to the market, which rose by 68.5 percent over this period, the new issue fell 12 percent." (Stigler, 1964a).

7. Regarding the comparison of the variance ratios for the pre-SEC (1923-1928) and post-SEC (1949-1955) periods, Stigler

argued that a decline in price variance would imply that investors were receiving material information: "[p]rice dispersion is a manifestation - and, indeed, it is a measure - of ignorance in the market." (Stigler, 1961). Analogously, there would be greater variation in the price of new security prices if investors suffered greater information deficiencies in the post-SEC period. Thus Stigler hypothesized that no change in this ratio between the benchmark and test periods indicated that the SEC's mandatory new issue disclosure requirements had no material effect. Conversely, an improvement in the new issue prices relative to the market improved in the post-SEC period implied that the mandatory disclosure requirements had protected investors from overpricing when new securities were first issued.

8. Merino and Neimark (1982) point out that by requiring disclosure of certain financial information institutionalized a major change in investor behavior. Thus, this may be another reason that fewer "risky" issues were floated in the post-SEC period.

9. Ultramares Corporation versus Touche (225 N.Y. 170, 174 N.E. 441, 1931) is the predominant authority in the area of third party liability of accountants for less than intentional acts of misrepresentation. The defendants certified the balance sheet of Ultramares with a net worth of over \$1 million when in fact the company was worth far less. The trial court found that the defendants were negligent in not pursuing inquiries that would have revealed fictitious accounts receivables. The New York Court of Appeals reversed the appellate division's verdict and decided that the auditors should not be held liable to creditors and investors for negligence if their report was primarily for the benefit of the client.

10. In addition, Merino and Neimark (1982) claim that Benston's study failed to assess the accounting policies underlying financial disclosure. For instance, the basis for depreciation charges need not be revealed, and could be changed without any notification being given. Benston might retort in such cases that no prima facie evidence existed that such disclosure was economically warranted; such a reply however asserts (rather than demonstrates) the efficiency of market processes.

11. The Advisory Committee on Corporate Disclosure to the SEC (1977) noted that a great deal of information in SEC filings is redundant, but there were other advantages to the filing process:

"....knowledge that information...made publicly available will, when...incorporated in a filing with the Commission, become potentially the subject of serious liabilities under the securities act will cause the informat when initially released to be more credible and reliable. Thus the subsequent filing has...a disciplining effect in assuring that the

earlier release is accurate. Furthermore, the information contained in the filings is usually much more extensive than that released earlier. Thus, it provides to analysts and others a means by which the more abbreviated information released may be qualitatively reviewed, parsed, and assessed. To some extent, the detail itself may constitute additional necessary information which would not be available but for the requirements contained in the various filing forms."

12. This discussion ignores the cost of producing accounting information, and the distribution of that burden between various parties.

13. Friend and Westerfield (1974) draw our attention to some possible difficulties with Benston's distinction between "disclosure" and "non-disclosure" firms. Although the 193 "non-disclosure" companies (with one possible exception) did not disclose sales, they did disclose net income and that this was "the more theoretically relevant variable." They infer therefore, "that Benston's... test does not distinguish between non-disclosure and disclosure firms but between less and more disclosure firms that trade on the NYSE." (Friend and Westerfield, 1974; Friend, 1976).

14. Benston relies on Stigler's "Captive Hypothesis" to explain how market processes were subverted and the securities acts installed. Benston argues that the SEC's "primary" interest in administering the Securities Acts was serving "enduring groups whose demands it believes to be proxies for the public's needs....securities analysts, stock brokers, investment bankers, certified public accountants, financial executives and business groups" (Benston, 1976 p. 169). Benston supports his conclusion with the work of Manne and Solomon (1974), which argued that the 1933 Securities Act was supported by leading Wall Street houses as a mechanism to curtail competition from "new or less efficient firms that cut prices." In examining comparable claims in Stigler's (1964a) article, Friend and Herman (1964, p.382) observe that such claims represent "a triumph of ideology over scholarship." Not only did the leading Wall Street firms lobby against significant provisions of the acts that were eventually accepted, but these firms then prosecuted a "capital strike" against the 1933 Act for nine months after the 1934 Act's amendments were adopted (Seligman, 1982, p. 114-15). It seems very unlikely that interest groups who were so active in opposing the act could be held responsible for its successful passing.

15. This argument overlooks the fact that, compared with owners, management usually have specialized expertise and thus a comparative advantage in managing. Hence, managers may appropriate excessive compensation and still return to the owners more than they would earn from running the firm themselves. In

such a case, Jensen and Meckling's argument is deficient; it would be more logical to argue that the "opportunity forgone" (by allowing the existing management to operate the firm) is employing the (next best) management team available. It is unrealistic to assume that the opportunity cost to the owners is assuming control themselves (Tinker, 1987).

16. The logit and probit models are so similar as to yield essentially identical results. Aldrich and Nelson (1984) claim that, in practice, logit and probit yield estimated choice probabilities that are virtually indistinguishable, except with very large samples (ibid., pp.34). Several studies assert that multiple linear regression results are consistent with those of logit and probit (Benston and Kransey, 1978, p.220). The study investigates the suitability of multiple linear regression, logit, and probit for a particular data set.

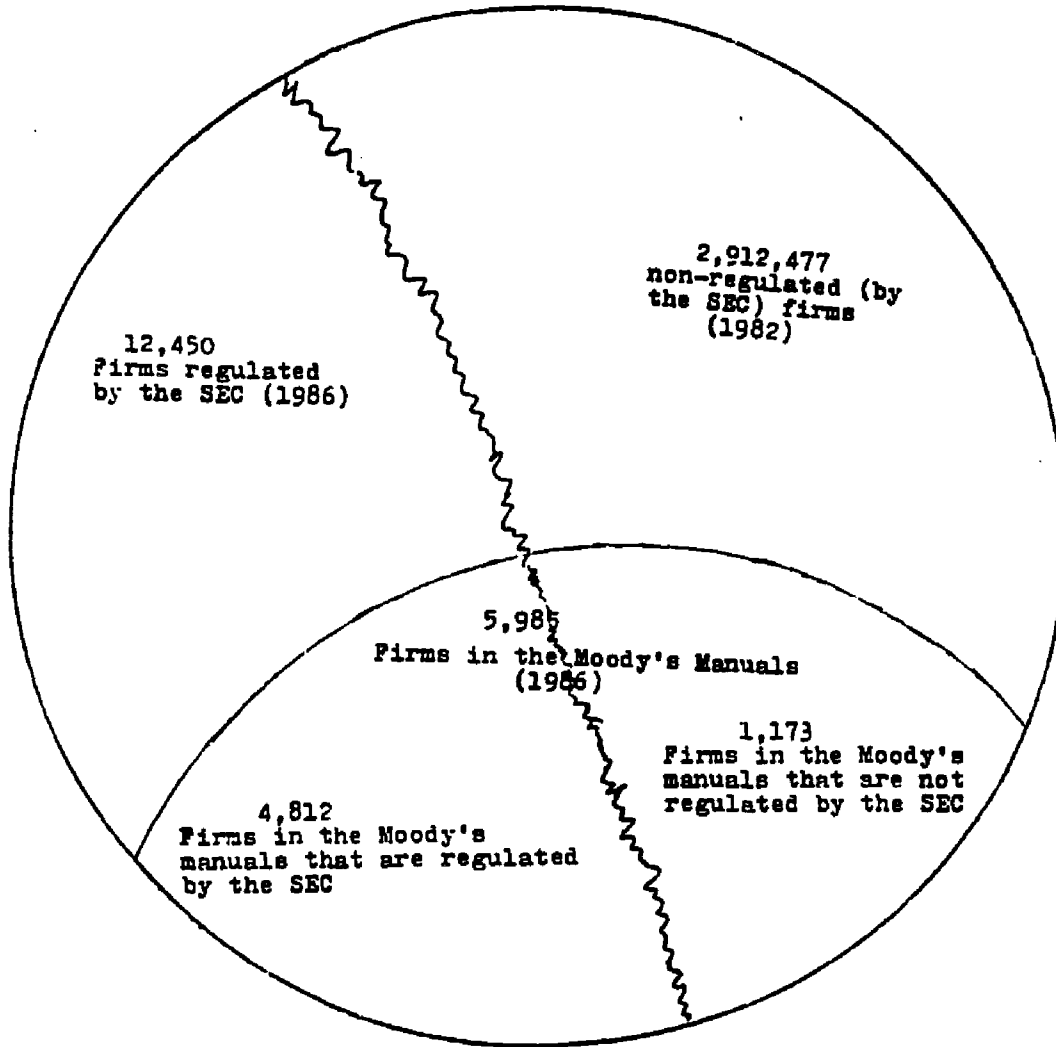
17. Instead of the Tobin-Palmer measure of monopoly-competitiveness, we might have used Herfindahl Index of concentration (Rosenbluth, 1955). The Herfindahl Index is calculated as follows:

$$C = \sum_{i=1}^N (X_i / X)^2$$

where C = concentration measurement,
 X = total revenue,
 X_i = ith firm's revenue,
 N = number of firms in the study.

18. A spurious correlation is defined in relationship between two variables, A and B for example, in which A's correlation with B is solely the result of the fact that A varies along with some other variable, C for example, which is indeed the true predictor of B. In this case, when the effects of C are controlled, held constant, etc., B no longer varies with A (SPSS, 1975).

FIGURE 1
 THE STUDY POPULATION AND DATA SOURCES



UNIVERSE: 2,926,000 Corporations filing tax returns (1982).

- Sources:
1. Statistical Abstracts of the US, 106th Ed., 1986.
 2. Directory of Companies Required to File Annual Reports with the Securities and Exchange Commission: Under the Securities Exchange Act of 1934, Sept. 30, 1986.
 3. The Moody's manuals, 1986.

TABLE 1
NUMBER OF FIRMS REPORTED IN THE MOODY'S
MANUALS 1986

Moody's Manuals-1986	Firms whose names begins with		Non-regulated firms, whose names begin with "A", Identified using the SEC Directory-1986
	A -Z	A only	
Industrial M.	1,797	151	14
Public Utility M.	473	30	9
Transportation M.	564	50	31
OTC Industrial M.	3,151	295	49
	----- 5,985 =====	----- 526 =====	----- 103 =====

Using the above results, number of firms in Moody's
Manuals that are unregulated can be estimated as
follows:

$$\frac{103}{526} \times 5,985 = 1,173$$

Thus, 1,173 = firms in the Moody's Manuals are
expected to be unregulated (that
are not in the SEC Directory).

Table 2

PILOT SAMPLE OF FIRMS DIVIDED BY THE TYPE OF VIOLATION
AND REGULATED VERSUS NON-REGULATED*

	Regulated firms	Non-regulated firms	TOTAL
1.-Registration provision	7	31	38
2.-False statements	4	6	10
3.-Late or not filing	9	2	11
4.-Compound violations of first three	9	34	43
5.-Other	4	6	10
	** 33	*** 79	112

* Sources: The SEC Docket's litigation releases; Jan. 1st - June 30th, 1985 and the SEC Directory of 1985.

** Data Sources: The SEC microfiches and the Moody's manuals.

*** Data Sources: The Moody's manuals, the SEC litigation files (in Washington), and the Court files.

Table 3

Multiple regression estimation model for Full Sample
(154 firms)

$$V = f \{R, C, A, P, D\}$$

	Coefficients	Standard Error	T-value	Significant at
Intercept	.319417			
Regulated/ non-regulated R(1)	-.042034	.071817	-.585	28%
Degree of competition C(1)	-.000783	.000853	-.919	20%
New issues/ no-new issues A(1)	.531520	.077348	6.872	.0001%
Age of the firm A(2)	-.002830	.002206	1.283	10%
Rate of return on equity relative to the industry return P(1)	-.002183	.001296	1.684	5%
Debt to owners' equity D(1)	.009434	.005608	1.684	5%

R-Squared = .28

Table 3
(continued)

Pearson correlation (matrix) coefficients

	V(1)	R(1)	C(1)	A(1)	A(2)	P(1)	D(1)
V(1)	1.0000	-.0085	-.0769	.4887	-.1429	-.0878	.1212
R(1)		1.0000	-.1241	.0123	.1069	-.1551	.0910
C(1)			1.0000	-.0385	-.0628	.0116	-.0249
A(1)				1.0000	-.0791	.0619	.0226
A(2)					1.0000	.1002	-.0051
P(1)						1.0000	.0539
D(1)							1.0000

Distribution of the 154 firms:

	Regulated	Non-regulated	Total
Violators	31	36	67
Non-violators	41	46	87
	-----	-----	-----
	72	82	154
	=====	=====	=====

Table 4

Logit estimation model for Full Sample
(154 firms)

$$V = f (R, C, A, P, D)$$

	Coefficients	Standard Error	t-value	Significant at
Intercept	10.10517			
Regulated/ non-regulated R(1)	-1.6014E-29	-1.9177E-30	8.351	.0001%
Degree of competition C(1)	-4.6386E-33	-4.6712E-32	.099	50%
New issues/ no-new issues A(1)	-3.8886E-30	-3.7659E-31	10.319	.0001%
Age of the firm A(2)	1.6139E-31	6.2643E-31	.258	40%
Rate of return on equity relative to the industry return P(1)	-8.8432E-32	-5.8173E-31	.152	44%
Debt to owners' equity D(1)	8.0671E-31	1.2270E-30	.657	26%

Chi-Square = 8.817E-30

Distribution of the 154 firms:

	Regulated	Non-regulated	Total
Violators	31	36	67
Non-violators	41	46	87
	-----	-----	-----
	72	82	154
	=====	=====	=====

Table 5

Probit estimation model for Full Sample
(154 firms)

$$V = f (R, C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	8.97203			
Regulated/ non-regulated R(1)	-1.7320E-30	-4.1025E-31	4.222	.0001%
Degree of competition C(1)	1.3760E-32	2.7409E-31	.050	50%
New issues/ no-new issues A(1)	3.6736E-31	7.0368E-32	5.221	.0001%
Age of the firm A(2)	1.8079E-31	1.3880E-30	.130	45%
Rate of return on equity relative to the industry return P(1)	-2.1051E-32	-2.7390E-31	.077	50%
Debt to owners' equity D(1)_	9.3382E-32	2.8091E-31	.332	37%

Chi-squared = 7.177E-31

Distribution of the 154 firms:

	Regulated	Non-regulated	Total
Violators	31	36	67
Non-violators	41	46	87
	-----	-----	-----
	72	82	154
	=====	=====	=====

Table 6

Discriminant analysis for Full Sample
(154 firms)

$$V = f \{R, C, A, P, D\}$$

Standardized Discriminant Function Coefficients

Regulated/ non-regulated R(1)	-.09420
Degree of competition C(1)	-.14416
New issues/ no-new issues A(1)	.94096
Age of the firm A(2)	-.20160
Rate of return on equity relative to the industry return P(1)	-.26794
Debt to owners' equity D(1)	.26207

Chi-square: 48.972

Table 6
(continued)

Classification Results:

Actual Group -----	No. of cases -----	Predicted Group Membership	
		Violators -----	Non-violators -----
Violators	67	29 43.3%	38 56.7%
Non-violators	87	78 89.7%	9 10.3%

Percent of "Grouped " cases correctly classified: 75.32%

Distribution of the 154 firms:

	Regulated	Non-regulated	Total
Violators	31	36	67
Non-violators	41	46	87
	-----	-----	-----
	72	82	154
	=====	=====	=====

Table 7

Multiple regression model for Violation type 1
(33 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	.276605			
Degree of competition C(1)	-.010465	.009157	-1.142	13%
Age of the firm A(2)	.016851	.012241	1.377	10%
Rate of return on equity relative to the industry return P(1)	-.018010	.008452	-2.131	2%
Debt to owners' equity D(1)	.020026	.031650	.633	27%

R-squared: .27

Pearson correlation (matrix) coefficients

	R(1)	C(1)	A(2)	P(1)	D(1)
R(1)	1.0000	-.2591	.3010	-.3465	.2186
C(1)		1.0000	-.3574	-.1440	-.1844
A(2)			1.0000	.0256	-.0203
P(1)				1.0000	-.2168
D(1)					1.0000

Distribution of the 33 firms:

	Regulated	Non-regulated	Total
Violators	14	19	33
	=====	=====	=====

Table 8

Logit estimation model for Violation type 1
(33 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	10.10517			
Degree of competition C(1)	-2.0056E-33	-1.9586E-33	1.024	16%
Age of the firm A(2)	2.2042E-32	1.5943E-32	1.383	9%
Rate of return on equity relative to the industry return P(1)	-3.2009E-33	-3.2141E-33	.996	16%
Debt to owners' equity D(1)	-8.3300E-33	-2.3908E-33	3.484	.001%

Chi-square: 1.804E-32

Distribution of the 33 firms:

	Regulated	Non-regulated	Total
Violators	14 =====	19 =====	33 =====

Table 9

Probit estimation model for Violation type 1
(33 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	8.97203			
Degree of competition C(1)	-6.4686E-33	-1.2494E-32	.518	30%
Age of the firm A(2)	-5.1428E-33	-7.3577E-33	.696	25%
Rate of return on equity relative to the industry return P(1)	-1.0777E-33	-2.1403E-33	.504	30%
Debt to owners' equity D(1)	-1.4406E-32	-8.1784E-33	1.783	5%

Chi-square: 1.018E-32

Distribution of the 33 firms:

	Regulated	Non-regulated	Total
Violators	14	19	33
	=====	=====	=====

Table 10

Discriminant analysis for Violation type 1
(33 firms)

$$V = f (C, A, P, D)$$

Standardized Discriminant Function Coefficients

Degree of competition C(1)	.44553
Age of the firm A(2)	-.51134
Rate of return on equity relative to the industry return P(1)	.75559
Debt to owners' equity D(1)	-.23595

Chi-square: 9.248

Classification results

Actual group -----	No. of cases -----	Predicted Group Membership	
		Regulated -----	Non-regulated -----
Regulated	14	5 35.7%	9 64.3%
Non-regulated	19	16 84.2%	3 15.8%

Percent of "Grouped" cases correctly classified: 75.76%

Distribution of the 33 firms:

	Regulated	Non-regulated	Total
Violators	14 =====	19 =====	33 =====

Table 11

Multiple regression estimation model for Violation type2
(40 firms)

$$V = f \{C, A, P, D\}$$

	Coefficients	Standard error	t-value	Significant at
Intercept	.116216			
Degree of competition C(1)	-.011282	.013181	-.856	20%
New issues/ no-new issues A(1)	.312312	.178570	1.749	5%
Age of the firm A(2)	.009033	.006047	1.494	8%
Rate of return on equity relative to the industry return P(1)	-.003259	.001623	-2.008	3%
Debt to owners' equity D(1)	.017648	.009746	1.811	4%

R-squared: .21

Table 11
(continued)

Pearson correlation (matrix) coefficients

	R(1)	C(1)	A(1)	A(2)	P(1)	D(1)
R(1)	1.0000	-.1708	.0613	.1508	-.2172	.2178
C(1)		1.0000	.1972	-.2605	-.0257	-.1263
A(1)			1.0000	-.3617	.1621	-.2570
A(2)				1.0000	.1218	.0333
P(1)					1.0000	.0576
D(1)						1.0000

Distribution of the 40 firms:

	Regulated	Non-regulated	Total
Violators	19	21	40
	=====	=====	=====

Table 12

Logit estimation model for Violation type 2
(40 firms)

$$V = f \{C, A, P, D\}$$

	Coefficients	Standard error	t-value	Significant at
Intercept	10.10517			
Degree of competition C(1)	-3.8014E-32	-2.7426E-32	1.386	9%
New issues/ no-new issues A(1)	-1.2411E-30	-6.3990E-32	19.396	.001%
Age of the firm A(2)	-2.4343E-32	-3.7485E-32	.649	26%
Rate of return on equity relative to the industry return P(1)	3.2018E-33	1.7926E-32	.179	43%
Debt to owners' equity D(1)	-3.2404E-32	-3.0521E-32	1.062	15%

Chi-squared; 2.688E-32

Distribution of the 40 firms:

	Regulated	Non-regulated	Total
Violators	19	21	40
	=====	=====	=====

Table 13

Probit estimation model for Violation type 2
(40 firms)

$$V = f \{C, A, P, D\}$$

	Coefficients	Standard error	T-value	Significant at
Intercept	8.97203			
Degree of competition C(1)	-1.9026E-32	-2.7151E-32	.701	24%
New issues/ no-new issues A(1)	1.1616E-31	1.1846E-32	9.806	.001%
Age of the firm A(2)	-5.4081E-34	-1.6471E-33	.328	37%
Rate of return on equity relative to the industry return P(1)	-1.6408E-34	-1.8170E-33	.090	50%
Debt to owners' equity D(1)	-1.5474E-33	-2.8828E-33	.537	30%

Chi-squared: 1.234E-32

Distribution of the 40 firms:

	Regulated	Non-regulated	Total
Violators	19 =====	21 =====	40 =====

Table 14
 Discriminant analysis for Violation type 2
 (40 firms)

$$V = f (C, A, P, D)$$

Standardized Discriminant Function Coefficients

Degree of competition C(1)	-.32853
New issues/ no-new issues A(1)	.74739
Age of the firm A(2)	.61656
Rate of return on equity relative to the industry return P(1)	-.75883
Debt to owners' equity D(1)	.68964

Chi-square: 8.487

Table 14
(continued)

Classification results

Actual group	No. of cases	Prediction group membership	
		Regulated	Non-regulated
Regulated	19	7 36.8%	12 63.2%
Non-regulated	21	16 76.2%	5 23.8%

Percent of "Grouped" cases correctly classified: 70%

Distribution of the 40 firms:

	Regulated	Non-regulated	Total
Violators	19 =====	21 =====	40 =====

Table 15

Multiple regression estimation model for Violation type 3
(25 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	.577429			
Degree of competition C(1)	-.040687	.043117	-.944	18%
New issues/ no-new issues A(1)	-.298839	.204743	-1.460	8%
Age of the firm A(2)	.016650	.014716	1.131	14%
Rate of return on equity relative to the industry return P(1)	-.001461	.001673	-.873	20%
Debt to owners' equity D(1)	-.014113	.011024	-1.280	11%

R-squared: .29

Table 15
(continued)

Pearson correlation (matrix) coefficients

	R(1)	C(1)	A(1)	A(2)	P(1)	D(1)
R(1)	1.0000	-.2065	-.3590	.1437	-.2403	-.2368
C(1)		1.0000	-.0016	-.2866	-.0582	-.1642
A(1)			1.0000	.1557	.2543	.1998
A(2)				1.0000	.1197	.3172
P(1)					1.0000	.1069
D(1)						1.0000

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	13	12	25
	=====	=====	=====

Table 16

Logit estimation model for Violation type 3
(25 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	10.10517			
Degree of competition C(1)	-7.0400E-32	-1.5446E-32	4.558	.0001%
New issues/ no-new issues A(1)	5.2272E-31	2.3437E-32	22.307	.0001%
Age of the firm A(2)	1.7660E-32	1.1243E-32	1.571	7%
Rate of return on equity relative to the industry return P(1)	1.2534E-33	7.1120E-33	.176	43%
Debt to owners' equity D(1)	-1.0851E-32	-9.1410E-33	1.187	13%
Chi-squared:	1.301E-32			

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	13	12	25
	=====	=====	=====

Table 17

Probit estimation model for Violation type 3
(25 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	8.9723			
Degree of competition C(1)	8.6578E-34	3.7572E-34	2.304	2%
New issues/ no-new issues A(1)	3.1592E-32	2.8011E-33	11.278	.0001%
Age of the firm A(2)	2.3810E-33	2.9982E-33	.794	22%
Rate of return on equity relative to the industry return P(1)	-1.5728E-34	-1.7652E-33	.089	50%
Debt to owners' equity D(1)	-3.0056E-33	-5.0080E-33	.600	28%

Chi-squared: 4.937E-33

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	13 =====	12 =====	25 =====

Table 18
 Discriminant analysis for Violation type 3
 (25 firms)

$$V = f \{C, A, P, D\}$$

Standardized Discriminant Function Coefficients

Degree of competition C(1)	.41520
New issues/ no-new issues A(1)	.61673
Age of the firm A(2)	-.52664
Rate of return on equity relative to the industry return P(1)	.37743
Debt to owners' equity D(1)	.57182

Chi-square: 6.928

Table 18
(continued)

Classification results

Actual group -----	No. of cases -----	Predicted group membership	
		Regulated -----	Non-regulated -----
Regulated	13	3 23.1%	10 76.9%
Non-regulated	12	8 66.7%	4 33.3%

Percent of "Grouped" cases correctly classified: 72%

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	13 =====	12 =====	25 =====

Table 19
Multiple regression estimation for Violation type 4
(25 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	-.121292			
Degree of competition C(1)	-.001811	.014197	-.128	45%
New issues/ no-new issues A(1)	.242273	.385239	.629	27%
Age of the firm A(2)	.037022	.016608	2.229	2%
Rate of return on equity relative to the industry return P(1)	-.002782	.001954	-1.424	9%
Debt to owners' equity D(1)	.023468	.065019	.361	36%
R-squared:	.29			

Table 19
(continued)

Pearson correlation (matrix) coefficients

	R(1)	C(1)	A(1)	A(2)	P(1)	D(1)
R(1)	1.0000	-.1739	-.1380	.4541	-.2691	-.0134
C(1)		1.0000	.0208	-.2724	.0259	-.1473
A(1)			1.0000	-.1793	.5642	-.2509
A(2)				1.0000	-.0272	-.1868
P(1)					1.0000	-.1053
D(1)						1.0000

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	12	13	25
	=====	=====	=====

Table 20
Logit estimation model for Violation type 4
(25 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	-.10017			
Degree of competition C(1)	-2.2951E-33	-1.5602E-33	1.471	8%
New issues/ no-new issues A(1)	-5.5594E-32	-1.3790E-33	40.315	.0001%
Age of the firm A(2)	-2.2015E-33	-1.1394E-33	1.932	4%
Rate of return on equity relative to the industry return P(1)	2.6246E-34	1.2329E-33	.213	42%
Debt to owners' equity D(1)	-2.0265E-32	-2.9988E-33	6.758	.0001%

Chi-squared: 3.982E-35

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	12 =====	13 =====	25 =====

Table 21

Probit estimation model for Violation type 4
(25 firms)

$$V = f (C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	1.03050			
Degree of competition C(1)	9.8776E-33	1.3281E-32	.744	23%
New issues/ no-new issues A(1)	3.3580E-32	1.6474E-33	20.384	.0001%
Age of the firm A(2)	6.0062E-33	6.1486E-33	.977	17%
Rate of return on equity relative to the industry return P(1)	-1.0466E-35	-9.7248E-35	.108	50%
Debt to owners' equity D(1)	2.7394E-32	8.0180E-33	3.417	.003%
Chi-squared:	1.929E-33			

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	12 =====	13 =====	25 =====

Table 22

Discriminant analysis for Violation type 4
(25 firms)

$$V = f \{C, A, P, D\}$$

Standardized Discriminant Function Coefficients

Degree of competition C(1)	-.05723
New issues/ no-new issues A(1)	.34382
Age of the firm A(2)	.94267
Rate of return on equity relative to the industry return P(1)	-.71332
Debt to owners' equity D(1)	.16866

Chi-square: 6.877

Table 22
(continued)

Classification results

Actual group	No. of cases	Predicted group membership	
		Regulated	Non-regulated
Regulated	12	4 33.3%	8 66.7%
Non-regulated	13	11 84.6%	2 15.4%

Percent of "Grouped" cases correctly classified: 76%

Distribution of the 25 firms:

	Regulated	Non-regulated	Total
Violators	12 =====	13 =====	26 =====

Table 23
Multiple regression estimation model for 124 firms
(after having 30 hold out sample from full sample of 154 firms)

$$V = f (R, C, A, P, D)$$

	Coefficients	Standard Error	T-value	Significant at
Intercept	.328753			
Regulated/ non-regulated R(1)	-.028196	.084464	-.334	37%
Degree of competition C(1)	-.000766	.000875	-.875	19%
New issues/ no-new issues A(1)	.500988	.085502	5.859	.0001%
Age of the firm A(2)	-.004114	.002925	-1.406	8%
Rate of return on equity relative to the industry return P(1)	-.004512	.006393	-.706	24%
Debt to owners' equity D(1)	.010523	.006285	1.674	5%

R-Squared = .26

Pearson correlation (matrix) coefficients

	V(1)	R(1)	C(1)	A(1)	A(2)	P(1)	D(1)
V(1)	1.0000	-.0084	-.0872	.4744	-.1285	-.0259	.1319
R(1)		1.0000	-.1409	.0079	.1587	-.1986	.0835
C(1)			1.0000	-.0521	-.0580	-.0124	-.0290
A(1)				1.0000	-.0078	.0050	.0324
A(2)					1.0000	.2066	.0405
P(1)						1.0000	.3693
D(1)							1.0000

Table 23
(continued)

Distribution of the 124 firms:

	Regulated	Non-regulated	Total
Violators	25	24	54
Non-violators	33	37	70
	-----	-----	-----
	58	66	124
	=====	=====	=====

PREDICTION OF 30 HOLD OUT SAMPLE
BY USING MULTIPLE REGRESSION RESULTS OF 124 FIRMS

Actual group	No. of cases	Predicted group membership	
		Violators	Non-violators
Violators	13	8 61.5%	5 38.5%
Non-violators	17	1 5.9%	16 94.1%

Percent of "grouped" cases correctly predicted: 80%

Distribution of hold out sample of 30 firms:

	Regulated	Non-regulated	Total
Violators	6	7	13
Non-violators	8	9	17
	-----	-----	-----
	14	16	30
	=====	=====	=====

Table 24

Logit estimation model for 124 firms
(after having 30 hold out sample from full sample of 154 firms)

$$V = f \{R, C, A, P, D\}$$

	Coefficients	Standard Error	t-value	Significant at
Intercept	10.10517			
Regulated/ non-regulated R(1)	-1.8648E-29	-1.9334E-30	9.645	.0001%
Degree of competition C(1)	-2.1290E-32	-2.1242E-31	.100	50%
New issues/ no-new issues A(1)	-5.8849E-30	-5.3024E-31	11.099	.0001%
Age of the firm A(2)	2.7726E-31	8.2359E-31	.337	37%
Rate of return on equity relative to the industry return P(1)	-3.5580E-31	-4.860E-31	.731	23%
Debt to owners' equity D(1)	4.0832E-31	5.6254E-31	.726	24%

Chi-Square = 5.986E-30

Table 24
(continued)

Distribution of the 124 firms:

	Regulated	Non-regulated	Total
Violators	25	29	54
Non-violators	33	37	70
	-----	-----	-----
	58	66	124
	=====	=====	=====

Distribution of hold out sample of 30 firms:

	Regulated	Non-regulated	Total
Violators	6	7	13
Non-violators	8	9	17
	-----	-----	-----
	14	16	30
	=====	=====	=====

Table 25
 Probit estimation model for 124 firms
 (after having 30 hold out sample from full sample of 154 firms)

$$V = f (R, C, A, P, D)$$

	Coefficients	Standard error	t-value	Significant at
Intercept	8.97203			
Regulated/ non-regulated R(1)	1.1229E-30	2.3027E-31	4.876	.0001%
Degree of competition C(1)	-3.9182E-33	-7.7324E-32	.051	50%
New issues/ no-new issues A(1)	8.2323E-32	1.4671E-32	5.611	.0001%
Age of the firm A(2)	-5.8344E-32	-3.4280E-31	.170	43%
Rate of return on equity relative to the industry return P(1)	6.9559E-32	1.8816E-31	.370	36%
Debt to owners' equity D(1)	-6.3457E-32	-1.7292E-31	.367	36%

Chi-squared = 8.610E-32

Table 25
(continued)

Distribution of the 124 firms:

	Regulated	Non-regulated	Total
Violators	25	29	54
Non-violators	33	37	70
	-----	-----	-----
	58	66	124
	=====	=====	=====

Distribution of hold out sample of 30 firms:

	Regulated	Non-regulated	Total
Violators	6	7	13
Non-violators	8	9	17
	-----	-----	-----
	14	16	30
	=====	=====	=====

Table 26

Discriminant analysis for 124 firms
(after having 30 hold out sample from full sample of 154 firms)

$$V = F (R, C, A, P, D)$$

Standardized Discriminant Function Coefficients

Regulated/ non-regulated R(1)	-.06442
Degree of competition C(1)	-.15911
New issues/ no-new issues A(1)	.93090
Age of the firm A(2)	-.26350
Rate of return on equity relative to the industry return P(1)	-.14611
Debt to owners' equity D(1)	.32778

Chi-square: 36.374

Table 26
(continued)

Classification results

Actual group	No. of cases	Predicted group membership	
		Violators	Non-violators
Violators	54	23 42.6%	31 57.4
Non-violators	70	62 88.6%	8 11.4%

Percent of "Grouped" cases correctly classified: 75%

Distribution of the 124 firms:

	Regulated	Non-regulated	Total
Violators	25	29	54
Non-violators	33	37	70
	58	66	124

Distribution of hold out sample of 30 firms:

	Regulated	Non-regulated	Total
Violators	6	7	13
Non-violators	8	9	17
	14	16	30

APPENDIX I

ADDITIONAL DOCUMENTS FOR DEFINITION OF REGULATION -Securities Acts of 1934-

V-14 9:4 '86

Sec.12

(g) (1) Every issuer which is engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce shall—

(A) within one hundred and twenty days after the last day of its first fiscal year ended after the effective date of this subsection on which the issuer has total assets exceeding \$1,000,000 and a class of equity security (other than an exempted security) held of record by seven hundred and fifty or more persons; and

(B) within one hundred and twenty days after the last day of its first fiscal year ended after two years from the effective date of this subsection on which the issuer has total assets exceeding \$1,000,000 and a class of equity security (other than an exempted security) held of record by five hundred or more but less than seven hundred and fifty persons.

register such security by filing with the Commission a registration statement (and such copies thereof as the Commission may require) with respect to such security containing such information and documents as the Commission may specify comparable to that which is required in an application to register a security pursuant to subsection (b) of this section. Each such registration statement shall become effective sixty days after filing with the Commission or within such shorter period as the Commission may direct. Until such registration statement becomes effective it shall not be deemed filed for the purposes of section 18 of this title. Any issuer may register any class of equity security not required to be registered by filing a registration statement pursuant to the provisions of this paragraph. The Commission is authorized to extend the date upon which any issuer or class of issuers is required to register a security pursuant to the provisions of this paragraph.

[Rule 12g-1 (not reproduced in this Service), as amended by Release No. 33-6652, dated July 8, 1986, effective August 15, 1986, provides that domestic issuers whose total assets at fiscal year end do not exceed \$5,000,000 are exempt from this registration requirement.—Editor.]

(2) The provisions of this subsection shall not apply in respect of—

(A) any security listed and registered on a national securities exchange.

(B) any security issued by an investment company registered pursuant to section 8 of the Investment Company Act of 1940.

(C) any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawable capital, issued by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution.

APPENDIX I
(continued)

(D) any security of an issuer organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(E) any security of an issuer which is a "cooperative association" as defined in the Agricultural Marketing Act, approved June 15, 1929, as amended, or a federation of such cooperative associations, if such federation possesses no greater powers or purposes than cooperative associations so defined.

(F) any security issued by a mutual or cooperative organization which supplies a commodity or service primarily for the benefit of its members and operates not for pecuniary profit, but only if the security is part of a class issuable only to persons who purchase commodities or services from the issuer, the security is transferable only to a successor in interest or occupancy or premises serviced or to be served by the issuer, and no dividends are payable to the holder of the security.

(G) any security issued by an insurance company if all of the following conditions are met:

(i) Such insurance company is required to and does file an annual statement with the Commissioner of Insurance (or other officer or agency performing a similar function) of its domiciliary State, and such annual statement conforms to that prescribed by the National Association of Insurance Commissioners or in the determination of such State commissioner, officer or agency substantially conforms to that so prescribed.

(ii) Such insurance company is subject to regulation by its domiciliary State of proxies, consents, or authorizations in respect of securities issued by such company and such regulation conforms to that prescribed by the National Association of Insurance Commissioners.

(iii) After July 1, 1966, the purchase and sales of securities issued by such insurance company by beneficial owners, directors, or officers of such company are subject to regulation (including reporting) by its domiciliary State substantially in the manner provided in section 16 of this title.

(H)* any interest or participation in any collective trust funds maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (i) a stock-bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, or (ii) an annuity plan which meets the requirements for deduction of the employer's contribution under section 404(a) (2) of such Code.

(3) The Commission may by rules or regulations or, on its own motion, after notice and opportunity for hearing, by order, exempt from this subsection any security of a foreign issuer, including any certificate of deposit for such a security, if the Commission finds that such exemption is in the public interest and is consistent with the protection of investors.

(4) Registration of any class of security pursuant to this subsection shall be terminated ninety days, or such shorter period as the Commission may determine, after the issuer files a certification with the Commission that the number of holders of record of such class of security is reduced to less than three hundred persons. The Commission shall after notice and opportunity for hearing deny termination of registration if it finds that the certification is untrue. Termination of registration shall be deferred pending final determination on the question of denial.

APPENDIX I
(continued)

(5) For the purposes of this subsection the term "class" shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may for the purpose of this subsection define by rules and regulations the terms "total assets" and "held of record" as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection.

Sec.15

(d)* Each issuer which has filed a registration statement containing an undertaking which is or becomes operative under this subsection as in effect prior to the date of enactment of the Securities Acts Amendments of 1964, and each issuer which shall after such date file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 13 of this title in respect of a security registered pursuant to section 12 of this title. The duty to file under this subsection shall be automatically suspended if and so long as any issue of securities of such issuer is registered pursuant to section 12 of this title. The duty to file under this subsection shall also be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons. For the purposes of this subsection, the term "class" shall be construed to include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may, for the purpose of this subsection, define by rules and regulations the term "held of record" as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection. Nothing in this subsection shall apply to securities issued by a foreign government or political subdivision thereof.

APPENDIX I
(continued)

-Securities Acts of 1933-

Exempted Securities

Sec. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

(1) Any security which, prior to or within sixty days after the enactment of this title, has been sold or disposed of by the issuer or bona fide offered to the public, but this exemption shall not apply to any new offering of any such security by an issuer or underwriter subsequent to such sixty days;

(2) Any security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or territory or by any public instrumentality of one or more States or territories, or by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing; or any security issued or guaranteed by any bank; or any security issued by or representing an interest in or a direct obligation of a Federal Reserve bank; or any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian; or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A),

APPENDIX I
(continued)

(5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security; or any interest or participation in a single or collective trust fund maintained by a bank or in a separate account maintained by an insurance company which interest or participation is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of the Internal Revenue Code of 1954, or (B) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of such Code, other than any plan described in clause (A) or (B) of this paragraph (i) the contributions under which are held in a single trust fund maintained by a bank or in a separate account maintained by an insurance company for a single employer and under which an amount in excess of the employer's contribution is allocated to the purchase of securities (other than interests or participations in the trust or separate account itself) issued by the employer or by any company directly or indirectly controlling, controlled by or under common control with the employer or (ii) which covers employees some or all of whom are employees within the meaning of section 401(c)(1) of such Code. The Commission, by rules and regulations or order, shall exempt from the provisions of section 5 of this title any interest or participation issued in connection with a stock bonus, pension, profit-sharing, or annuity plan which covers employees some or all of whom

APPENDIX I
(continued)

are employees within the meaning of section 401 (c) (1) of the Internal Revenue Code of 1954, if and to the extent that the Commission determines this to be necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title. For purposes of this paragraph, a security issued or guaranteed by a bank shall not include any interest or participation in any collective trust fund maintained by a bank; and the term "bank" means any national bank, or any banking institution organized under the laws of any State, territory, or the District of Columbia, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; except that in the case of a common trust fund or similar fund, or a collective trust fund, the term "bank" has the same meaning as in the Investment Company Act of 1940.¹

[Note: See Appendix, I-F, p. 26, re additional exemption for securities issued under mortgage indenture insured under National Housing Act.]

APPENDIX I
(continued)

(3) Any note, draft, bill of exchange, or bankers' acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited;

(4) Any security issued by a person² organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part

¹ As amended by Public Law 291, 73d Congress; Public Law 91-373; Public Law 91-547, sec. 27(b), 84 Stat. 1434, approved Dec. 14, 1970; and Public Law 91-567, sec. 6(a), 84 Stat. 1498, eff. with respect to securities sold after Jan. 1, 1970, approved Dec. 22, 1970. As originally enacted, this paragraph read as follows:

"(2) Any security issued or guaranteed by the United States or any Territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more States or Territories exercising an essential governmental function, or by any corporation created and controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States, or by any national bank, or by any banking institution organized under the laws of any State or Territory, the business of which is substantially confined to banking and is supervised by the State or territorial banking commission or similar official; or any security issued by or representing an interest in or a direct obligation of a Federal reserve bank:"

² Public Law 291, 73d Congress, substituted the word "person" for the word "corporation."

APPENDIX I
(continued)

of the net earnings of which inures to the benefit of any person, private stockholder, or individual;

(b) Any security issued (A) by a savings and loan association, building and loan association, cooperative bank, homestead association, or similar institution, which is supervised and examined by State or Federal authority having supervision over any such institution, except that the foregoing exemption shall not apply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 per centum of the face value of such security; or (B) by (i) a farmer's cooperative organization exempt from tax under section 521 of the Internal Revenue Code of 1954, (ii) a corporation described in section 501(c)(16) of such Code and exempt from tax under section 501(a) of such Code, or (iii) a corporation described in section 501(c)(2) of such Code which is exempt from tax under section 501(a) of such Code and is organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization or corporation described in clause (i) or (ii);¹

APPENDIX I
(continued)

(6) Any security issued by a motor carrier the issuance of which is subject to the provisions of section 214 of the Interstate Commerce Act, or any interest in a railroad equipment trust. For purposes of this paragraph 'interest in a railroad equipment trust' means any interest in an equipment trust, lease, conditional sales contract, or other similar arrangement entered into, issued, assumed, guaranteed by, or for the benefit of, a common carrier to finance the acquisition of rolling stock, including motive power;²

(7) Certificates issued by a receiver or by a

¹ Para. (5) amended, eff. Dec. 14, 1970, Public Law 91-547, sec 27(c), 34 Stat. 1434. Para. (5) formerly read:

"(5) Any security issued by a building and loan association, homestead association, savings and loan association, or similar institution, substantially all the business of which is confined to the making of loans to members (but the foregoing exemption shall not apply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 percentum of the face value of such security), or any security issued by a farmer's cooperative association as defined in paragraphs (12), (13), and (14) of section 103 of the Revenue Act of 1932."

² As amended by Section 308(a)(1) of the Railroad Revitalization and Regulatory Reform Act of 1976, Public Law 94-210, 90 Stat. 56, approved February 5, 1976.

APPENDIX I
(continued)

trustees in bankruptcy, with the approval of the court;

(8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory of the United States or the District of Columbia;

[NOTE: See Appendix, I-G, p. 27, for limitation on this section with respect to investment companies.]

(9) Any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange;

(10) Any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval; 3

APPENDIX I
(continued)

[NOTE: See Appendix, I-A, B, C, and D,
pp. 23-24, for additional exemptions pro-
vided by the Bankruptcy Act.]

(11) Any security which is a part of an issue offered and ⁴ sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.⁵

⁴ Public No. 291, 73d Cong. replaced the former section 4(3) with section 3(a)(9) and the second clause of section 3(a)(10). Section 4(3) read as follows:

"(3) The issuance of a security of a person exchanged by it with its existing security holders exclusively, where no commission or other remuneration is paid or given directly or indirectly in connection with such exchange; or the issuance of securities to the existing security holders or other existing creditors of a corporation in the process of a bona fide reorganization of such corporation under the supervision of any court, either in exchange for the securities of such security holders or claims of such creditors or partly for cash and partly in exchange for the securities or claims of such security holders or creditors."

⁵ Public No. 577, 83d Cong., inserted the words "offered and" before "sold."

⁶ Public No. 291, 73d Cong., added paragraph (11). As originally enacted, the Act contained a related provision designated Sec. 5(c) which was removed by Public No. 291. The original Sec. 5(c) read as follows:

"(c) The provisions of this section relating to the use of the mails shall not apply to the sale of any security where the issue of which it is a part is sold only to persons resident within a single State or Territory, where the issuer of such securities is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

APPENDIX I
(continued)

[NOTE: See Appendix, I-G, p. 27, for limitation of this section with respect to investment companies.]

(b) The Commission may from time to time by its rules and regulations, and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$500,000.¹

(c) The Commission may from time to time by its rules and regulations and subject to such terms and conditions as may be prescribed therein, add to the securities exempted as provided in this section any class of securities issued by a small business investment company under the Small Business Investment Act of 1958 if it finds, having regard to the purposes of that Act, that the enforcement of this Act with respect to such securities is not necessary in the public interest and for the protection of investors.²

APPENDIX I
(continued)

Exempted Transactions

Sec. 4. The provisions of section 5 shall not apply to—

(1) transactions by any person other than an issuer, underwriter, or dealer.

(2) transactions by an issuer not involving any public offering.

(3) transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except—

(A) transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter,

(B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by

¹ Public No. 55, 79th Cong., approved May 15, 1945, substituted "\$300,000" for "\$100,000." Public Law 91-363, approved Dec. 19, 1970, substituted "\$500,000" for "\$300,000."

² Public No. 83-600 added para. (c).

**APPENDIX I
(continued)**

the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), or such shorter period as the Commission may specify by rules and regulations or order, and

(C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of forty days, shall be ninety days, or such shorter period as the Commission may specify by rules and regulations or order.

(4) brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders.³

[NOTE: See Appendix, I-G, p. 27. for limitation of this section with respect to certain investment companies.]

APPENDIX I
(continued)

(5) (A) Transactions involving offers or sales of one or more promissory notes directly secured by a first lien on a single parcel of real estate upon which is located a dwelling or other residential or commercial structure, and participation interests in such notes—

(i) where such securities are originated by a savings and loan association, savings bank,

* Prior to amendment by P.L. 88-467, the section, as amended by Public No. 291, 73d Cong., and Public No. 577, 43d Cong., read as follows:

"Sec. 4. The provisions of section 5 shall not apply to any of the following transactions:

(1) Transactions by any person other than an issuer, underwriter, or dealer; transactions by an issuer not involving any public offering; or transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except transactions taking place prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter and transactions in a security as to which a registration statement has been filed taking place prior to the expiration of forty days after the effective date of such registration statement or prior to the expiration of forty days after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such forty days any time during which a stop order issued under section 8 is in effect as to the security), and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

"(2) Brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders."

APPENDIX I
(continued)

commercial bank, or similar banking institution which is supervised and examined by a Federal or State authority, and are offered and sold subject to the following conditions:

(a) the minimum aggregate sales price per purchaser shall not be less than \$250,000;

(b) the purchaser shall pay cash either at the time of the sale or within sixty days thereof; and

(c) each purchaser shall buy for his own account only; or

(ii) where such securities are originated by a mortgagee approved by the Secretary of Housing and Urban Development pursuant to sections 208 and 211 of the National Housing Act and are offered or sold subject to the three conditions specified in subparagraph (A)(i) to any institution described in such subparagraph or to any insurance company subject to the supervision of the insurance commissioner, or any agency or officer performing like function, of any State or territory of the United States or the District of Columbia, or the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Government National Mortgage Association.

APPENDIX I
(continued)

(B) Transactions between any of the entities described in subparagraph (A)(i) or (A)(ii) hereof involving non-assignable contracts to buy or sell the foregoing securities which are to be completed within two years, where the seller of the foregoing securities pursuant to any such contract is one of the parties described in subparagraph (A)(i) or (A)(ii) who may originate such securities and the purchaser of such securities pursuant to any such contract is any institution described in subparagraph (A)(i) or any insurance company described in subparagraph (A)(ii), the Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, or the Government National Mortgage Association and where the foregoing securities are subject to the three conditions for sale set forth in subparagraphs (A)(i)(a) through (c).

(C) The exemption provided by subparagraphs (A) and (B) hereof shall not apply to resales of the securities acquired pursuant thereto, unless each of the conditions for sale contained in subparagraphs (A)(1)(a) through (c) are satisfied.¹

¹Subsection (B) added by Public Law 94-29, Sec. 20, 89 Stat. 97, approved June 4, 1975.

APPENDIX II

From: THE WORK OF THE SEC

(A SEC Booklet)

The Division of Enforcement

This division is charged with enforcing Federal securities laws. Enforcement responsibilities include investigating possible violations of Federal securities laws and recommending appropriate remedies for consideration by the Commission. Possible violations may come to light through the Enforcement Division's own inquiries, through referrals from other divisions of the Commission, from outside sources such as the self-regulatory organizations, or by other means.

When possible violations of Federal securities laws warrant further investigation by the staff, the Commission is consulted before proceeding. The Commission's decisions may result in issuing subpoenas, formal orders of investigation, or other means of proceeding with actions. At the conclusion of investigations, the Commission may authorize the staff to proceed with injunctions preventing further violative conduct, with administrative proceedings in the case of entities directly regulated by the Commission, or with other remedies as appropriate.

**APPENDIX II
(continued)**

**THE SEC'S ENFORCEMENT PROGRAM
(from the SEC Annual Report of 1985)**

Enforcement Program

Introduction

The Commission's enforcement program seeks to preserve the integrity, efficiency and fairness of the securities markets by enforcing the Federal securities laws. These laws provide civil and administrative remedies designed to rectify past, and prevent future, violations.

Most Commission enforcement actions are preceded by a private investigation to determine whether a violation of the securities laws has occurred or is about to. Where necessary, the Commission may order a formal investigation, thereby authorizing the staff to issue subpoenas compelling testimony and production of documents.

Depending on results of an investigation, the Commission may authorize the staff to commence a civil action in a United States District Court, institute an administrative proceeding, or refer the matter to the Department of Justice for criminal prosecution. Matters also may be referred to state or local authorities or self-regulatory organizations for appropriate action.

The Commission's primary civil remedy is a Federal court injunction which directs the subject to comply with the law in the future. If it is violated, contempt of court proceedings may result in imprisonment or imposition of fines. Courts also may issue orders providing other equitable relief such as restitution, disgorgement of illicit profits, and other appropriate remedies.

The Commission is authorized to bring administrative proceedings against regulated entities such as broker-dealers, investment companies, or investment advisers, as well as persons associated with such entities. Where the Commission finds that a regulated entity has willfully violated the securities laws, it may impose remedial sanctions ranging from a censure to a revocation of the registration required for the entity to conduct business. The Commission also may censure or limit the activities of associated persons, or suspend or bar such persons from association.

Issuers of securities are subject to administrative proceedings if they fail to comply with the disclosure and certain other provisions of the Exchange Act under legislation enacted on August 10, 1984. The Commission's authority was extended to proxy and tender offer violations under Section 14 and to individuals causing the violations. Respondents may be ordered to comply with applicable provisions upon specified terms and conditions, or to take steps to effect compliance. Issuers may also be named as respondents in certain proceedings authorized by the Securities Act. In addition, the Commission may publish reports of investigation under Section 21(a) of the Exchange Act.

APPENDIX II (continued)

Criminal sanctions for Federal securities law violations include fines and imprisonment for up to five years for each violation. The Commission has developed close working relationships with the Department of Justice and U.S. Attorneys' offices to assist the investigation and prosecution of such cases. The Commission also cooperates closely with state securities regulators and self-regulatory organizations, including the National Association of Securities Dealers (NASD) and the various national securities exchanges.

Program Areas

Corporate Reporting and Accounting—

Insider Trading—

Regulated Entities and Associated Persons—

Securities Offering Violations—

Market Manipulation—

Changes in Corporate Control—

ENFORCEMENT

Types of Proceedings

As the table reflects, the securities laws provide for a wide range of enforcement actions by the Commission. The most common types of actions are injunctive proceedings instituted in the Federal district courts to enjoin continued or

threatened securities law violators, and administrative proceedings pertaining to broker-dealer firms and/or individuals associated with such firms which may lead to various remedial sanctions as required in the public interest. When an injunction is entered by a court, violation of the court's decree is a basis for civil or criminal contempt against the violator.

**APPENDIX II
(continued)**

**Table 28
TYPES OF PROCEEDINGS**

ADMINISTRATIVE PROCEEDINGS	
Persons Subject to, Acts Constituting, and Basis for, Enforcement Action	Sanction
Broker-dealer, municipal securities dealer, investment adviser or associated person	
Willful violation of securities laws or rules; aiding or abetting such violation; failure reasonably to supervise others; willful misstatement or omission in filing with the Commission; conviction of or injunction against certain crimes or conduct.	Censure or limitation on activities; revocation, suspension or denial of registration; bar or suspension from association (1934 Act, §§ 15B(c)(2)—(6), 15(b)(4)—(6), Advisers Act, § 203(e)—(f)).
Registered securities association	
Violation of or inability to comply with the 1934 Act, rules thereunder, or its own rules; unjustified failure to enforce compliance with the foregoing or with rules of the Municipal Securities Rulemaking Board by a member or person associated with a member.	Suspension or revocation of registration; censure or limitation of activities, functions, or operations (1934 Act, § 19(h)(1)).
Member of registered securities association, or associated person	
Entry of Commission order against person pursuant to 1934 Act, § 15(b); willful violation of securities laws or rules thereunder or rules of Municipal Securities Rulemaking Board; effecting transaction for other person with reason to believe that person was committing violations of securities laws.	Suspension or expulsion from the association; bar or suspension from association with member of association (1934 Act, § 19(h)(2)-(3)).
National securities exchange	
Violation of or inability to comply with 1934 Act, rules thereunder or its own rules; unjustified failure to enforce compliance with the foregoing by a member or person associated with a member.	Suspension or revocation of registration; censure or limitation of activities, functions, or operations (1934 Act, § 19(h)(1)).
Member of national securities exchange, or associated person	
Entry of Commission order against person pursuant to 1934 Act, § 15(b); willful violation of securities laws or rules thereunder, effecting transaction for other person with reason to believe that person was committing violations of securities laws.	Suspension or expulsion from exchange; bar or suspension from association with member (1934 Act, § 19(h)(2)-(3)).
Registered clearing agency	
Violation of or inability to comply with 1934 Act, rules thereunder, or its own rules; failure to enforce compliance with its own rules by participants.	Suspension or revocation of registration; censure or limitation of activities, functions, or operations (1934 Act, § 19(h)(1)).
Participant in registered clearing agency	
Entry of Commission order against participant pursuant to 1934 Act, § 15(b)(4); willful violation of clearing agency rules; effecting transaction for other person with reason to believe that person was committing violations of securities laws.	Suspension or expulsion from clearing agency (1934 Act, § 19(h)(2)).

**APPENDIX II
(continued)**

**Table 28—Continued
TYPES OF PROCEEDINGS**

ADMINISTRATIVE PROCEEDINGS	
Persons Subject to Acts Constituting, and Basis for, Enforcement Actions	Sanction
Securities information processor Violation of or inability to comply with provisions of 1934 Act or rules thereunder.	Censure or limitation of activities; suspension or revocation of registration (1934 Act, § 11A(b)(6)).
Transfer agent Willful violation of or inability to comply with 1934 Act, §§ 17 or 17A, or rules thereunder.	Censure or limitation of activities; denial, suspension, or revocation of registration (1934 Act, § 17A(c)(3)).
Any person Willful violation of 1933 Act, 1934 Act, Investment Company Act or rules thereunder; aiding or abetting such violation; willful misstatement in filing with Commission.	Temporary or permanent prohibition against serving in certain capacities with registered investment company (Investment Company Act, § 9(b)).
Officer or director of self-regulatory organization Willful violation of 1934 Act, rules thereunder, or the organization's own rules; willful abuse of authority or unjustified failure to enforce compliance.	Removal from office or censure (1934 Act, § 19(h)(4)).
Principal of broker-dealer Engaging in business as a broker-dealer after appointment of SIPC trustee.	Bar or suspension from being or becoming associated with a broker-dealer (SIPA, § 10(b)).
1933 Act registration statement Statement materially inaccurate or incomplete.	Stop order refusing to permit or suspending effectiveness (1933 Act, § 8(d)).
Issuer subject to §§ 12, 13, 14 or 15(d) of the 1934 Act or associated person Failure to comply with such provisions or having caused such failure by an act of omission that person knew or should have known would contribute thereto.	Order directing compliance or steps effecting compliance (1934 Act, § 15(c)(4)).
Securities registered pursuant to § 12 of the 1934 Act Noncompliance by issuer with 1934 Act or rules thereunder.	Denial, suspension of effective date, suspension or revocation of registration; prohibition against trading in securities when registration suspended or revoked (1934 Act, § 12(j)).
Public interest requires trading suspension.	Summary suspension of over-the-counter or exchange trading (1934 Act, § 12(k)).
Registered investment company Failure to file Investment Company Act registration statement or required report; filing materially incomplete or misleading statement or report.	Suspension or revocation of registration (Investment Company Act, § 8(e)).
Company has not attained \$100,000 net worth 90 days after 1933 Act registration statement became effective.	Stop order under 1933 Act; suspension or revocation of registration (Investment Company Act, § 14(a)).

**APPENDIX I
(continued)**

**Table 28—Continued
TYPES OF PROCEEDINGS**

ADMINISTRATIVE PROCEEDINGS	
Persons Subject to Acts Constituting, and Basis for, Enforcement Action	Sanction
Attorney, accountant, or other professional or expert	
Lack of requisite qualifications to represent others; lacking in character or integrity; unethical or improper professional conduct; willful violation of securities laws or rules; or aiding and abetting such violation.	Permanent or temporary denial of privilege of appearing or practicing before the Commission (17 CFR 201.2(e)(1)).
Attorney suspended or disbarred by court; expert's license revoked or suspended; conviction of a felony or of a misdemeanor involving moral turpitude.	Automatic suspension from appearance or practice before the Commission (17 CFR § 201.2(e)(2)).
Permanent injunction against or finding of securities violation in Commission-instituted action; finding of securities violation by Commission in administrative proceedings.	Temporary suspension from practicing; censure; permanent or temporary disqualification from practicing before the Commission; (17 CFR § 201.2(e)(3)).
Member of Municipal Securities Rulemaking Board	
Willful violation of 1934 Act, rules thereunder, or rules of the Board; abuse of authority.	Censure or removal from office (1934 Act, § 15B(c)(8)).
CIVIL PROCEEDINGS IN FEDERAL DISTRICT COURTS	
Persons Subject to, Acts Constituting, and Basis for, Enforcement Action	Sanction
Any person	
Engaging in or about to engage in acts or practices violating securities laws, rules or orders thereunder (including rules of a registered self-regulatory organization).	Injunction against acts or practices which constitute or would constitute violations (plus other equitable relief under court's general equity powers) (1933 Act, § 20(b); 1934 Act, § 21(d); Holding Company Act, § 18(f); Investment Company Act, § 42(e); Advisers Act, § 206(e); Trust Indenture Act, § 321).
Noncompliance with provisions of the law, rule, or regulation under 1933, 1934, or Holding Company Act, order issued by Commission, rules of a registered self-regulatory organization, or undertaking in a registration statement.	Writ of mandamus, injunction, or order directing compliance (1933 Act, § 20(c); 1934 Act, § 21(e); Holding Company Act § 18(g)).
Trading while in possession of material non-public information in a transaction on an exchange or from or through a broker-dealer (and transaction not part of a public offering), or aiding and abetting such trading.	Maximum civil penalty: three times profit gained or loss avoided as a result of transaction. (1934 Act, § 21(d)).
Securities Investor Protection Corporation	
Refusal to commit funds or act for the protection of customers.	Order directing discharge of obligations and other appropriate relief (SIPA, § 7(b)).
National securities exchange or registered securities association	
Failure to enforce compliance by members or persons associated with its members with the 1934 Act, rules or orders thereunder, or rules of the exchange or association.	Writ of mandamus, injunction or order directing such exchange or association to enforce compliance (1934 Act, § 21(e)).
Registered clearing agency	
Failure to enforce compliance by its participants with its own rules.	Writ of mandamus, injunction or order directing clearing agency to enforce compliance (1934 Act, § 21(e)).

**APPENDIX II
(continued)**

**Table 28—Continued
TYPES OF PROCEEDINGS**

CIVIL PROCEEDINGS IN FEDERAL DISTRICT COURTS	
Persons Subject to Acts Constituting, and Basis for, Enforcement Action	Sanction
Issuer subject to reporting requirements	
Failure to file reports required under § 15(d) of 1934 Act.	Forfeiture of \$100 per day (1934 Act, § 32(b)).
Registered investment company	
Name of company or of security issued by it deceptive or misleading.	Injunction against use of name (Investment Company Act, § 38(d)).
Officer, director, member of advisory board, adviser, depositor, or underwriter of investment company	
Engage in act or practice constituting breach of fiduciary duty involving personal misconduct.	Injunction against acting in certain capacities for investment company and other appropriate relief (Investment Company Act, § 36(a)).
III. CRIMINAL PROSECUTION BY DEPARTMENT OF JUSTICE	
Basis for Enforcement Action	Sanction or Relief
Any person	
Willful violation of securities laws or rules thereunder; willful misstatement in any document required to be filed by securities laws or rules; willful misstatement in any document required to be filed by self-regulatory organization in connection with an application for membership or association with member.	Maximum penalties: \$100,000 fine and 5 years imprisonment; an exchange may be fined up to \$500,000, a public-utility holding company up to \$200,000 (1933 Act, §§ 20(b), 24; 1934 Act, §§ 21(d), 32a); Holding Company Act, §§ 18(f), 29; Trust Indenture Act, §§ 321, 325; Investment Company Act, §§ 42(e), 49; Advisers Act, §§ 209(e), 217).
Persons who engage in Foreign Corrupt practices	
Any issuer (which has securities subject to reporting requirements of the 1934 Act) which violates § 30A(a) of the 1934 Act.	Maximum penalty: \$1,000,000 fine (1934 Act, § 32(c)(1)).
Any officer or director of an issuer, of any stockholder acting on behalf of such issuer who willfully violates § 30A(a) of the 1934 Act.	Maximum penalty: \$10,000 fine and 5 years imprisonment (1934 Act, § 32(c)(2)).
Any employee, or agent subject to the Jurisdiction of the United States of an issuer found to have violated § 30A(a) of the 1934 Act, who willfully carried out the act or practice constituting such violation.	Maximum penalty: \$10,000 fine and 5 years imprisonment (1934 Act, § 32(c)(3)).

*Statutory references are as follows: "1933 Act", the Securities Act of 1933; "1934 Act", the Securities Exchange Act of 1934; "Investment Company Act", the Investment Company Act of 1940; "Advisers Act", the Investment Advisers Act of 1940; "Holding Company Act", the Public Utility Holding Company Act of 1935; "Trust Indenture Act", the Trust Indenture Act of 1939; and "SIPA", the Securities Investor Protection Act of 1970.

**APPENDIX II
(continued)**

**Table 29
NATIONWIDE ENFORCEMENT PROGRAM
ENFORCEMENT CASES INITIATED BY THE COMMISSION
DURING FISCAL 1985 IN VARIOUS PROGRAM AREAS**

(Each case initiated has been included in only one category listed below, even though many cases involve multiple allegations and may fall under more than one category.)

Program Area in Which Civil Action, Administrative Proceeding, or 21(a) Report Was Initiated	Civil Actions	Administrative Proceedings	21(a) Reports	Total	% of Total Cases
Broker-Dealer Cases					
(a) Backoffice	7 (10)	19 (38)	.....	26 (48)	
(b) Fraud against customer	10 (27)	28 (37)	.....	38 (64)	
(c) Stock Loan	2 (6)	.....	.....	2 (6)	
(d) Other	3 (3)	10 (14)	.....	13 (32)	
Total Broker-Dealer Cases	22 (61)	57 (89)	.....	79 (150)	29.4%
Securities Offering Cases					
(a) Non-regulated Entity	43 (120)	6 (6)	.....	49 (126)	
(b) Regulated Entity	6 (23)	6 (12)	.....	12 (35)	
Total Securities Offering Cases	49 (143)	12 (18)	.....	61 (161)	22.7%
Issuer Financial Statement and Reporting Cases					
(a) Issuer Financial Disclosure	22 (62)	17 (21)	.....	39 (83)	
(b) Issuer FCPA Violation .....	.....	2 (2)	.....	2 (2)	
(c) Issuer Reporting Other	3 (3)	.....	.....	3 (3)	
Total Issuer Financial Statement and Reporting Cases	25 (65)	19 (23)	.....	44 (88)	16.3%
Other Regulated Entity Cases					
(a) Investment Advisers	4 (11)	15 (24)	.....	19 (35)	
(b) Investment Companies	1 (1)	1 (2)	.....	2 (3)	
(c) Transfer Agents	1 (5)	1 (1)	.....	2 (6)	
Total Other Regulated Entity Cases	6 (17)	17 (2)	.....	23 (4)	8.6%
Insider Trading Cases	12 (32)	6 (6)	.....	20 (40)	7.4%
Market Manipulation Cases	4 (18)	3 (5)	.....	7 (23)	2.6%
Fraud Against Regulated Entity	3 (11)	3 (6)	.....	6 (17)	2.2%
Corporate Control Violations	3 (13)	1 (1)	1 (1)	5 (15)	1.9%
Contempt Proceedings—Civil	3 (6)	.....	.....	3 (6)	1.1%
Related Party Transactions	2 (7)	.....	.....	2 (7)	0.7%
SUBTOTALS	129 (373)	120 (177)	1 (1)	250 (551)	
Delinquent Filings: Issuer Reporting	17 (18)	2 (2)	.....	19 (20)	7.1%
GRAND TOTALS	146 (391)	122 (179)	1 (1)	269 (571)	100%

The number of defendants, respondents or subjects is noted parenthetically.
This category includes injunctive actions, court orders pursuant to Section 21(e) of the Exchange Act, and contempt proceedings.

**APPENDIX II
(continued)**

**Table 30
INVESTIGATIONS OF POSSIBLE VIOLATIONS OF THE ACTS
ADMINISTERED BY THE COMMISSION**

Pending as of October 1, 1984	737
Opened in fiscal year 1985	339
Total	1,076
Closed in fiscal year 1985	356
Pending as of September 30, 1985	720

During the fiscal year ending September 30, 1985, 119 Formal Orders of Investigation were issued by the Commission upon recommendation of the Division of Enforcement.

**Table 31
ADMINISTRATIVE PROCEEDINGS INSTITUTED DURING FISCAL YEAR
ENDING SEPTEMBER 30, 1985**

Broker-Dealer Proceedings	76
Investment Adviser, Investment Company and Transfer Agent Proceedings	18
Stop Order and Regulation A Proceedings	7
Rule 2(e) Proceedings	11
Disclosure Proceedings (Section 15(c)(4) of the Exchange Act)	7
Total Proceedings in fiscal year 1985	117

**Table 32
INJUNCTIVE ACTIONS**

Fiscal Year	Actions Initiated	Defendants Named
1975	174	749
1976	158	722
1977	166	715
1978	135	607
1979	108	511
1980	103	387
1981	115	398
1982	136	418
1983	151	418
1984	179	508
1985	143	385

APPENDIX III

SOME SCHEDULES FROM STATISTICAL ABSTRACT OF THE US, 106th Ed.1986
(Sec.18 Business Enterprise; pp.517-39)

Schedule

NO. 874. NUMBER OF RETURNS, RECEIPTS, AND NET INCOME, BY TYPE OF BUSINESS: 1970 TO 1982

[Figures are estimates based on samples; see Appendix III. See also *Historical Statistics, Colonial Times to 1970*, series V 1-12. For further information regarding corporations, see table 895]

ITEM	Unit	1970	1975	1977	1978	1979	1980	1981	1982
Number.....	1,000.....	12,001	13,979	14,741	15,529	16,187	16,793	13,858	14,548
Receipts ¹	Bil. dol.....	2,082	3,885	4,899	5,377	5,345	7,159	7,725	7,788
Net income (less deficit) ²	Bil. dol.....	199	196	263	320	361	302	264	198
Proprietorships, number ³	1,000.....	9,400	10,882	11,348	12,018	12,330	12,702	9,585	10,108
Business receipts ¹	Bil. dol.....	238	339	394	443	488	506	427	434
Net income (less deficit) ²	Bil. dol.....	33	45	51	59	81	55	53	51
Partnerships, number.....	1,000.....	938	1,073	1,153	1,234	1,300	1,380	1,461	1,514
Total receipts ¹	Bil. dol.....	93	147	177	219	258	292	272	297
Net income (less deficit) ²	Bil. dol.....	10	8	13	14	15	8	-3	-7
Corporations, number.....	1,000.....	1,665	2,024	2,242	2,377	2,557	2,711	2,812	2,926
Total receipts ¹	Bil. dol.....	1,751	3,199	4,128	4,715	5,599	6,361	7,026	7,024
Net income (less deficit) ²	Bil. dol.....	66	143	219	247	285	239	214	154

¹ See footnote 1, table 876. ² See footnote 2, table 876. ³ Through 1980, covers individually owned businesses and farms; thereafter nonfarm business. ⁴ Total taxable receipts before deduction of cost of goods sold, cost of operations, and net loss from sales of property other than capital assets. Includes business receipts, interest, and receipts not specified. ⁵ Includes constructive taxable income from related foreign corporations.

Source: U.S. Internal Revenue Service, 1975 *Statistics of Income, Business Income Tax Returns*, annual; thereafter, *Statistics of Income, Sole Proprietorship Returns*, annual; *Statistics of Income Partnership Returns*, annual; and *Statistics of Income, Corporation Income Tax Return*, annual.

Schedule

NO. 875. NUMBER OF RETURNS AND BUSINESS RECEIPTS, BY SIZE OF RECEIPTS AND TYPE OF BUSINESS: 1980 TO 1982

[See headnote, table 876 and footnote 3, table 874. See also *Historical Statistics, Colonial Times to 1970*, series V 1-12. For further information regarding corporations, see table 895]

SIZE-CLASS OF RECEIPTS	1980		1981		1982							
	Re- turns (1,000)	Re- ceipts (bil. dol.)	Re- turns (1,000)	Re- ceipts (bil. dol.)	Returns (1,000)			Receipts (bil. dol.)				
					Total	Non- farm pro- pri- etor- ships	Part- ner- ships ¹	Cor- por- ations ¹	Total	Non- farm pro- pri- etor- ships	Part- ner- ships ¹	Cor- por- ations ¹
Total.....	16,793	6,523.4	13,859	6,934.2	14,548	10,108	1,514	2,926	6,842.3	433.7	251.8	6,187.0
Under \$25,000 ²	10,290	64.7	8,028	48.8	8,582	7,203	759	620	49.6	45.0	1.7	2.9
\$25,000-\$49,999.....	1,611	63.8	1,474	49.9	1,513	1,117	178	218	49.8	39.9	3.3	6.6
\$50,000-\$99,999.....	1,589	110.9	1,352	90.8	1,360	844	191	325	88.5	59.2	7.8	21.5
\$100,000-\$499,999.....	2,202	473.6	2,066	439.3	2,152	838	293	1,021	450.0	166.4	41.8	242.1
\$500,000-\$999,999.....	412	282.2	423	282.4	416	66	52	296	273.9	47.0	23.8	203.3
\$1,000,000 or more.....	486	5,528.6	512	6,023.6	524	36	42	446	5,930.5	76.2	173.7	5,660.6
	PERCENT DISTRIBUTION											
Under \$25,000 ²	61.3	1.0	57.9	.7	59.0	71.3	50.1	21.2	.7	10.4	.7	(2)
\$25,000-\$49,999.....	10.8	1.0	10.6	.7	10.4	11.1	11.8	7.4	.7	9.2	1.3	.1
\$50,000-\$99,999.....	9.5	1.7	9.8	1.3	9.3	8.3	12.6	11.1	1.3	13.7	3.1	.3
\$100,000-\$499,999.....	13.1	7.3	14.9	6.3	14.8	8.3	19.4	34.9	6.6	36.4	16.5	3.9
\$500,000-\$999,999.....	2.5	4.3	3.1	4.1	2.9	.7	3.4	10.1	4.0	10.8	9.4	3.3
\$1,000,000 or more.....	2.9	84.8	3.7	86.9	3.8	.4	28	15.3	86.7	17.8	69.0	92.3

² Less than .05 percent. ¹ Business receipts. Active firms only. ² Includes firms with no receipts. Source: U.S. Internal Revenue Service, *Statistics of Income, Sole Proprietorship Returns*, annual; *Statistics of Income, Partnership Returns*, annual; and *Statistics of Income, Corporation Income Tax Return*, annual.

**APPENDIX III
(continued)**

Schedule

**NO. 879. PARTNERSHIP RETURNS—SELECTED INCOME STATEMENT AND BALANCE SHEET ITEMS:
1970 TO 1982**

(In millions, except as indicated. All figures are estimates based on samples. See headnote, table 878. See also Appendix III and Historical Statistics, Colonial Times to 1970, Series V 7-9)

ITEM	1970	1975	1977	1978	1979	1980	1981	1982
Active partnerships, number (1,000).....	936	1,073	1,153	1,234	1,300	1,360	1,481	1,514
Number with net income (1,000).....	640	661	710	782	766	774	749	781
Number with balance sheets (1,000).....	558	783	806	1,024	(NA)	1,194	1,198	1,223
Number of partners (1,000).....	3,698	4,951	6,080	6,121	6,955	8,420	9,448	9,765
Assets, total ¹	118,753	235,468	298,098	353,896	447,130	587,504	715,233	845,281
Buildings/depreciable assets (net).....	(NA)	113,125	(NA)	158,728	(NA)	239,140	367,270	310,846
Inventories, end of year.....	(NA)	11,985	(NA)	17,203	(NA)	33,218	56,860	100,729
Land.....	(NA)	38,732	(NA)	48,442	(NA)	70,241	76,333	87,620
Liabilities, total.....	(NA)	183,878	(NA)	293,050	(NA)	486,734	580,034	701,830
Accounts payable.....	(NA)	12,302	(NA)	20,943	(NA)	33,669	29,082	37,255
Short-term debt ²	(NA)	22,709	(NA)	27,811	(NA)	48,002	55,882	73,278
Long-term debt ³	(NA)	136,297	(NA)	114,843	(NA)	178,044	196,509	236,218
Nonrecourse loans.....	(NA)	(*)	(NA)	83,747	(NA)	118,910	138,134	154,509
Partner's capital accounts.....	(NA)	41,593	(NA)	60,846	(NA)	108,770	135,189	143,651
Total receipts.....	93,348	148,418	180,849	219,192	258,198	291,998	272,130	298,690
Business receipts.....	90,209	142,508	171,424	207,731	242,654	271,109	230,627	251,809
Interest received ⁴	842	2,447	3,103	4,347	7,248	10,889	13,773	15,280
Deductions, total.....	83,558	140,690	167,585	204,745	242,982	263,749	274,886	304,005
Cost of goods sold/operations.....	46,041	84,873	75,853	87,217	102,067	113,886	130,044	144,588
Salaries and wages.....	8,129	12,468	14,745	16,586	19,393	22,338	21,953	23,326
Taxes paid.....	3,159	5,771	6,914	7,366	8,329	9,553	6,040	5,289
Interest paid.....	4,470	12,087	13,455	16,023	21,276	26,382	19,588	21,517
Depreciation ⁵	4,579	10,109	12,335	14,520	17,663	21,578	27,263	32,382
Net income (less loss).....	9,790	7,736	13,264	14,447	15,208	8,248	-2,735	-7,315
Businesses with profit.....	14,419	22,432	28,930	33,689	40,001	45,082	50,567	53,657
Businesses without profit.....	4,629	14,694	15,665	19,243	24,796	36,813	53,302	60,871

NA Not available. ¹ Total assets, total liabilities, and partner's capital accounts are somewhat understated because not all partnership returns filed contained a complete balance sheet. ² Represents mortgages, notes, and bonds payable in less than one year. ³ Represents mortgages, notes, and bonds payable in one year or more. ⁴ Tax year 1975 long term debt included nonrecourse loans. ⁵ Beginning 1982, includes both interest and dividends. * Beginning 1981, not comparable with earlier years due to change of form to form 4562.

Source: U.S. Internal Revenue Service, *Statistics of Income Bulletin*, Summer 1983 and Spring 1985.

Schedule

NO. 891. NONFINANCIAL CORPORATE BUSINESS-SECTOR BALANCE SHEET: 1965 TO 1984

(In billions of dollars. Represents year-end outstandings)

ITEM	1965	1970	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984, prel.
Total assets.....	828	1,241	2,090	2,274	2,632	2,974	3,332	3,773	4,183	4,294	4,531	4,809
Tangible assets ¹	587	872	1,533	1,693	1,890	2,110	2,443	2,780	3,099	3,206	3,317	3,517
Reproducible.....	489	758	1,361	1,476	1,648	1,899	2,138	2,403	2,638	2,712	2,783	2,941
Land.....	87	113	172	187	214	251	305	377	458	496	534	577
Financial assets.....	259	370	556	612	672	784	869	963	1,058	1,088	1,214	1,265
Liquid assets.....	83	69	125	140	143	153	178	194	212	239	267	298
Demand deposits and currency.....	33	44	54	56	59	63	69	73	63	72	71	80
Time deposits.....	9	5	22	24	29	31	38	40	55	60	77	81
Consumer credit.....	15	17	23	25	26	28	29	30	32	33	37	44
Trade credit.....	119	189	249	266	304	380	430	477	498	486	543	577
Miscellaneous assets.....	62	94	160	179	196	223	252	292	315	328	347	366
Total liabilities.....	348	542	771	855	930	1,072	1,236	1,383	1,507	1,588	1,715	1,838
Credit market instruments.....	222	355	546	591	663	741	836	912	1,015	1,085	1,145	1,320
Profit taxes payable.....	20	11	14	22	20	25	27	25	19	4	10	10
Trade debt.....	98	162	180	191	213	264	318	357	363	378	427	454
Foreign direct investment in U.S.....	9	13	28	31	35	42	54	68	90	122	133	155
Net worth.....	477	699	1,319	1,440	1,601	1,802	2,096	2,410	2,647	2,707	2,816	2,963

¹ Values at current cost.

Source: Board of Governors of the Federal Reserve System, *Balance Sheets for U.S. Economy*.

APPENDIX III
(continued)

Schedule

**NO. 895. CORPORATION INCOME TAX RETURNS—SELECTED BALANCE SHEET, INCOME STATEMENT,
AND TAX ITEMS: 1970 TO 1982**

(In billions of dollars, except number of returns. Federal returns and active corporations only. See headnote, table 520. See also *Historical Statistics, Colonial Times to 1970*, series V 129-136)

ITEM	1970	1975	1977	1978	1979	1980	1981	1982
Number of returns, total (1,000)	1,885	2,024	2,242	2,377	2,578	2,711	2,812	2,826
Number with net income (1,000)	1,008	1,228	1,425	1,524	1,599	1,597	1,597	1,808
Small Business Corporation returns (1,000)	257	358	428	479	519	545	541	584
Assets, total	2,635	4,287	5,326	6,014	6,845	7,617	8,547	9,258
Notes and accounts receivable	615	1,052	1,338	1,589	1,817	1,885	2,240	2,420
Inventories	190	318	396	443	504	535	588	581
Investments in Government obligations	197	316	381	404	421	472	515	606
Net capital assets, except land ¹	553	825	1,002	1,116	1,285	1,419	1,592	1,762
Liabilities, total	1,882	3,189	3,975	4,520	5,125	5,873	6,303	6,888
Accounts payable	149	253	347	404	483	542	620	679
Short-term debt ²	171	272	320	381	453	505	588	667
Long-term debt ³	363	587	694	781	866	967	1,058	1,224
Net worth	752	1,097	1,351	1,495	1,720	1,944	2,244	2,470
Receipts, total	1,751	3,199	4,128	4,715	5,816	6,361	7,026	7,024
Business receipts	1,621	2,962	3,814	4,354	5,153	5,732	6,245	6,157
Interest on government obligations	10	17	22	25	30	38	51	(NA)
Other interest	62	126	154	195	259	329	443	⁴ 516
Rents and royalties	17	27	39	39	40	54	68	83
Net short-term capital gain less net long-term capital loss	(2)	(2)	1	1	1	2	2	3
Net long-term capital gain less net short-term capital loss	5	8	12	15	20	25	29	26
Net gains, sales of noncapital assets	5	8	11	12	15	20	17	21
Dividends received from domestic corporations	5	9	14	13	17	19	17	18
Dividends received from foreign corporations	3	5	8	9	13	15	14	14
Deductions, total	1,683	3,053	3,909	4,487	5,332	6,125	6,814	6,869
Cost of sales and operations	1,148	2,130	2,725	3,113	3,722	4,205	4,509	4,271
Bad debts	8	14	14	16	17	19	22	27
Taxes paid	50	82	104	118	129	183	170	166
Interest paid	62	129	153	192	262	345	477	515
Contributions or gifts	1	1	2	2	2	2	3	3
Depreciation	53	86	107	121	138	157	186	213
Depletion	6	5	6	6	8	9	8	7
Pension, profit-sharing, stock bonus, and annuity plans	12	27	36	42	47	52	53	54
Net loss, sale of noncapital assets	1	2	2	2	4	6	8	10
Net income (less loss)	66	143	219	247	285	239	214	154
Income subject to tax	72	147	213	240	280	247	240	205
Income tax before credits ⁵	33	66	96	107	119	104	101	85
Tax credits, total	5	26	40	44	54	42	44	40
Foreign tax credit	5	20	26	28	37	25	22	19
Investment credit	1	8	11	13	15	15	19	17
Income tax after credits ⁶	28	39	58	63	65	62	57	45
Additional tax for tax preferences	(2)	(2)	(2)	(2)	(2)	(2)	1	(2)
Income tax, total	26	40	57	64	66	63	58	47
Distribution to stockholders, except in own stock	32	45	62	70	87	97	120	132

NA Not available. Z Less than \$500 million. ¹ Net capital assets, except land, consisted of depreciable, depletable, and intangible assets less accumulated depreciation, depletion and amortization. ² Short-term debt is the abbreviated title given to mortgages, notes and bonds payable in less than 1 year. Long-term debt is the abbreviated title given to mortgages, notes and bonds payable in 1 year or more. ³ Includes interest on government obligations for the United States. ⁴ Consists of normal tax, surtax, and alternative tax for tax years 1970 through 1978, and regular tax and alternative tax for tax years 1979-1981. Tax year 1970 includes surcharge of \$784 million.

Source: U.S. Internal Revenue Service, *Statistics of Income, Corporation Income Tax Returns*, annual.

APPENDIX III
(continued)

Schedule

**No. 896. ACTIVE CORPORATIONS—INCOME TAX RETURNS, BY ASSET SIZE-CLASS, 1980 AND 1982,
and BY INDUSTRY, 1982**

[In billions of dollars, except as indicated. Detail may not add to total because of rounding and the exclusion of data to prevent disclosure of individual taxpayer's identity. See headnote and footnotes, table 520. See also *Historical Statistics, Colonial Times to 1970*, series V 167-183 and V 193-196.]

INDUSTRY AND ITEM	Total	ASSET SIZE-CLASS					
		Under 10 mil. dol.	10-24.9 mil. dol.	25-49.9 mil. dol.	50-99.9 mil. dol.	100-249.9 mil. dol.	250 mil. dol. and over
1980							
Number of returns (1,000).....	2,711	2,675	17	8	5	3	3
Returns with—							
Assets, end of year (1,000).....	2,832	2,597	17	8	5	3	3
Net income (1,000).....	1,587	1,571	13	8	3	2	2
Income tax less credits ¹ (1,000).....	989	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)
Total receipts ²	6,361.3	1,960.5	307.4	214.5	248.4	371.0	3,229.5
Business receipts.....	5,731.6	1,911.5	287.6	192.7	218.9	329.8	2,789.0
Interest ³	366.9	30.5	11.1	15.4	19.6	29.0	261.4
Total deductions ⁴	6,125.4	1,953.0	296.6	205.4	236.0	355.5	3,076.6
Cost of sales and operations.....	4,204.9	1,364.4	229.4	146.3	167.3	248.7	2,063.5
Interest paid.....	344.8	49.7	11.1	12.9	16.9	24.7	229.2
Receipts less deductions.....	235.9	37.5	10.8	9.1	10.4	15.5	152.7
Net income less deficit.....	239.0	37.2	10.3	8.4	9.8	14.8	158.4
Income tax ⁵	105.1	17.3	4.8	3.8	4.1	6.4	68.8
Income tax less credits ⁶	63.0	14.4	4.1	3.1	3.2	4.7	33.4
Distributions to stockholders ⁷	97.4	8.9	2.3	2.4	3.3	5.7	74.6
1982							
Number of returns (1,000).....	2,926	2,887	18	9	5	3	3
Returns with—							
Assets, end of year (1,000).....	2,816	2,777	18	9	5	3	3
Net income (1,000).....	1,506	1,584	12	5	3	2	2
Income tax less credits ¹ (1,000).....	970	(NA)	(NA)	(NA)	(NA)	(NA)	(NA)
Total receipts ²	7,024.1	2,173.0	336.9	246.4	240.0	378.4	3,847.3
Business receipts.....	6,157.0	2,060.1	314.5	219.4	203.2	327.6	3,031.1
Interest ³	529.8	48.8	12.9	19.8	26.2	33.8	388.4
Total deductions ⁴	6,869.3	2,155.8	331.5	242.9	233.9	367.8	3,537.0
Cost of sales and operations.....	4,270.9	1,411.5	234.7	159.0	148.5	236.6	2,078.1
Interest paid.....	515.0	69.6	13.8	17.9	23.2	32.2	356.4
Receipts less deductions.....	154.8	17.4	7.5	6.0	6.1	7.6	110.3
Net income less deficit.....	154.3	16.8	7.0	5.3	5.3	6.7	113.2
Income tax ⁵	86.8	14.5	4.5	3.5	3.6	5.0	55.7
Income tax less credits ⁶	47.1	11.8	3.7	2.7	2.8	3.8	22.7
Distributions to stockholders ⁷	132.5	13.1	3.3	3.2	4.0	6.7	102.2
Percent distribution:							
Number of returns.....	100.0	96.7	.8	.3	.2	.1	.1
Total assets or liabilities.....	100.0	8.9	3.1	3.4	4.1	8.0	73.6
Total receipts.....	100.0	30.9	4.8	3.5	3.4	5.3	51.9
Total deductions.....	100.0	31.4	4.8	3.5	3.4	5.4	51.5
Net income less deficit.....	100.0	10.9	4.8	3.4	3.4	4.4	73.4
Income tax ⁵	100.0	18.7	5.1	4.0	4.1	5.6	64.2
Agriculture, forestry, and fishing:							
Number of returns.....	91,320	90,978	250	58	24	7	6
Total assets or liabilities.....	50.4	39.3	3.8	2.0	1.7	1.1	2.6
Total receipts.....	65.4	49.7	4.2	3.0	2.4	.9	5.1
Mining:							
Number of returns.....	36,678	35,523	600	267	128	80	78
Total assets or liabilities.....	182.4	20.7	9.3	6.2	11.0	12.8	129.8
Total receipts.....	203.1	26.2	6.5	6.4	5.9	6.8	151.5
Construction:							
Number of returns.....	262,345	260,894	1,013	263	97	55	26
Total assets or liabilities.....	153.1	88.5	15.1	8.8	6.8	8.7	25.2
Total receipts.....	261.7	202.9	22.7	13.0	7.2	10.3	25.6
Manufacturing:							
Number of returns.....	259,106	251,692	4,033	1,439	706	554	657
Total assets or liabilities.....	2,060.7	157.7	62.8	52.4	50.0	100.3	1,637.7
Total receipts.....	2,486.3	369.0	108.9	81.1	78.0	126.7	1,723.6
Transportation and public utilities:							
Number of returns.....	115,470	114,073	637	244	123	109	284
Total assets or liabilities.....	919.9	37.8	9.8	8.6	8.9	17.2	837.4
Total receipts.....	632.3	76.8	12.6	10.4	9.3	15.4	507.8
Wholesale and retail trade:							
Number of returns.....	636,547	634,293	3,337	984	446	299	198
Total assets or liabilities.....	753.4	308.9	49.8	34.3	33.1	54.7	274.6
Total receipts.....	2,017.7	1,063.2	140.9	86.8	63.6	137.3	505.9
Finance, insurance, real estate:							
Number of returns.....	461,630	441,084	7,337	5,305	3,789	2,280	1,575
Total assets or liabilities.....	4,987.5	157.5	120.8	190.5	262.6	347.3	3,908.8
Total receipts.....	949.9	106.3	23.7	32.2	41.0	60.7	684.0
Services:							
Number of returns.....	819,706	817,919	1061	367	186	109	64
Total assets or liabilities.....	237.9	112.9	15.9	13.0	13.5	17.8	64.8
Total receipts.....	380.8	272.7	19.1	15.0	14.6	15.5	43.9

NA Not available. ¹ Credits include foreign tax, investment, work incentive, U.S. possessions tax, job, nonconventional source fuel, alcohol fuel, and, beginning 1982, research credits. ² Includes items not shown separately. ³ Includes interest on Government obligations and other interest. ⁴ Income tax is before deductions for foreign tax, U.S. possessions tax, investment, work incentive (WIN) jobs, nonconventional source fuel, alcohol fuel credits and, beginning 1982, research credits. ⁵ Other than own stock.

Source: U.S. Internal Revenue Service, *Statistics of Income, Corporation Income Tax Returns*, annual.

APPENDIX IV

A Copy of the SEC Litigation Release

LITIGATION

Litigation Release No. 11447/June 2, 1987

**SECURITIES AND EXCHANGE
COMMISSION v. WINDSOR HOLDING
CORP., et al., Civil Action No. 87-1490
(D.D.C. June 2, 1987)**

The Securities and Exchange Commission ("Commission") announced today the filing of a Complaint in the United States District Court for the District of Columbia against Windsor Holding Corp. ("Windsor"), Jose R. Arrojo ("Arrojo"), Ronald A. Kahn ("Kahn"), Arthur Usheroff ("Usheroff"), and David Garvin ("Garvin"). The Commission's Complaint seeks a permanent injunction enjoining: (1) Windsor from violations of Sections 10(b), 13(a), and 13(b)(2)(A) and (B) of the Securities Exchange Act of 1934 ("Exchange Act") and Rules 10b-5, 13a-1, 13a-13 and 12b-20 thereunder, and Section 17(a) of the Securities Act of 1933 ("Securities Act"); (2) Arrojo from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 17(a) of the Securities Act and aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder, and violations of Rule 13b2-1 thereunder; (3) Kahn from violations of Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, Section 17(a) of the Securities Act, and aiding and abetting violations of Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 thereunder, and violations of the rules promulgated under Section 13(b)(2) of the Exchange Act; (4) Usheroff from violations of Sections 17(a)(2) and (3) of the Securities Act; and (5) Garvin from aiding and abetting violations of Sections 17(a)(2) and (3) of the Securities Act.

The Commission's Complaint alleges that, beginning on or about December 1982, Windsor, Arrojo and Kahn, aided and abetted by Garvin, engaged in conduct which resulted in the overstatement of, among other things, Windsor's pre-tax income. As part of this conduct, the Complaint alleges that Arrojo, after a conversation with Kahn, caused Windsor to falsify its 1982 year-end physical inventory by falsifying inventory tags during the course of a physical inventory. Arrojo received assistance from two Windsor plant managers, one a former and the other a current employee, who also falsified inventory tags at his instruction. In addition, Wind-

sor's then controller, after a conversation with Kahn, withheld accounts payable invoices from the accounts payable system. This information was not brought to the attention of Windsor's independent auditors. The falsification of inventory and withholding of accounts payable invoices at 1982 year-end caused an approximate \$2 million overstatement of, among other things, Windsor's pre-tax income. The Complaint further alleges that Garvin aided and abetted the falsification of Windsor's inventory by not disclosing his knowledge of the 1982 year-end falsification of inventory tags to Windsor's board of directors, senior management, independent auditors or outside counsel.

In addition, the Complaint alleges that Windsor, Usheroff and Kahn omitted to disclose in Windsor's registration statement filed with the Commission an oral compensation arrangement between Windsor and a corporation owned by Usheroff which called for Usheroff to be compensated for, among other things, services rendered in connection with Windsor's August 1983 public offering.

The Complaint further alleges that in December 1983, Arrojo caused the falsification of Windsor's 1983 year-end physical inventory by falsifying inventory tags in the same fashion as he had in 1982. In October 1983, Kahn resigned as president and director of Windsor. The falsification of inventory in 1983 caused an approximate \$1.6 million overstatement of Windsor's inventory.

The Complaint further alleges that Windsor, aided and abetted by Arrojo and Kahn, filed with the Commission certain annual and quarterly reports which contained misrepresentations and omissions of material facts as a result of the overstatement of Windsor's physical inventories. Other annual and quarterly reports allegedly contained misrepresentations and omissions of material facts concerning certain payments, advances and forgiven debts.

The Complaint further alleges that Windsor, aided and abetted by Arrojo and Kahn, failed 1) to make and keep books, records and accounts which in reasonable detail, accurately and fairly reflected the transactions and dispositions of Windsor's assets and 2) to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions were recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles, con-

APPENDIX IV
(continued)

cerning costing and accounting for inventory and accounts payable.

Without admitting or denying the allegations of the Commission's Complaint, the defendants consented to the entry of Final Judgments enjoining them from violating the provisions of the federal securities laws set forth above.

Concurrently with the filing of the Commission's Complaint, the Commission issued an Order Instituting Proceedings pursuant to Section 15(c)(4) of the Securities Exchange Act of 1934 and Opinion, Findings and Order ("Order") against Leo D. Sye ("Sye"), a former Windsor employee, and as well as an Order against Benny Aguirre ("Aguirre"), a former Windsor employee, and Pedro Leon ("Leon"), a current Windsor employee.

Sye, Aguirre and Leon have submitted Offers of Settlement in which they consented to the entry of such Orders without admitting or denying any matters therein. Sye, a former Windsor controller, was ordered to comply with Section 13(b)(2)(A) and (B) of the Exchange Act and with Rules 13b2-1 and 13b2-2 thereunder for causing Windsor's failure to comply with the books and records and internal control provisions of the Exchange Act as a result of his withholding accounts payable invoices from the payables system at year-end 1982 and for omitting to disclose such information to Windsor's auditors. Aguirre, a former Windsor plant manager, and Leon, currently a Windsor plant manager, were ordered to comply with Section 13(b)(2)(A) of the Exchange Act and Rule 13b2-1 for causing Windsor's failure to comply with the books and records provisions of the Exchange Act as a result of their falsification of inventory tags. (See Exchange Act Release Nos. 24534 and 24535 (June 2, 1987).

Litigation Release 11448/June 2, 1987

SEC v. QUILLIN PORTER, et al. USDC W.D. Ark., Civil Action No. 87-5068, Waters, J.

T. Christopher Browne, Regional Administrator of the Fort Worth Regional Office of the Commission, announced that on May 26, 1987, the Commission instituted a civil action in the Federal District Court for the Western District of Arkansas against Quillin Porter ("Porter") and Equity Investors of Arkansas, Inc. ("EIA"), alleging violations of Section 7(a) of the Investment Com-

pany Act of 1940 ("Investment Company Act"). The Complaint seeks injunctive relief and the appointment of a Trustee for the liquidation of EIA.

According to the Complaint, since mid-1985, EIA, aided and abetted by Porter, has violated Section 7(a) of the Investment Company Act through the offer, sale and redemption of shares in EIA, an unregistered investment company. As of the date of the filing, EIA was said to have raised approximately \$5 million from 258 investors residing in 20 or more states. In furtherance of its prayer, pursuant to Section 42(e) of the Investment Company Act, for appointment of a Trustee to liquidate EIA, the Commission alleged that (1) Porter had represented to the Arkansas Securities Department on May 14, 1987 that EIA had been dissolved when dissolution had not, in fact, taken place; (2) EIA had assets remaining in bank and brokerage accounts which had not been returned to investors; and (3) EIA had loaned monies to third parties, including entities controlled by Porter or persons associated with Porter, which remained owed and owing to investors.

In addition to permanent injunctions against Porter and EIA, and the appointment of a Trustee to liquidate EIA, the Commission sought preliminary injunctions and temporary restraining orders against Porter and EIA prohibiting further violations of Section 7 of the Investment Company Act; and temporary restraining orders against Porter and EIA, as well as against Securities Savings Trust, a nominal defendant, prohibiting the removal or destruction of assets, book and records belonging to EIA.

On May 26, 1987, the Honorable Frank Waters, United States District Judge for the Western District of Arkansas, entered a temporary restraining order and freeze of assets. On May 27, 1987, Judge Waters issued an order appointing Terry Lee of Silom, Arkansas as Trustee to liquidate EIA. Judge Waters also entered a preliminary injunction against Porter and EIA and granted the Commission's request for expedited discovery.

The Commission acknowledges the assistance and cooperation of the Arkansas Securities Department, in particular, Ms. Becky Berry, Assistant Commissioner, in this matter.

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