

February 8, 1996

Mr. Milton V. Freeman  
Arnold & Porter  
Thurman Arnold Building  
1200 New Hampshire Avenue, N.W.  
Washington, D.C. 20036-6885

Re: Rule 10b-5 Afterword to your Foreword in 61 Fordham L. Rev.

Dear Milt:

Last September I was sorry to learn you were being pilloried by the bench and bar for having fathered Rule 10b-5 as set forth in your 1993 Foreword in Fordham Law Review celebrating the 50th birthday of 10b-5.

In your Foreword describing the birth of Rule 10b-5 on May 18, 1942 you say:

“Somebody called me and said there is something wrong going on in Boston (a company president was buying in shares from his own shareholders without telling them of much improved earnings). He asked what we could do about it. I wasted no time; I got some people in, we drafted a rule, we presented it to the Commission, and, without any hesitation, the Commission tossed the paper on the table saying they were in favor of it. One Commission member said, ‘Well, we’re against fraud, aren’t we?’ So, before the sun was down, we had the rule that is now Rule 10b-5.”

You also stated:

“I do not remember who I asked in to help me, so I have had to take the blame for this all by myself.”

On November 18, 1967 in your Chicago remarks on the birth of Rule 10b-5 (34 years before your Fordham Foreword) you identified that “Somebody” as Jim Treanor, Director of the Trading & Exchange Division. And you also identified Sumner Pike as the Commissioner who spoke out against fraud. 22 Bus. Law 922 (1967).

Inspired by your forthright guilty plea acknowledging your paternity for the birth of Rule 10b-5, I hereby plead guilty of being that “Somebody.” And here is my account of what happened.

You may have forgotten that in 1942 when the SEC was moved out of Washington lock, stock and barrel into the Penn AC Building in Rittenhouse Square, Philadelphia, to make room for the World War II defense agencies, a Section on Litigation and Enforcement in the Corporation Finance Division was created. Thanks to Edward H. Cashion, assistant

general counsel, I was appointed Chief of the Section. One of my chores was to examine the monthly reports highlighting activities in the regional offices. I began noticing a pattern of fraudulent transactions involving the purchase of securities. This created great frustration among enforcement personnel because, as you know, Section 17(a) of the 1933 Act was the customary enforcement tool but only applied to sales of securities and therefore the SEC staff was powerless to take action.

Consequently, when I observed this new fraudulent practice emerging in four or five regional offices I called on you for help in the morning of May 18, 1942, went up to your office and outlined the problem. You told me Paul Rowen had spoken to you about a similar fraudulent pattern in Boston. You did not tell me when this call from Paul had occurred but you immediately told me: "You know there is a section under the 1934 Act, Section 10(b), which covers fraud in the purchase as well as fraud in the sale of securities and authorizes the Commission to adopt rules and regulations implementing such prohibition." And you said: "Why don't we just take Section 17 under the '33 Act and insert the word 'purchase?'" I took a quick look at Section 10(b) and said: "Great; that clearly covers the manipulations we are talking about. Why don't we do it?"

You thereupon called over your secretary and showed her exactly how to type up the proposed new rule. You did not call any people in. That's all there was to it. You and I and your secretary were the only people involved in drafting the proposed rule. Either you or I telephoned Orval L. DuBois, the Commission's Secretary, and asked to be put on the Commission's calendar that afternoon.

I do not recall any further consultation or discussion with anyone after our morning conference in your office. No memo or other document was prepared.

That same afternoon we received calls from the Secretary's office and proceeded to the Commission meeting. You and I and Ed Cashion and Orval were the only staff people present. See attached excerpts from the official Commission minutes of May 18, 1942 and August 30, 1995 letter to me from Paul Gonson, SEC Solicitor. Copies of the proposed order were distributed to the four commissioners who were present, namely: Ganson Purcell, Chairman, Robert E. Healy, Sumner T. Pike, and Edmund Burke, Jr. The fifth commissioner, Robert H. O'Brien, was absent.

In the presentation to the Commission you explained the staff's frustration arising from the fact that the anti-fraud section in the '33 Act was limited to fraud in the sale of securities and the staff was without power to act in purchase transactions. I'm sure you told them the details of the Boston purchase originating from Paul Rowen. I also described the following case: a corporation which for several years had been highly profitable during which it distributed juicy dividends to stockholders. However, it fell on hard times, suffered heavy losses, ceased paying dividends and discontinued periodic reports to stockholders. This continued for several years until good fortune smiled again, profits came rolling in but there was no resumption of dividends. However, generous salaries were taken by insiders; all good news was completely suppressed and was known only to the insiders. I do not recall the name or location of the company nor the market

price of its stock but my recollection is that it was substantial in its good years possibly in the range of \$26 per share and then a sharp drop and virtually no trading whatever in the bad years. At that stage the CEO began buying up shares at a fraction of what the market price would have been if information had been furnished to stockholders. This clearly was manipulation within the parameters of Section 10(b).

And it was at that point that Sumner Pike, one of the two Republican members of the Commission, made the comment you quoted. My version of what he said was: "Well, gentlemen, we are all against fraud, aren't we?" Virtually identical versions.

Through the years whenever Rule 10b-5 was mentioned I immediately made it known that I was present at the birth and recalled the foregoing account of what happened. I had completely forgotten that Ed Cashion was present until I read the Commission minutes sent me by Paul Gonson. I am sure Ed was present simply because I had notified him that you and I had requested a hearing before the Commission to present our recommendation.

I attach a copy of the complete Commission minutes of May 18, 1942 and SEA Release No. 3230, May 21, 1942, 13 F.R. 8177 adopting 10b-5.

The Commission meeting began at 3:00 p.m. and adjourned at 5:50, according to Orval DuBois' notes. I would guess our appearance probably lasted 15 minutes. The sole purpose in adopting the rule was to give the SEC staff an enforcement tool in dealing with fraud in the purchase of securities. No one dreamed at that time of the avalanche of fraud litigation which followed.

I'm taking the liberty of sending a copy of this letter to Paul Gonson and Lou Loss.

With warmest regards to you and Phyllis,

Sincerely,  
Mayer U. Newfield

MUN/wb

cc: Professor Louis Loss  
Mr. Paul Gonson