GEORGE MASON UNIVERSITY ANTONIN SCALIA LAW SCHOOL
LAW & ECONOMICS CENTER

3301 Fairfax Drive, Arlington, Virginia 22201 | Phone 703.993.8040 | Fax: 703.993.8181
WWW.MASONLEC.ORG

September 22, 2021

By Electronic Mail
rule-comments@sec.gov
Chair Gary Gensler
U.S. Securities and Exchange Commission
100 F St., NE
Washington, D.C. 20549-0609

RE: Public Input on Climate Change Disclosures

Submitted By: Bernard S. Sharfman*

Dear Chair Gensler,

In March of 2021, Allison Herrin Lee, then Acting Chair of the Securities and Exchange Commission (SEC), requested public input[1] on expanding climate change disclosures. In May, Commissioner Lee argued that the SEC had broad authority to require such disclosures, even if the disclosures are "not material" to a reasonable investor.[2] She based this argument on wording found in the federal securities law that repeatedly states that the SEC has authority to require disclosures as long as they are "in the public interest" *and/or* "for the protection of investors."[3] As she correctly points out, this wording is not qualified by any standard of materiality. Therefore, it is highly likely that the SEC will adopt this approach in arguing the legality of whatever new climate change disclosures are to be found in a proposed rule that you expect to be published by year end.[4]

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* Bernard S. Sharfman is a Research Fellow with the Law & Economics Center at George Mason University's Antonin Scalia Law School. The research associated with this writing is supported by a grant from the Law & Economics Center. The opinions expressed here are the author's alone and do not represent the official position of the Law & Economics Center or any other organization with which he is currently affiliated. Mr. Sharfman is also a Senior Corporate Governance Fellow with the RealClearFoundation.

[1] Allison Herren Lee, *Public Input Welcomed on Climate Change Disclosures*, U.S. SEC. & EXCH. COM. (March 15, 2021), https://www.sec.gov/news/public-statement/lee-climate-change-disclosures.

[2] Allison Herren Lee, *Living in a Material World: Myths and Misconceptions about "Materiality*," U.S. SEC. & EXCH. COM. (May 24, 2021), https://www.sec.gov/news/speech/lee-living-material-world-052421. The U.S. Supreme Ct. defined material facts in the proxy context as facts for which there is "a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *See TSC v. Northway*, 426 U.S. 438 (1976).

[3] *See* both the Securities Act of 1933 and the Securities Exchange Act of 1934.

[4] Gary Gensler, *Prepared Remarks Before the Principles for Responsible Investment "Climate and Global Financial Markets" Webinar*," U.S. SEC. & EXCH. COM. (July 28, 2021), https://www.sec.gov/news/speech/gensler-pri-2021-07-28.

If the SEC is not limited by materiality,[5] then what are the statutory parameters or boundaries that it still must abide by in promulgating mandatory climate change disclosures? That is, how far beyond the SEC's 2010 interpretative release on climate change disclosures,[6] which focused on the disclosure of climate change risk factors "that make an investment in the registrant speculative or risky" or "are reasonably likely to have a material effect on a public company's financial condition or operating performance," can the SEC go in creating a mandatory climate change disclosure regime? In this comment letter, I argue that its statutory authority does not allow the SEC to stray far from its 2010 approach. In addition, I provide a non-inclusive list of potential costs that the SEC must address and quantify when doing its cost-benefit analysis under *Business Roundtable.*[7]

I. "In the public interest"

The language of the statute is critical in determining what limitations the SEC faces in promulgating mandatory climate change disclosures. More specifically, what kind of parameters are to be placed on the term "in the public interest"? In this section I argue that the statutory language "for the protection of investors" places a limit on the SEC's legal authority when mandating mandatory climate change disclosures.

A. The Legal Parameters of "In the Public Interest"

Even though the term "in the public interest" is mentioned numerous times both the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"; together the "Acts"), the Acts do not attempt to define it. Therefore, it is up to the SEC to take the first crack at defining this term and under *Chevron*[8] the SEC's definition must be given deference.[9] However, that deference is still reviewable by a court and the SEC's definition can be rejected if the court has a "substantial reason for doing so."[10] That is, deference may be rejected under the Administrative Procedures Act ("APA") if its actions were found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[11] Therefore, in defining the term "in the public interest," the SEC must be cognizant of not running afoul of the APA.

But how does the SEC know when it is violating the APA when invoking the term "in the public interest"? As argued below, such disclosures are arbitrary and capricious when they go beyond the statutory requirement of being "for the protection of investors."

B. Staying within the Requirements of the Administrative Procedures Act

Whenever the term "in the public interest" appears in the Acts, the term "for the protection of investors" is almost always sure to follow. The only ambiguity is that it is not entirely clear whether the two terms are to be

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[5] The issue of whether the SEC has statutory authority to adopt this approach is not settled law and may eventually become the focus of litigation. However, an analysis of this issue is beyond the scope of this comment letter. Moreover, the overriding issue of whether the SEC has statutory authority to adopt mandatory disclosure rules without additional enabling legislation is also beyond the scope of this letter. For a discussion of this issue, *see* Andrew N. Vollmer, *Does the SEC Have Legal Authority to Adopt Climate-Change Disclosure Rules?*, MERCATUS CENTER, GEORGE MASON UNIV. (Aug. 19, 2021), https://www.mercatus.org/publications/financial-regulation/does-sec-have-legal-authority-adopt-climate-change-disclosure.
[6] U.S. SEC. & EXCH. COM., *Commission Guidance Regarding Disclosure Related to Climate Change*, Release Nos. 33-9106; 34-61469 (Feb. 2, 2010).
[7] Business Roundtable v. Sec. & Exch. Comm'n, 647 F.3d 1144, 1148, 1152 (D.C. Cir. 2011).
[8] Chevron U.S.A., Inc. v. NRDC, 467 U.S. 837 (1984).
[9] SEC v. Citigroup Global Markets Inc., 673 F.3d 158, 168 (2d Cir. 2012).
[10] *Id.*
[11] *Id.* quoting 5 U.S.C. § 706(2)(A).

understood as being conjunctive ("and") or disjunctive ("or").[12] However, in 1996, Congress added Section 2(b) to the Securities Act and Section 23(a)(2) to the Exchange Act that helps clarify this ambiguity. These parallel sections provide that:

> Whenever pursuant to this title the Commission is engaged in rulemaking and is required to consider or determine *whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors*, whether the action will promote efficiency, competition, and capital formation.[13]

The statutory language in italics confirms Congress's intent that the terms be understood in the conjunctive. Moreover, it is illogical to think otherwise. According to a speech by former Chairman Arthur Levitt, "the primacy of investor interests was present at the creation" of the SEC.[14] Moreover, according to Levitt, investor protection was the "overriding concern" of our securities laws.[15] Finally, while he was not talking about mandatory climate change disclosures, this quote from Levitt's speech is still extremely instructive: "[T]he foremost mission of the SEC for 62 years has been *investor protection*, and no matter how well-intentioned any additional role may be, it will inevitably distract attention from our primary focus. That's a price we can ill afford."[16] As a result, the SEC would be committing an arbitrary and capricious act, an act in violation of the APA, to promulgate mandatory disclosures based on the rationale of being "in the public interest" but yet excluding "for the protection of investors." In sum, the two must go together whenever the SEC promulgates mandatory disclosures.

C. "For the Protection of Investors"

What does "for the protection of investors" mean in the context of mandatory climate change disclosures? The term "for the protection of investors" is also not defined in the Acts. However, the meaning should be clear. The Acts were children of the 1929 stock market collapse and meant to correct the wrongs that paved the way for the Great Depression:

> The stock market crash of 1929 exposed a catalogue of corporate practices employed to deceive and discriminate against the small investor. These practices were largely instrumental in bringing on *mass financial ruin*. For years corporations had floated large quantities of unsound stocks without telling investors about the true state of their assets and earning power, or the identity of their promotors, managers, and chief stockholders. Corporate insiders, capitalizing on secret information about impending corporate action, had themselves extracted huge profits from ordinary investors by selling their own stock to the public in advance of expected price declines. Organizers of holding and investment companies, by obtaining unfair contracts or excessive payments from their operating subsidiaries, had siphoned off vast sums of subsidiary profits. In reorganizations, security conversions, and dividend declarations, the interests of small investors were often sacrificed to those of large stockholders.[17]

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[12] *See*, Wm. Dennis Huber, *The Myth of Protecting the Public Interest: The Case of the Missing Mandate in Federal Securities Law*, 16 J. BUS. & SECURITIES L. 401, 418 (2016).
[13] Securities Act § 2(b); Exchange Act § 23(a)(2).
[14] Arthur Levitt, *Remarks by Chairman Arthur Levitt*, US SEC. AND EXCH. COMM., Commonwealth Club, San Francisco, Cal. (May 17, 1996), https://www.sec.gov/news/speech/speecharchive/1996/spch101.txt.
[15] *Id.*
[16] *Id.*

[17] Unnamed author, *The Meaning of "Control" in the Protection of Investors*, 60 YALE L. J. 311, 311 (1951).

In response, the Acts were focused on protecting "investors from fraud, an unlevel informational playing field, the extraction of private benefits from the firm by firm insiders, and investors' propensity to make unwise investment decisions…."[18] Such protections made sure that investors are adequately informed of firm specific investment risks.

Such disclosures do include those that result from climate change. For example, the SEC's 2010 interpretative release on climate change disclosures recommends a number of disclosures that focus on firm specific investment risks. The following topics and how they affect the reporting company may require disclosure: the impact of climate-change legislation and regulation; international accords on climate change, such as the Paris Accord; indirect consequences of climate-change regulation, such as a reduction of demand for goods that create high levels of greenhouse gas emissions; and the physical impacts of climate change, such as severe weather, on the company's operations.

However, while the Acts provide the SEC with authority to require disclosures regarding firm specific investment risks, they do not specify or imply that disclosures "for the protection of investors" include those that are for the purpose of "expressive investor protection."[19] This is a term coined by Professor Michael Guttenberg and refers to disclosures that investors would use to protect themselves from investing in securities issued by firms with attributes that investors simply find objectionable.[20] For example, disclosures on the level of Scope 1, 2, or 3 emissions that an issuing company may produce. Such disclosures would allow investors to reject investment in the securities of a company that produces carbon emissions that go beyond a certain level. While these disclosures would help investment advisors structure ESG funds that investors may want to invest in, such "expressive investor protection" is not currently provided for in the Acts and therefore requiring such climate change disclosures would be an arbitrary and capricious act under the APA. Simply put, promulgating such disclosures is not currently within the SEC's authority. For the SEC to have such authority, Congress must provide it in new legislation.

D. Updating the SEC's 2010 Interpretative Release on Climate Change Disclosures

Since 2010 we have become much more aware of how impactful climate change events can be to a company's financial well-being. Investors need to be made aware of low probability, high impact climate change events that management may know of but investors do not. Once these risk factors are disclosed, investors can then gauge just how well the company can *adapt*. As discussed by Armen Alchian many years ago, the ability to adapt to a changing business environment is critical to the profitability and success of any company.[21] Therefore, I propose that the SEC require a company to disclose known low-probability high-impact climate-change events as risk factors under Item 503(c) of Regulation S-K—for example, the possibility that a company may be significantly impacted by multiple freak winter storms that take down an entire state's power grid for days.[22]

E. Summary of Part I

No doubt there are investors out there who want to make their investment decisions based on how much a particular company is impacting the environment and would benefit if the SEC were to require mandatory climate change disclosures that go beyond adequately informing them of the firm specific investment risks they are taking

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[18] Michael D. Guttentag, *On Requiring Public Companies to Disclose Political Spending*, 2014 COL. BUS. L. REV. 593, 619 at n.92 (2014) citing Michael D. Guttentag, *Protection from What? Investor Protection and the Jobs Act*, 13 UC DAVIS BUS. L.J. 207, 222-233 (2013).
[19] *See*, Guttenberg, *On Requiring Public Companies to Disclose Political Spending*, *supra* note 18, at 606.
[20] *Id.*
[21] Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211 (1950).
[22] Wikipedia, *2021 Texas power crisis* (accessed Sept. 14, 2021), https://en.wikipedia.org/wiki/2021_Texas_power_crisis.

on. However, investing based on non-financial climate change disclosures is a matter of investor preference, not one of investor protection. Therefore, the SEC cannot make such disclosures mandatory. If it were to do so these would be arbitrary and capricious acts under the APA and therefore outside the SEC's authority.

II. THE COSTS OF MANDATORY CLIMATE CHANGE DISCLOSURES

Even if the SEC rejects the above analysis, the SEC will still be required to do a cost-benefit analysis of any new mandatory climate change disclosure requirements that they propose. Such an analysis, as required under *Business Roundtable*,[23] will not be presented here. However, what I can provide are some cost issues that the SEC will need to address in order to make its analysis complete.

A. A Lack of Diversification in Investment Portfolios

Investors that use non-financial climate change disclosures as a primary basis for portfolio composition will risk creating undiversified portfolios. Yes, investing in a portfolio that is overweighted with huge market value companies that are perceived to be low carbon emitters, such as Amazon, Facebook, Microsoft, Apple, and Alphabet, have yielded investors handsome returns during the pandemic, but that does not mean the future will replicate the past.[24] As Vincent Deluard observed, ESG[25] funds were overweighted in the healthcare and technology industries during the first part of 2020, the two best-performing sectors during that time period.[26] This created the appearance that many ESG funds were outperforming their non-ESG peers.

However, this type of over-performance is not sustainable over time unless the investor is very lucky. In the long-run, a lack of portfolio diversification resulting from the use of non-financial objectives adds extra unsystematic risk to the ex-ante risk adjusted return calculation, reducing an investment portfolio's expected risk-adjusted return. As noted by Professor Damodaran, "the notion that adding an ESG constraint to investing increases expected returns is counter intuitive. After all, "a constrained optimum can, at best, match an unconstrained one, and most of the time, the constraint will create a cost."[27] Here, the cost is a lack of proper diversification.

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[23] Business Roundtable v. Sec. & Exch. Comm'n, 647 F.3d 1144, 1148, 1152 (D.C. Cir. 2011).

[24] Vincent Deluard, *ESG Investors Are Winning Their Unintended War on People*, INTL FCSTONE FIN. INC. (May 2020), https://wwwtest.intlfcstone.com/globalassets/featured-insights/v_deluard_0520_06302020.pdf. While outside the scope of this comment letter, Deluard makes a very insightful observation about the unintended consequences of ESG investing:

> [T]he single most salient characteristics of these [ESG] funds is that they favor machines and intangible assets over humans. The average company in the ESG basket has 20% fewer employees than the median Russell 3,000 company. This tilt explains their success in a year which has rewarded biotech firms and tech platforms and punished employee-heavy sectors, such as airlines, retailers, and cruise lines. Companies with no employees do not have strikes or labor disputes. There is no gender pay gap when production is completed by robots and algorithms. Financial networks have no carbon footprint.
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> Despite its noble goal, ESG investing unintendedly spreads the greatest illnesses of post-industrial economies: winner-take-all capitalism, monopolistic concentration, and the disappearance of jobs for normal people.

[25] In this writing, the emphasis is on the "Environmental."

[26] Bernard S. Sharfman, *ESG Investing Under ERISA*, Y. J. REG. ONLINE BULLETIN 112, 123 (2020).

[27] Aswath Damodaran, *Sounding good or Doing good? A Skeptical Look at ESG* (Sept. 21, 2020), http://aswathdamodaran.blogspot.com/2020/09/sounding-good-or-doing-good-skeptical.html.

B. A Deadly Distraction

Many have argued that the SEC should require standardized climate-change reporting data in order to facilitate the providing of ESG ratings and the setting up of ESG funds. Large investment advisers, rating agencies, consultants, proxy advisers, and those lawyers and auditors in the compliance field will definitely support this for the fees it will bring in,[28] but does requiring such mandatory one-size-fits-all information really do anything to mitigate climate change?

Not according to Tariq Fancy, BlackRock's former chief investment officer for sustainable investing. In a recent op-ed, he states: "But doesn't investing in sustainable mutual funds or ETFs increase funding to environmental and social causes? No, it doesn't. While the investor may indirectly own more shares in companies with slightly higher ESG scores, those companies don't receive the new funding. Instead, the money goes to the seller of the shares in the public market."[29] In sum, he thought it was unlikely that the creation of ESG funds was going to have any real-world impact on reducing carbon emissions.

Mr. Fancy also observed that "one lesson COVID-19 has hammered home is that systemic problems—such as a global pandemic or climate change—require systemic solutions. Only governments have the wide-ranging powers, resources and responsibilities that need to be brought to bear on the problem."[30] Moreover, he concluded that a focus on ESG investing harmed mitigation efforts "by creating a *societal placebo* that *delayed* overdue government reforms."[31] That is, this focus has reduced our sense of urgency to advocate for strong governmental actions that will have a real impact on mitigating climate change. Mr. Fancy refers to this as a "deadly distraction."[32]

The view that ESG investing can be harmful to society is not Mr. Fancy's alone. According to prominent finance professor Aswath Damodaran of the Stern School of Business at New York University:

> In keeping with my belief that you learn more by engaging with those who disagree with you, than those who do, I have tried my best to see things through the eyes of ESG true believers, and I must confess that the more I look at ESG, the more convinced I become that "there is no there there". More than ever, I believe that ESG is not just a mistake that will cost companies and investors money, while making the world worse off, but that it create more harm than good for society.[33]

Moreover, in an earlier writing, Professor Damodaran states:

> If the debate about ESG had been about facts, data and common sense, and ESG had won, I would gladly incorporate that thinking into my views on corporate finance, investing and valuation. But that has not been

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[28] For example, mutual funds and ETFs that track indices structured for the ESG investor can typically charge significantly higher fees than funds and ETFs that plain vanilla indices like the S&P 500. *See*, Sharfman, *supra* note 26, at 127-28. *See also*, Aswath Damodaran, *The ESG Movement: The "Goodness" Gravy Train Rolls On!* (Sept. 14, 2021), https://aswathdamodaran.blogspot.com/2021/09/the-esg-movement-goodness-gravy-train.html, for an excellent diagram of the interested parties that would financially benefit by increased levels of ESG investing.
[29] Tariq Fancy, *The fairytale of sustainable investing*, RESPONSIBLE INVESTOR (June 8, 2021), https://www.responsible-investor.com/articles/tariq-fancy-the-fairytale-of-sustainable-investing.
[30] Tariq Fancy, *BlackRock hired me to make sustainable investing mainstream. Now I realize it's a deadly distraction from the climate-change threat*, THE GLOBE & MAIL (March 25, 2021; updated March 30, 2021), https://www.theglobeandmail.com/business/commentary/article-sustainable-investing-is-a-deadly-distraction-from-actually-averting/?utm_medium=Referrer:+Social+Network+/+Media&utm_campaign=Shared+Web+Article+Links.
[31] *Id.*
[32] *Id.*
[33] Aswath Damodaran, *The ESG Movement: The "Goodness" Gravy Train Rolls On!* (Sept. 14, 2021), https://aswathdamodaran.blogspot.com/2021/09/the-esg-movement-goodness-gravy-train.html.

the case, at least so far, simply because ESG has been posited by its advocates as good, and any dissent from the party line on ESG (that it is good for companies, investors and society) is viewed as a sign of moral deficiency. At the risk of being labeled a troglodyte (I kind of like that label), I will argue that many fundamental questions about ESG have remained unanswered or have been answered sloppily, and that it is in its proponents' best interests to stop overplaying the morality card, and to have an honest discussion about whether ESG is a net good for companies, investors and society.[34]

According to Kenneth Pucker, former chief operating officer at Timberland, ESG investing represents "a sort of Kabuki play in five acts:"[35]

Act I: Companies wake up to their responsibility to address growing social and environmental challenges.

Act II: Academics create a body of research around the topic.

Act III: Ratings agencies, index providers, data firms, consultants, and other financial institutions rush to create environmental, social, and governance (ESG) products, highlighting the opportunity for companies and investors to deliver financial outperformance and social and environmental impact. The ultimate win-win.

Act IV: Investors and others slowly recognize that ESG investing, as currently practiced, will not likely lead to financial outperformance and is mostly unconcerned with planetary impact.

Act V: Reawakening to the opportunities and limits of investing to address growing social and environmental challenges.

We find ourselves today at the intermission after Act III. Unfortunately, as we move to Act IV, it will become clear that the exaggeration of the win-win of the so-called "investor revolution" is distracting from the work needed to reset our economic system. As ESG investing has been accelerating, the planet has experienced the warmest two decades on record, Antarctica has been melting, U.S. income inequality has been gapping, and species have been disappearing at rates unseen for millennia. And the Dow Jones Industrial Average is hitting new highs and asset managers are collecting attractive fees to oversee a popular new investment category.

Here's what's wrong. Investors are finally taking ESG investment seriously. But as currently practiced, most ESG investing delivers little to no social or environmental impact.

In sum, before the SEC gets caught up in the ESG investing craze by promulgating mandatory climate change disclosures and thereby reinforcing the belief that investors can help mitigate climate change while at the same time earning market rate returns or better, the SEC should thoroughly evaluate and come to the determination, not just having the wish or belief, that this should be the expected result of its actions. If not and the SEC still decides to follow through on promulgating such disclosures, then it may have helped create another "deadly distraction." As part of becoming informed, I strongly recommend that you and your staff closely read Tariq Fancy's, Professor Damodaran's, and Kenneth Pucker's writings on the topic of ESG investing.[36]

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[34] Aswath Damodaran, *Sounding good or Doing good? A Skeptical Look at ESG* (Sept. 21, 2020), http://aswathdamodaran.blogspot.com/2020/09/sounding-good-or-doing-good-skeptical.html.

[35] Kenneth Pucker, *The Trillion-Dollar Fantasy, Institutional Investor*, INSTITUTIONAL INVESTOR (Sept. 13, 2021), https://www.institutionalinvestor.com/article/b1tkr826880fy2/The-Trillion-Dollar-Fantasy.

[36] For example, *see* Tariq Fancy, *The Secret Diary of a 'Sustainable Investor,' Part 1* (Aug. 20, 2021), https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-1-70b6987fa139; Tariq Fancy, *The Secret*

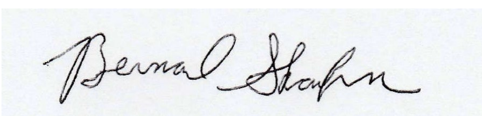
C. Compliance Costs

Finally, it needs to be noted that the compliance bill for mandatory disclosures may be huge. For example, it has been reported that PricewaterhouseCoopers (PwC) is planning on hiring 100,000 new employees and investing $12 billion over the next five years in order to help meet its clients' ESG reporting requirements.[37] We can assume that this represents only the tip of the iceberg and probably does not even represent what public companies will actually pay to have the compliance work done. In any event, much work needs to done in this area as there is currently a dearth of empirical research.

D. Summary of Part II

Before the SEC decides to promulgate mandatory climate change disclosures, it needs to take into consideration the significant costs involved. A potential lack of portfolio diversification, billions if not tens of billions of dollars in expected compliance costs, and, perhaps most importantly, the unintended consequences of its actions in regard to the mitigation of climate change. I believe an appraisal of such costs may very well lead the SEC to the conclusion that promulgating mandatory non-financial climate change disclosures is not the way to "promote efficiency, competition, and capital formation."[38]

Very truly yours,



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Bernard S. Sharfman

Diary of a 'Sustainable Investor,' Part 2 (Aug. 20, 2021), https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-2-831a25cb642d; Tariq Fancy, *The Secret Diary of a 'Sustainable Investor,' Part 3* (Aug. 20, 2021), https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-3-3c238cb0dcbf; Luigi Zingales and Bethany McLean, *The Smoke and Mirrors of ESG Investing with Tariq Fancy* (Sept. 9, 2021), CAPITAL ISN'T PODCAST, https://capitalisnt.com/episodes/the-smoke-and-mirrors-of-esg-investing-with-tariq-fancy?utm_source=twitter&utm_medium=post&utm_campaign=poll1-twitter-stigler-the-smoke-and-mirrors-of-esg-investing-with-tariq-fancy.

[37] Jessica DiNapoli, *PwC planning to hire 100,000 over five years in major ESG push*, REUTERS.COM (June 15, 2021), https://www.reuters.com/business/sustainable-business/pwc-planning-hire-100000-over-five-years-major-esg-push-2021-06-15/.

[38] Securities Act § 2(b); Exchange Act § 23(a)(2).