

## 40 YEARS OF CHANGES IN SECURITIES PRACTICE: A PERSONAL REFLECTION

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In the late 1990's, I had occasion recently to reminisce about 40 years of practicing in the corporate/securities field, focusing on the major changes that have occurred. Here is a survey of changes in the securities laws, the SEC's administration of those laws, and other changes that have affected my practice. Note that these reflections do not include the various paradigm shifts resulting from the Sarbanes-Oxley Act of 2002.

### THE WORLD OF THE LATE 1950's

- Securities practice was a highly specialized practice. Few lawyers represented public companies.
- IPO's were just starting to be common. Registered offerings were relatively novel.
- Life was simple. We had stocks and bonds, but no derivatives, strips, 0's, asset backed securities, options, swaps, derivatives or other sophisticated products.
- Transactions were also relatively simple. There were firm and best efforts underwritings. Shelf registrations were relatively rare and normally related to a specific block of a single security.
- Acquisitions of public companies typically were done by long form merger. There was no concern for a topping third party bids and no need for lockups, or large bust up fees, etc.
- Very sharp distinctions existed between broker-dealers, banks, thrifts, insurance companies, advisors, etc. There was a firm barrier between investment and commercial banking. Customers, even institutional ones, were clearly separated from market professionals. Each stock traded almost entirely in one market.
- Commodities were potatoes, pigs' bellies, etc., but not financial products such as interest rate, stock index or currency futures.
- Fixed stock exchange commission rates prevailed (the commission on 10,000 shares was 100 x the round lot commission), with a staggering and Byzantine structure of "customer directed giveups" and other de facto (but not improper) rebates. The money managers liked the system. They could spend lots of customers' money on commissions and get research and other goods and services in return for themselves from executing brokers. The customer, as such, could not get the de facto rebate.
- "Technology" was primitive by current standards: no xerox, telecopier, overnight mail, e-mail, computers, etc. Carbon paper high tech. When a first draft went to the printer, the

wait for a proof normally was at least a few days, and could be over a week. Our first copier made copies that faded in the sunlight.

-- SEC was a simpler agency. It was essentially a “legal” agency, especially Corporation Finance. It paid no attention to such issues as capital allocation or the economics of the industry, including the level of fixed brokerage commissions. Whenever the NYSE requested a change in the fixed commission rate, the SEC routinely approved, with no knowledge, or even interest, in the economic consequences.

-- There was no Enforcement Division. The Trading and Markets Division regulated most aspects of the industry except investment companies. The major Divisions had Enforcement Branches, but enforcement did not receive major emphasis and was not coordinated Commission-wide.

-- The SEC had very little awareness of, or interest in, market mechanisms or economic impact of regulation. No one really knew how the markets worked overall, neither the SEC, Congress nor the players themselves. Each participant understood his particular pattern or niche, but no one had an overview.

-- The brokerage industry was run with monopoly power to fixed rates, but none of the obligations of natural monopolies such as public utilities — e.g., the obligation to serve the public. Self-regulatory organization controlled the industry largely in the industry’s own interest, with minimal effective SEC oversight.

-- The “suitability” concept had yet to be developed as a protection of investors. In its earliest form, it was a rule to protect *the broker* against undue credit risk, to be sure that the customer would be able to pay his bill.

#### CORPORATE FINANCE PRACTICE IN THE 50’S WAS VERY DIFFERENT

-- §5 was central -- Basically registration issues were determined on an all or none basis. There were no generally applicable short forms. S-1 was used for transactions ranging from the IPO to a small selling stockholder sale of a seasoned listed company.

-- There was no expedited review. Most filings received the same level of review. A three- month delay for comments was common.

-- The SEC’s disclosure philosophy was liability oriented, to protect buyers from buying a stock that was puffed to seem better than it was. Little concern was shown for the information needs of open market sellers.

-- Filed disclosures were strictly limited “hard” and “historical” disclosures of “facts” which the SEC could verify in an enforcement action. No express or implied predictions or forward-looking disclosure was permitted in filings. Like a shadow, disclosure showed the subject’s a general outline but it was distorted, lifeless and flat. “Guide 22,” a very

minor exception which grew from a common review comment, was a primitive ancestor of the current MD&A.

-- There was no §12(g) in '34 Act. Companies whose stock was not listed on a stock exchange were subject to §15(d) periodic reporting under '34 Act §13(a), but none of the other '34 Act requirements. The proxy rules and §16 applied only to exchange listed companies registered under '34 Act §12(b).

-- '34 Act reports were insignificant, Form 10-K called for disclosure of changes in the business during the past year (almost always answered as “none”), and financial statements (almost always incorporated by reference to annual shareholders report). The most recently filed description of a company’s business, other than the financials, often was very stale and out of date. Only companies with exchange listed securities updated management type information in filings through the proxy statement.

-- Resale of privately placed securities was a major concern.

-- The “change of circumstance doctrine” was critical, focusing primarily on whether someone purchased “with a view to distribution” (the “underwriter” definition in '33 Act §2(11)).

-- Unlike under Rule 144, the ability to resell privately placed stock was unrelated to size of sale, manner of sale, public availability of information, market impact, broker compensation or other factors relevant to the public’s need for disclosure.

-- An “unanticipated change of circumstances” was required to permit a sale within a year or two after the securities were purchased. If such a change occurred, it would negate the presumption that the holder had a distributive “view” when the securities were acquired. The doctrine had its own presumptions — e.g. death often was determined to be unanticipated.

-- A two year rule of thumb evolved as a presumptively satisfactory holding period.

-- In acquisitions, form prevailed over substance and often determined the transaction structure. Under Rule 133, the “no sale rule,” a transaction approved by vote at the corporate level, such as a merger, was not a '33 Act sale, but a voluntary exchange of stock for stock was a sale.

-- No action letters were not public. They were bootlegged and spread by word of mouth. Lore was as important as law. A “priesthood” of cognoscenti existed.

-- The availability of the §4(2) private placement exemption was very uncertain. Numbers were key as a practical matter, but offerees also had to be able to “fend for themselves” and have “access to the same kind of information that the Act would make available in a registration statement.” The SEC’s *Continental Tobacco* brief caused great consternation in interpreting *SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953) and its

progeny, suggesting that access to information could not simply be supplied voluntarily by the issuer in context of the deal itself. The SEC's rationale: the issuer should not have the choice of giving a voluntary disclosure document or a statutory prospectus. Under this theory, private places had to have independent access to information, and would be largely limited to insiders and persons with a close historic relationship with the issuer, as a practical matter.

-- The ground rules on shelf registration were very uncertain.

-- Gun jumping was a major issue.

-- Hostile takeovers were unknown, as well as defenses such as poison pills, golden parachutes, lock ups (bust up fees, crown jewel options, etc.), white knights and MBO transactions (where insiders did essentially what hostile bidders would do in highly leveraged recaps), etc.

-- "Delaying amendments" were required to be filed within 20 days after each filing or amendment, to keep registration statements from becoming effective automatically in 20 days after the most recent filing. The SEC Staff would call counsel around the 18th day to remind the issuer of the need to send a telegram changing a word or two in the filing, to reset the 20 day clock.

-- Filing of a "pricing amendment" was needed on the effective date or the day before, causing considerable logistic problems.

-- "Red herring" legends had to be in red ink, requiring an extra press run, with related delay and expense.

## HISTORY AND EVOLUTION SINCE THE 1950'S

-- The Special Study of 1963 shed light on the wide variety of market mechanisms, roles and functions which enlightened everyone for the first time — SEC, Congress, the participants themselves and the public.

-- Hostile tenders became more common. They were unregulated initially and, except for §16(a) reporting under the '34 Act, large stock accumulations were unregulated and unreported. Tenders often were done as "Saturday night specials," started just before a weekend and closed during the following week, which gave targets little practical opportunity to respond.

-- The 1964 amendments to the '34 Act added §12(g) and subjected OTC companies to the same '34 Act requirements that applied to companies with exchange listed securities.

-- I had a lucky accident and became a Special Advisor to the SEC's Division of Corporation Finance, a Division that wanted no advice. They were happy with the internal consistency of the status quo.

-- An explosion of liability theories, especially implied liabilities for violating statutes or self regulatory organization rules that did not provide explicitly for civil liability, led to calls for reform. (Liability under '34 Act §10(b) and Rule 10b-5 is such an implied liability.)

-- In late 1960s, the codification project was started by ALI. A big Question — whether to pursue the legislative or administrative path to reform? The consensus answer: pursue both.

My prediction: legislative reform could take five years; administrative reform could take six months.

The results: Administrative evolution of the “integrated disclosure system” took many years from late 1960’s to early 1980’s, with continuing refinements ever since. (The “aircraft carrier” package of proposals may launch a significant new round of revision.) The Code took 10 years to write and never even became a Bill for Congress to consider, although it provided the intellectual basis for key aspects of the administrative reforms.

-- The Wheat Report was published in April 1969, following about a year and a half of intensive effort. Major reforms suggested by the Wheat Report that quickly followed:

Rules 144 and 145 were adopted, a major breakthrough in concept, permitting unregistered resale based on public need for disclosure, not private circumstances of the investor.

The Integrated Disclosure System began to evolve, integrating '34 Act filings into '33 Act filings, especially for liability purposes — I called this the “Securities Act of '67” ('33 + '34 = '67).

The '34 Act filings were upgraded and eventually evolved into a fill annual update of basic company disclosures.

Short registration forms were adopted — e.g., S-2 and S-3.

The predecessor of Reg D was adopted to rationalize private placements under §4(2).

Rule 145 reversed the no-sale approach of Rule 133, Rule 133 was repealed and all forms of acquisitions were treated the same for '33 Act purposes.

-- The SEC progressively changed its attitude on soft and forward-looking information in filings. Such disclosure was permitted in early 1970’s, then encouraged by safe harbor rules and now is required to a significant extent by MD&A etc.

-- The Williams Act, originally sponsored as an anti-raider measure, was adopted with a more balanced view — not to protect inefficient management against attack, but to level the playing field in a fair fight for control in which shareholders could decide.

-- The Watergate Scandal and irregular (or corrupt) payment pattern led to the Foreign Corrupt Practices Act, with new requirements focusing on accountability, adequacy of books and records and financial controls, in addition to regulation of transactions that were “foreign” and “corrupt practices.”

-- Enforcement concern focused on insider trading.

-- “Qualitative” disclosing, reflecting on integrity of management, was required in addition to “quantitative” disclosure.

-- New trading practices emerged. The Philadelphia Stock Exchange almost pulled down the house of cards by allowing institutions to become exchange members, and trade with floor brokers at intra-member rates (if they did not have their own floor personnel), which were a fraction of the fixed public customer rates. This led eventually to ‘34 Act §19(b) and the demise of fixed commissions.

## MORE RECENT TRENDS

-- More suits were brought by sellers who complained that favorable soft information was withheld in the context of going private, LBO’s, acquisitions, etc. An early example was in *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), involving an acquirer that failed to disclose the enormous “surplus surplus” that could be withdrawn from the insurance company target. Among other factors this development helped change the SEC’s attitude toward forward looking, evaluative and other forms of soft information.

-- There has been an explosive growth of technology — computers, etc.

-- There has been an explosive growth of new products — options, futures, O’s%, strips, derivatives, mortgaged backed securities, other securitized assets, financial “commodities,” collars, swaps, tracking stock, hybrid preferred, repurchase agreements, reverse repos, etc. There are financial instruments with values related to individual securities, individual commodities, indices of either, measures of interest rates, deltas between two variables, deltas between values at different times and even the weather,

-- Now almost any financial risk can be sliced, diced, mixed and matched to achieve almost any imaginable risk/reward allocation.

-- Indexing has matured from a strategy viewed with much hostility and skepticism to a well accepted investment technique.

-- I had my one good lifetime idea, an index option that would settle in cash. My client, the Philadelphia Stock Exchange, got caught in moratorium on new option products and we lost momentum. The Chicago Board of Trade developed the first stock index product using a futures model.

-- Institutionalization and internationalization of the markets occurred to a growing extent.

-- A breakdown of division between different types of market participants and financial service providers has occurred. Merrill Lynch, American Express, Sears and Citigroup now do almost everything. Credit card issuers and money market accounts compete with depository institutions.

-- SEC has become an economic as well as legal regulator, concerned with capital formation, the cost of services to the public, etc.

-- Soft and forward-looking information has come into wide use, especially through the MD&A which grew progressively from humble beginnings as a comment letter item that morphed into Guide 22 and later became Regulation S-K, Item 303.

-- Hostile tenders, originally a technique of “raiders” and shunned by “respectable” companies, investment banks and law firms, came of age, and are now acceptable in the most prestigious corporate and professional circles.

-- The multi-step M&A deal emerged — the “three piece suitor” — to protect against a topping bid of an unwelcome third party — e.g., a block purchase, lock up option to buy more stock from the company or insiders, friendly tender and then a clean up (hopefully short form) merger.

-- A variety of defensive anti-takeover techniques have emerged — poison pills, lock ups, bust up fees, crown jewel options, standstill agreements, golden parachutes and white knights (who sometime cause more grief than a hostile bidder would).

-- Going private transactions became common. Managements now initiate the same strategies, defensively and sometimes on their own unprovoked initiative, that hostile bidders use — e.g., the attempt of RJR management to do a highly leveraged going private MBO, putting the company in play and eventually losing the battle to KKR.

-- Junk bonds went from “fallen angels” (not originally issued as high yield debt), to a new product, created as such to finance highly leveraged transactions,

-- The Internet is changing patterns of both public and private financing.

-- Conference calls, electronic road shows and other new patterns of communications with analysts and large shareholders have raised questions of selective disclosure — a topic of renewed current SEC concern.

- '33 Act Rule 473 eliminated the need for delaying amendments and Rule 430A eliminated the need for pre-effective pricing amendments.
- Rule 415 rationalized shelf registrations.
- Red herring legends no longer need be in red.
- Rule 144(k) drastically relaxed §5, permitting non-affiliates to sell privately placed securities without restriction after a two-year holding period that could include tacking.
- Doctrines such as “bespeaks caution” have flourished, and are now essentially codified in the statutes, to the benefit of defendants in litigation. In other respects as well, legislature and judicial developments have swung the pendulum toward defendants.
- A series of statutory changes have significantly changed the regulatory environment for market professionals.
- The traditional turgid and highly stylized prose of filings is giving way to plain English.
- The desirability of continuing disclosure has largely eclipsed gun jumping concerns for companies already public.
- The aircraft carrier, if it is ever launched in whole or in part, will bring more significant changes.