Readying for More Reform

Will Congress end the requirement that only SEC-registered securities be sold to the public?

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Federal securities and banking laws passed by Congress in the 1930s departed from previous law in one key respect: The earlier law treated securities transactions as simply one of the many different kinds of commercial deals in which the involved parties agreed upon the terms of their transaction and the courts enforced the terms of the agreements. But the 1930s securities acts went much further, identifying some types of securities transactions as socially dangerous and endeavoring to classify and prohibit those transactions. The prohibitions held, even for parties that wanted to make the transactions. Two of the landmark pieces of 1930s securities legislation — the 1933 Securities Act and the 1934 Securities and Exchange Act — stated that principle explicitly: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title or of the rules and regulation thereunder... shall be void."

The 1930s laws' two most striking prohibitions were the Glass-Steagall Act's requirement that commercial banking firms not engage in securities underwriting and the 1933 Securities Act's requirement that only securities registered with the Securities and Exchange Commission can be made available for sale to the public. Those prohibitions were striking because they prohibited long-accepted commercial practices on the grounds that the practices were socially harmful.

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In 1999, the Gramm-Leach-Bliley Financial Modernization Act repealed the Glass-Steagall prohibition. Affiliations between firms in commercial banking and securities underwriting and dealing are now permitted when done through a holding company structure. However, the requirement that publicly traded securities be registered with the SEC remains law, at least for now. The 2001 transfer of control of the Senate to the Democrats halted efforts to reform securities law. But, looking beyond the present Congress, there are signs that the 1933 Securities Act requirement will eventually be dropped. Just as it took several developments for Glass-Steagall to be repealed, so developments are already taking place that could lead to reform of the 1933 Act.

ANTECEDENTS TO REPEAL

By the time the Glass-Steagall prohibition was repealed, four things had happened: First, the separation principle of the statute was evaded in practice. Second, the prohibition, at variance with the standard practice in most other important commercial jurisdictions, created problems for the international competitiveness of U.S. commercial and investment banks. Third, although the separation principle was evaded in practice, doing so imposed significant costs on U.S. firms. Fourth, the belief in the policy sense of the prohibition had been undermined by academic work that challenged the assumptions underlying the prohibition. Similar developments are well underway in relation to the 1933 Securities Act.

Evaded in practice The Glass-Steagall prohibitions were incomplete from the very beginning because such a total prohibition was impractical on its face. If a commercial bank were absolutely prohibited from participating in the issuance or sale of any security, then it would be unable to sell equity or debt in itself. The same sort of impracticality has always faced the 1933 Securities Act; if every sale of a security required registration with the SEC, then the commission

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would be overwhelmed by small transactions and by transactions among business associates or between private corporations and their shareholders. So, in each case, the prohibition affected only significant or important deals and not all securities transactions.

In the case of the Glass-Steagall Act, the key prohibition was limited to affiliations between commercial banks and organizations "engaged principally in the issue, flotation, underwriting, public sale, or distribution… of stocks, bonds, debentures, notes or other securities." That meant that such affiliations could exist with organizations "engaged less than principally" in the proscribed activities. Because even a traditional investment banking house engages in activities other than underwriting — activities such as managing assets, buying and selling securities for clients, advising on transactions, and so on — the "principally" caveat created an opening that, in time, made the prohibition meaningless. As John Macey wrote, "Congress, in passing the [Gramm-Leach-Bliley] Act, merely gave formal recognition to changes that had already occurred in the financial markets."

The 1933 Securities Act contained similar exceptions. The most important was for "transactions by an issuer not involving any public offering." In its early years, the SEC worked hard to limit the usefulness of that exemption. The commission developed and persuaded the courts to adopt the approach that, because private offerings were an exemption, the exemption should be strictly construed. The courts, in turn, adopted the view that any offer that did not fall within the restrictive definition of a private offer, even if made by mistake, would make the entire offering illegal. The objective was to make the private offering exemption difficult to use, and to force most sales of securities into registration.

That legal strategy worked quite well until the late 1970s, when the SEC hit an obstacle. Registration is not a particularly costly process for a large issue of securities, because the costs are a small percentage of a large issue. But, because many of the registration costs are the same regardless of the size of the issue, small firms with small issues found the costs difficult to bear. Those companies sought and obtained relief from Congress in the form of an amendment to the statute creating an exemption for sales of securities to "accredited investors." In response to the amendment, the SEC promulgated a new regulation in 1981 that greatly expanded the scope of offerings that would be treated as private and exempt. Most importantly, the regulation made the test of whether the exemption was satisfied turn not on all offers, but only upon the persons actually buying the securities. What is more, the regulation defined an "accredited investor" such that it included most financial institutions and pension funds, plus any person or couple

with a net worth in excess of $1 million.

In the years since 1981, the number of persons with a net worth in excess of $1 million has mushroomed. Today, it is possible to sell very large issues under the private placement exemption, subject only to the restriction that there be no public solicitation. What that means in practice is that no communication soliciting interest in the security can be sent to a general group, but can be sent to such entities as the existing customers of investment banking houses — the very group to which the securities industry sells securities.

INTERNATIONAL COMPLICATIONS

The past 20 years have seen the development of global offerings — offerings of securities made to prospective purchasers in multiple jurisdictions. Whereas, in the 1950s, a U.S. multinational firm might have been satisfied to sell securities only in the United States, in the 1980s and 1990s the same firm may have found it advantageous to place securities in Japan and Europe as well. Partly in response to those global transactions, investment-banking firms expanded their geographic reach and built international networks of offices in all the principal financial centers. The foreign offices of U.S. investment banks were not subject to the strictures of the Glass-Steagall Act; instead, they could and did follow the local practice of affiliating with a commercial banking organization. Those variations in local practice made it difficult for an investment bank to play a uniform role in all phases of a global offering.

In the same way, the requirement that a public offering be registered in the United States, but not in other jurisdictions, creates difficulties in proceeding with a global offering on a uniform basis. The usual situation is to hold the entire global offering hostage to the U.S. timetable, which is a consequence of the American registration requirement. Even if the offering is structured to avoid the U.S. regulation (for instance by excluding the American markets from the offering), problems remain. If a communication related to the offering is made into the United States when there is no U.S. registration, or even if there is a registration in process that is not yet effective, the prohibitions of the American statute are applicable. When offerers outside the United States responded to that assertion of U.S. regulatory jurisdiction by barring American journalists from press conferences, the SEC, under pressure from the media, was forced to promulgate a narrow safe harbor.

NEEDLESS COST

Securities trading prohibitions need not be of concern to Congress if they do not impose significant costs. However, they do. In the case of Glass-Steagall, the regulators developed elaborate laws and procedures surrounding what constituted, and did not constitute, being "principally" engaged in the prohibited activity. That led firms to take on significant costs in attempting to prove that their transactions did not violate the prohibitions. The firms also absorbed continuing compliance costs as they attempted to ensure that they did not, in the eyes of the relevant regulator, cross the line between simply engaging, and engaging "principally."

Similarly, the 1933 Act's requirement that stocks sold to the public be registered with the SEC has placed significant costs on issuers and their underwriters who must decide whether to register or use an exemption. In either case, failure to comply with the demands of the statute carries a heavy penalty: If the statute is violated, purchasers of the security have the right to get their money back in full. If the securities rise in value, purchasers can keep them. If the securities fall in value, purchasers can get their money back.

If the issuer and its underwriters register the security, they must worry about the arcane gun-jumping doctrines, doctrines that treat any activity that might have the effect of promoting the sale of the security prior to the effective date of the registration statement as an illegal offer. If the issuer and its underwriters choose to rely on an exemption, they must worry that every requirement of the exemption is satisfied. In the case of the important private placement exemption, they must ensure that there is no public solicitation. For instance, if someone associated with the issue sends out an e-mail to a general list containing information about the offering, there has been a public solicitation and the offering is in violation of the statute. Issuers and underwriters have spent millions of dollars on legal fees and legal staffers to assure that there are no such violations.

ACADEMIC CRITICISM

The Glass-Steagall prohibition was based on the idea that engaging in underwriting increased the riskiness of banks. The idea did not make sense on its face. The activity of underwriting securities is a sales activity in which the underwriter sells the securities for the issuer in exchange for a fee — and that is not a particularly risky venture. Perhaps lawmakers were confused by the form of transaction in which the underwriter buys the security at the last minute from the issuer and then resells it to the buyer. Perhaps lawmakers believed that securities underwriters assume some sort of risk, as insurance underwriters do. Whatever the reason, Congress apparently believed — wrongly — that banks' participation in underwriting created additional risk for depositors.

That belief was challenged by George Benston's landmark 1990 book, *The Separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*. In it, the author presented an exhaustive and carefully argued case that the increased-risk idea never had analytic or factual merit. Benston also demonstrated that bank affiliation with securities underwriting had not, in fact, been a factor in the failure of banks during the Depression. With the release of Benston's book, the intellectual underpinnings of the Glass-Steagall Act were dissolved.

Using information In the same way, current academic research is dissolving the underpinnings of the 1933 Securities Act. The act is based on the theory that, unless the registration requirement is mandatory, investors will not receive the information they need to make a rational investment. The problem with the theory is that simply receiving the information will not make investors informed; they also must read, understand, and cor-

rectly analyze the information that is disclosed. An investor who is not disposed to do that work gets no protection from the statutory requirement. And an investor who is disposed to do the work is perfectly able to demand the information and require the supplier to attest to its truthfulness. The investor who requires the information and does not receive it can simply refuse to invest. If an investor is not interested enough to ask for such information, then it is unlikely that he makes proper use of when its dissemination is required by law. And for the investor to be able to understand and correctly analyze the information, he has to be quite sophisticated about numerous issues, including the legal structure of the securities being offered and the business in which the issuer is engaged.

Any investor with the sophistication to use the information is also in a position to evaluate the legal structure under which the offering is being made. The irony is that the investor with sufficient sophistication to use the information in the registration statement that the statute requires is an investor who does not need the statutory protection. And an investor who does not know how, or who does not desire, to use the information provided receives no protection from the statute — as many purchasers of overpriced Internet stocks (all carefully offered under the 1933 Act) now know.

Current academic work At least six scholars of securities regulation have now published articles in the past few years advocating repeal or significant modification of the 1933 Act. Their proposals differ greatly in detail, but they all share a belief that the mandatory registration requirement does not do any good. That is a dramatic change from conventional wisdom. For more than 50 years following the passage of the act, there was no serious proponent of the view that it was undesirable.

The most noted of the reform proposals comes from Yale law professor Roberta Romano, who argued in a 1998 article published in the *Yale Law Journal* that securities law in general, and the 1933 Act in particular, should be made optional. That is, if the seller and buyers want to comply with the requirements and accept the rules of the 1930s laws, they would be free to do so. And if they do not, they would be free to fashion an alternative set of rules and procedures to govern their transaction. Making the regulatory regime optional would open it up to competition, Romano says. If the laws offer the benefits that their proponents claim, then the parties would choose to use them. If they do not, and there are alternative transactional arrangements that offer a better tradeoff of benefits and costs, the parties would be free to fashion such alternatives.

Wake Forest law professor Alan Palmiter offered a less ambitious, but equally elegant, approach in a 1999 article published in the *Columbia Business Law Review*. He would make the 1933 Act optional, but would leave the 1934 Securities and Exchange Act unchanged. In transactions in which the parties opted out of the 1933 Act, the 1934 Act's fraud remedies and continuing disclosure obligations would still apply.

Other students of securities regulation have contributed to the growing literature on statutory reform. Merritt Fox of the University of Michigan, Stephen Choi and Andrew Guzman of the University of California at Berkeley, and Paul Mahoney of the University of Virginia have all published articles suggesting that the structure of the securities acts should be rethought. Although they differ significantly on what approach is correct, they all are skeptical about the securities acts in general, and the 1933 Act in particular.

CONCLUSION

When, and if, Congress decides to return to the task of reviewing the existing regulation of securities markets in an effort to reduce its cost and improve its effectiveness, the four developments that I have described suggest that repeal of the mandatory provisions of the 1933 Act will be high on its agenda. As America works to emerge from recent financial difficulties, lawmakers would be well advised to consider reform of the laws governing the investment system that fuels the nation's economic growth. R

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