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Current Problems in Securities Regulation

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COMMENTARY/Current Problems in Securities Regulation*

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As any securities lawyer, investor, or for that matter, individual in our well-informed society knows, problems exist today in the area of securities regulation. Among these we find that achievement of completely effective disclosure—the cornerstone of prudent and intelligent investment—still lies beyond our reach. In one sense, of course, this problem is not current. It has been around since Adam failed to serve a prospectus on Eve, or vice-versa. But the enormous strides in sophistication and complication of business have created more bruises on the old apple, and it is getting harder every day to know which bruise is worth reporting and when.

Other problems—the fantastic rise of institutional investing,[1] the take-over craze and its "funny money,"[2] the introduction of block trading,[3] the impact

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1. Enstam and Kamen, *Control and the Institutional Investor,* 23 BUS. LAW. 289 (1968); Loomis, *They're Tearing Up Wall Street,* FORTUNE, Aug. 1, 1969, at 88; Louis, *The Mutual Funds Have the Votes,* FORTUNE, May 1967, at 150; Rustin, *Little Profit on Small Investors,* Wall Street J., July 31, 1969, at 4, col. 1.

2. Once upon a time, corporate securities transactions were negotiated using cash (*i.e.,* money). Later, stock was elevated to the status of cash, and corporate stock transactions were accepted as part of the ordinary. For a myriad of reasons, including tax considerations, the collective corporate genius devised hybrid securities (notes with warrants attached; subordinated convertible debentures; etc.) and packages of securities, including traditional "money" as well as the new evidences of money interests, with which to structure corporate transactions. "Funny money," like the term "Chinese money," is frequently used to describe the nontraditional elements of financing packages. Many people no doubt could claim the honor of coining the "funny money" term, but upon which man the accolade should fall is unknown. For discussion of the take-over craze and the use of "funny money" see Brown, *United Fruit's Shotgun Marriage,* FORTUNE, April 1969, at 132; Burck, *The Merger Movement Rides High,* FORTUNE, Feb. 1969, at 79; Davidow, *Conglomerate Concentration and Section Seven: The Limitations of the Anti-Merger Act,* 68 COLUM. L. REV. 1231 (1968); Loomis, *Ten Conglomerates and How They Grew,* FORTUNE, May 15, 1969, at 152; *Businessmen in the News-The Biggest, Wildest Merger Year Ever,* FORTUNE, June 15, 1968, at 43.

of back office breakdown[4]—are newer, but no less current. The emergence of mutual funds, life insurance companies, and banks as money managers for the whole population of investors; the conglomeration of industry at a greater speed than the market and the investor can sensibly follow; the sheer vitality and ingenuity of today's money managers—these too create today's problems and challenges.

The list of problems runs on and, if I am going to do more than catalogue them, some pruning is in order. This commentary will focus on the areas of disclosure, conglomerates, and institutional investment. Each cross-fertilizes the other, but each deserves individual consideration.

Disclosure

Disclosure has been a problem, and will continue to be one, as long as there are traders who swear by caveat emptor. In point of fact, the common law long ago beat the government to this topic and every lawyer knows that the ancient tort of fraud and the common law of fiduciary loyalty will catch an errant client just as surely as the modern sanctions found in the federal securities statutes.[5] Lest there be any doubt about it, we have *Zahn v. Transamerica Corp.*[6] The common law, however, is made by judges who have to wait patiently for plaintiffs and, in recent years, the SEC has proven to be somewhat more eager.[7] My interest, however, has been primarily in the federal area of fair-trading rules, and consequently I will leave the non-federal aspects of disclosure for illumination by others.

A basic responsibility of the Securities and Exchange Commission is to insist upon a situation whereby those interested in securities can arrive at informed decisions. Except for certain limited situations, the Government does not intervene; it does not determine the value of, circumstances per-

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3. Loomis, *supra* note 1, at 137; *Battling the Big Board to Serve the Big Traders*, BUS. WEEK, June 14, 1969, at 104.

4. Loomis, *supra* note 1, at 88; Louis, *Flood Warnings on Wall Street*, FORTUNE, Aug. 1968, at 98; Note, *The Back Office Problem and the Anti-Trust Laws*, 69 COLUM. L. REV. 299 (1969); *Blue Days for Brokers*, TIME, Aug. 15, 1969, at 71. *See generally* Loomis, *Big Board, Big Volume, Big Trouble*, FORTUNE, May 1968, at 146.

5. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-jj (1964); Securities Act of 1933, 15 U.S.C. §§ 77a-aa (1964). *See also* Jennings, *Insider Trading in Corporate Securities: A Survey of Hazards and Disclosure Obligations Under Rule 10b-5*, 62 NW. U.L. REV. 809 (1968).

6. 162 F.2d 36 (3d Cir. 1947).

7. *See* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968) [Certiorari was denied to two individual defendants, 394 U.S. 976 (1969)]. *See also In re* Merrill Lynch, Pierce, Fenner, and Smith, Inc., CCH FED. SEC. L. REP. ¶ 77,629 (1968); Loomis, *The SEC Has a Little List*, FORTUNE, Jan. 1967, at 111; *Businessmen, the Law and Ethics*, FORTUNE, Oct. 1968, at 39.

mitting sale of, or methods of distributing securities issues. Of course the Commission exercises certain functions to further the goal that the markets and those operating in them for or on behalf of the public measure up to accepted standards. In simpler terms, the object of all SEC activity is to provide a fair trade for the trader.

Disclosure is a more subtle problem than most of the case law—even the recent cases—suggests. Insider trading on clearly material and undisclosed facts creates an easy case. A harder question involves defining what amount to "material" facts, and perhaps the most difficult questions of all lie in deciding the timing and necessary content of disclosure attempts.[8] Disclosure problems are not limited to the category of information withheld. Equal disruption of fair trading can result from excessively casual or inaccurate reporting which can induce an investor to take a position in a security with unfounded high hopes, later to learn he has bought a generous supply of wallpaper.[9] The name of the disclosure game, therefore, is not just "too little, too late." It can also be "too much, too soon." One of my favorite stories illustrates this point.

There were a captain and a first mate on a ship. The first mate drank to excess, but he was trying to reform. He had really cut down on his drinking, when one day he slipped a bit. It was the captain's turn to make the entry in the ship's log that day and he wrote, "The first mate was drunk today." This upset the first mate and he argued with the captain that, after all, he had been on his good behavior, and that it was discouraging to have this entry made about him. The captain said, however, that the first mate could not argue the fact, since it was true and the mate couldn't deny it. The next day it was the first mate's turn to keep the ship's log. His entry read, "The captain was sober today."

The short of the matter is that disclosure should not be viewed simply as a set of rules which, if followed, allow everything else to be sublimated. Disclosure is more fundamentally a principle which seeks to create an atmosphere for informed trading. The rules of disclosure stand to enforce the principle. Like all rules, they shift and change as the infinite ingenuity of the marketplace creates new types of deals which give birth to new categories of investor-oriented information. But the principle remains constant.

The ultimate goal of the disclosure principle is not merely to force ad-

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8. *See* Bromberg, *Corporate Information: Texas Gulf Sulphur and Its Implications*, 22 Sw. L.J. 731 (1968); Wiesen, *Disclosure of Inside Information—Materiality and Texas Gulf Sulphur*, 28 Md. L. Rev. 189 (1968); Note, *Texas Gulf Sulphur: Expanding Concepts of Corporate Disclosure under SEC Rule 10b-5*, 43 St. John's L. Rev. 425 (1969); Note, *Texas Gulf Sulphur: Its Holdings and Implications*, 22 Vand. L. Rev. 359 (1969).

9. *See, e.g.*, Escott v. BarChris Const. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Comment, *BarChris: Due Diligence Refined*, 68 Colum. L. Rev. 1411 (1968).

herence to specific disclosure rules, but to promote the continuous and timely sharing of information which matters to investors. A measure of the widespread understanding of this principle is the typical comment by the uninitiated: "Why, if everyone knew what I do, I wouldn't be able to make any money." That's right; that's what it is all about. Today's corporations and money managers are by and large the leading exponents of the disclosure principle. Their adherence to the principle is proven by the relative shortage of cases dealing with violation of disclosure rules.

Even assuming a bona fide desire to contribute to informed investor choice, however, the one who holds the information to disclose has problems today. Some problems arise from the tough area of judgment calls where the question is what is material and when.[10] Honest men honestly differ on these matters, and to a certain extent there may be no correct answer. The market makes a fool of us all in time, some say, and twenty-twenty hindsight makes judgment calls seem deceptively simple. We have come a long way in corporate responsibility, and the fact that corporations know when judgment is required is good proof that fair trading is an attainable, albeit elusive goal.

Disclosure and the Growth of Conglomerates

Obstacles to informed trading remain, and some of them are of man's own making. This leads me to my second area of discussion: conglomerates. Back in 1966, before L'Affaire Litton, I was—as a federal employee—concerned about the special disclosure problems created by conglomerates, but my speeches on the subject went largely unheard. Many conglomerates operated then, as now, in divisional structures with capital packages keyed to operating results reported under the parent organization's name. No one has to be told now that such reporting can lead to problems.[11]

The quality and extent of corporate reporting by conglomerate entities is, of course, only one of the current problems posed by conglomerates. It may also be one of the relatively simple problems to cure. By and large the problem is resolved by breaking down parent organization financial statements to show operating results for its different business segments. Certain technical problems are raised by a requirement for such breakdowns. Threshold questions involve what constitutes a different business segment or "line of products."[12] Performance statistics within corporate

10. *See* articles cited *supra* note 8.

11. Burck, *supra* note 2; Davidow, *supra* note 2, at 1280; Louis, *The Accountants are Changing the Rules*, FORTUNE, June 15, 1968, at 177; Loomis, *supra* note 2.

12. Schwartz, *Legal Implications of Product Line Reporting*, 23 BUS. LAW. 527 (1968); Sommer, *Conglomerate Financial Reporting*, 23 BUS. LAW. 521 (1968).

divisions or with respect to different lines of products are not always simple to establish because of intracompany services and products and allocation of overhead, research and development and administrative costs. Nonetheless, these technical difficulties are surmountable, and it is important to recognize that improvement in the quality of conglomerate disclosure is an issue apart from questions about the fundamental desirability of conglomerate growth.[13]

One of the most popular methods by which conglomerates grow is the tender offer, or takeover bid. This mechanism, for reasons I will explain, creates some of the same basic disclosure problems as the lack of standardized reporting formats.[14] There are reasons for the popularity of tender offers. These include speed, simplicity, and also—of particular significance— the fact that, unlike a negotiated merger, the concurrence of existing management is not required.[15] Unfortunately, insufficient disclosure is often made. In this respect the two other principal methods by which control of a company is changed, the proxy contest and the negotiated merger or purchase of assets, differ from the tender offer. With these other methods, stockholders are required to vote and the consequent application of the proxy rules serves to provide full disclosure. Before the Williams bill[16] was enacted there was no express provision of law which affirmatively required adequate disclosure in the case of tender offers. The antifraud rules of the securities statutes and other relevant laws were the sole tools available to the Commission and to persons aggrieved. The offeror could mask his identity, his plans, and his purposes.[17] Investors were thus confronted with the necessity of making an important investment decision—the determination whether to sell their shares, or keep them—without disclosure of material facts. The problem is compounded by the fact that the tender offeror usually wishes to bring all possible pressure on investors to decide quickly, without reflection, and indeed without opportunity to consider relevant and material information. The appeal is to get aboard the band wagon immediately or lose the

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13. Since the date of these remarks the Commission has adopted rules which require registrants and their subsidiaries to disclose "the approximate amount or percentage of total sales and operating revenues and of contribution to income before income taxes and extraordinary items attributable to each line of business which contributed, during either of the last 2 fiscal years, a certain proportion to (1) the total of sales and revenues, or (2) income before income taxes and extraordinary items." 34 Fed. Reg. 12176 (1969).

14. *See* CCH FED. SEC. L. REP. ¶ 77,729 (1969).

15. *See generally* McDonald, *The New Game of Business*, FORTUNE, May 15, 1969, at 143, 286; O'Hanlon, *Goodrich's Four-Ply Defense*, FORTUNE, July 1969, at 110; *How to Fend Off a Take-Over*, FORTUNE, Feb. 1969, at 83. *See also* Greenfield, *Regulation of Contested Cash Tender Offers*, 46 TEXAS L. REV. 915 (1968).

16. 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (Supp. IV, 1969).

17. H.R. REP. No. 1711, 90th Cong., 2d Sess. (1968). *See also* articles cited *supra* note 15.

opportunity to participate in what is made to appear an attractive offer. The creation of such a situation is totally inconsistent with the basic philosophy of the federal securities laws that investors should be furnished with full disclosure of material facts and given the opportunity to make an unhurried investment decision upon the basis of such disclosure. What I have described above is hopefully a thing of the past since passage of the Williams bill and the drafting of Commission rules[18] which implement its provisions. The Williams bill, however, can stand improvement, and other problems concerning tender offers remain.[19]

To the extent that the take-over creates a disclosure problem, it too is susceptible to fairly painless correction. Some of the speed of a take-over may be lost in the process, but the gain in sensible investor choice amply offsets the loss. The threat of a take-over, or an actual take-over, can do much to shake antediluvian managements out of their complacency. Where this results in a more creative use of corporate resources, whether by existing management or by others, the take-over bid or threat can achieve desirable goals. My commitment to full disclosure recognizes that such cases may slow down, slightly, the speed of the impact, but it in no way kills the advantage.

Further Problems with Conglomerates

The issues involved in conglomerate growth—and block trading is yet another issue—are, for the most part, securities problems. The federal legal structure does not ask or allow the Commission to resolve the policy issues arising out of the rapidly increasing concentration of wealth and power in our society.

At the moment there is an abundance of concern over the socio-economics of conglomerate growth. Some people believe that the tax laws should not encourage corporate marriages,[20] while others believe that the tax laws should create actual barriers to corporate take-overs.[21] Indeed, a prominent practitioner in the field of modern corporate growth has suggested a special tax in connection with such transactions.[22] In another arena, we are all aware of the recent antitrust interest in conglomerate acquisitions.[23] We must be

18. 33 Fed. Reg. 11015-18, *as amended,* 33 Fed. Reg. 14109-10 (1968).

19. *See* Schmults & Kelly, *Disclosure in Connection with Cash Take-Over Bids: The New Regulations,* 24 BUS. LAW. 19 (1968).

20. *See* Tax Reform Act of 1969, H.R. 13270, 91st Cong., 1st Sess. § 411 (1969); H.R. REP. No. 413, 91st Cong., 1st Sess. 101-11 (1969).

21. *See generally Are The Conglomerates Finished?* FORTUNE, May 15, 1969, at 135, 136.

22. James J. Ling, Chairman of the Board of Directors of Ling-Temco-Vought proposed that the Government levy a two percent tax on corporate consolidations. N.Y. Times, April 18, 1969, at 61, col. 3.

23. *See Davidow, supra* note 2, at 1235; *Congress Hears the Conglomerates,* BUS.

sure that the growing fear in Washington of conglomerates is accompanied by an appreciation of the positive economic good which conglomerates can achieve. Treating all conglomerates alike and meting out to all the severest restrictions—while appropriate for certain purposes—may run the very serious risk of overkill. The baby may well go out with the bath water.

There is ground on which I, as a securities-oriented student, can share concern with those whose main fear is overconcentrated wealth. I do not favor mixing *wealth* with *water*. There is a chance, especially with the ever increasing flow of "funny money" into the market place, for conglomerates to pump a great deal of water into the nation's capital structure. A problem of the first order would result, but this problem, similar to those which used to characterize the milieu of both the public utility holding company and the investment company, is not without its remedy.

Institutional Investment

There has been a rapid development in the past few years toward institutionalization of our securities markets.[24] This means, simply, that more and more of the outstanding equity is being acquired by financial intermediaries, and that more and more of the activity in our markets is a reflection of quickening activity by those institutions and those who would imitate them. A brief sketch of the dimensions of this trend may be helpful.

In 1954, institutions owned $66 billion in equities, amounting to 25 percent of those then outstanding. By 1968, this group held $260 billion worth, or about 34 percent of all outstanding equities. Bank trust accounts alone accounted for an incredible $163 billion in stock holdings in 1968, the stock assets of the five largest banks exceeding the total stock assets of all open-end investment companies combined.

Institutionalization has been truly startling, not only in its scope, but in its velocity. For instance, the net assets in the mutual fund industry now stand at over $52 billion, almost $10 billion more than a year ago.[25] The entrance of the insurance companies into the fund field, a development which has not gone unnoticed,[26] adds an additional sales force potential of 200,000 to the 50,000 salesmen and brokerage representatives now selling fund shares.[27] This additional sales force has access to an estimated 130 million life in-

WEEK, Aug. 2, 1969, at 27; *The Sharp New Line on Antitrust*, BUS. WEEK, June 14, 1969, at 120; *Some Candid Answers from James J. Ling*, FORTUNE, Aug. 1, 1969, at 92.

24. *See* articles cited *supra* note 1.

25. Hershman, *The Mutual Fund Explosion*, DUN'S REV., July 1969, at 21, 25.

26. *Id. See also* Sheehan, *Life Insurance's Almighty Leap into Equities*, FORTUNE, Oct. 1968, at 142; *Insurance Giants Move into Funds*, BUS. WEEK, March 15, 1969, at 114.

27. Sheehan, *supra* note 26, at 144.

surance policyholders. Five million Americans now own mutual fund shares, a figure which is likely to double, at least, in the next five years, at which time, with the continuation of the present rate of growth, the industry should reach $100 billion in assets. Behind these figures lie truly startling transactional volume and turnover figures; figures which are symptomatic of the series of changes occurring in our nation's capital allocation.

Institutionalization of savings will direct more and more of public savings into professionally managed vehicles, vehicles which place greater emphasis on equity investment. It will be important to prove or disprove the contention that investment decisions by the advisors to such pools of capital tend to become homogeneous largely because they reflect the decisions of a relatively few money managers trained in similar techniques and constantly peering over the shoulders of their colleagues and competitors. If a trend to parallel decision-making develops, investment managers will be faced with the possibility that their decisions will cause even larger swings in the market and more pronounced reactions thereto, especially where markets, because of the slower growth of available equities or their more rapid absorption by the institutions, are thin. This problem is made more urgent by the fact that stock exchanges were designed as central meeting places where relatively small buy and sell orders of individual investors could be matched—not the tens or hundreds of thousand share blocks which are becoming commonplace among trading institutions.[28] The position of floor specialist was developed to provide liquidity and correct temporary imbalances in the supply and demand for particular stocks created by many relatively small orders coming to the market on a random basis. The specialist no longer can, alone, meet the large needs of the institutions.

Meanwhile, as the activities of the funds and other institutional investors create their own disclosure needs, the smaller, individual investor will tend to become lost even more in the maze of sophistication. He too will need information upon which to trade, and his problems will be magnified as his impact on the market diminishes. Traditional distinctions among financial intermediaries are rapidly disappearing as the supermarket approach is adopted by institutional investors. Banks, insurance companies, and others have begun to form multi-faceted financial service organizations, called financial conglomerates, or—to use a phrase designed to sound more friendly—congenerics, to offer various services including equity based vehicles, both traditional and novel.[29] The insurance companies are in the

28. Loomis, *supra* note 1, at 137.
29. Rose, *The Case for the One-Bank Holding Company*, FORTUNE, May 15, 1969, at 163, 322, 326.

mutual fund business and the banks are trying to test the water.[30] The distribution processes for such equity oriented products do not always follow the traditional channels used in the securities business. They involve new merchandising techniques which require assessment and response by the regulators, state and federal, and by those now engaged in these activities.

We have all watched, with great interest, the development during the past few years of the insurance-equity package, the variable annuity. With this development many of the major life insurance companies have now entered the mutual fund business directly. Not too long ago insurance men laughed at a forecast of such a development. The problems with which some life insurance companies are now struggling, in part, relate to a reorientation of sales attitudes and techniques. The need to teach sales forces, inbred with the different concepts of life insurance, to sell mutual funds is eloquent testimony to the strong rivalry that has existed between these two investment (or savings) media. The advice of fund men to their clients to "buy term and invest the difference" drew long and heated answers from the life insurance men. But the trend is not one-way. Fund organizations are entering the life insurance field (indeed, some started many years ago) and are learning that the insurance sales message is just as difficult for fund salesmen.[31]

In the past, institutional investors such as mutual funds, bank trust departments and pension funds tended to be conservative, investing for the long term. Recently, however, a "cult of performance" has emerged and attention has been focused on those equities with the "best track records" in the previous year or even six months.[32] More of these institutions, particularly certain mutual funds, have become short term traders who act not only with speed, but in volume. This emphasis on short term performance has fed the fires of volume. It is not unusual for the so-called "go-go" funds (or merely very aggressive common stock funds) to exceed 100 percent turnover rates in less than a year; and some of the activity generated by these funds is highly speculative.

Other problems are developing from the growing emphasis on "instant performance." One of these concerns valuation methods[33] and the validity of values assigned through use of these methods to assets held by funds, assets with significant restrictions on ready liquidation. We have already witnessed the difficulties faced by one fund and its investors caught first by inadequate internal procedures and then by the collapse in value of one

30. *See* articles cited *supra* notes 25 and 28.
31. *Can Fifty Money Managers All be Wrong?* FORBES, March 1, 1969, at 46.
32. *Performance in Reverse?* FORBES, March 15, 1969, at 58.
33. *See Letter Stock is Worth the Worry*, BUS. WEEK, Jan. 18, 1969, at 108.

such portfolio security.[34] Apart from the losses which may be suffered by individual investors, and the damage to the image of other funds, this case provides some clues as to the thinness of the ice on which some are skating.

Conclusion

I have chosen to focus upon problems—disclosure, conglomerates, and institutional investment—which illuminate some of the basic issues in today's securities regulation. It seems that, as is the case with many areas of federal regulatory law, the smooth running, trouble free aspects may well go unnoticed. There are members of the public who have the impression that the Government considers itself as a colossal Interference Agency, specializing in Monday morning quarterbacking. This impression is mildly accurate, but woefully incomplete.

The main business of government relates to change and improvement. In carrying on this function, the SEC is quite aware of the whole range of benefits which the private sector contributes to the economy. It has in the past enjoyed, and continues to thrive on, a cordial working partnership with businessmen and their lawyers. For the most part, this partnership has been tremendously successful.

The sophistication of financial markets, which continue to grow at what appears to be a geometric rate, will continue to spin off new and subtle versions of the securities problems I have discussed. In order to maintain fundamental fairness in the securities markets, such problems will have to be resolved. Resolution of problems presupposes a reasonable understanding of the forces which create the problems, and those of us who inhabit the securities world are obligated to speak out on the important issues. This brief commentary is offered in partial satisfaction of my obligation.

34. *See In re* Mates Financial Services, CCH FED. SEC. L. REP. ¶ 77,721 (1969); *Mates Checked*, TIME, Jan. 3, 1969, at 61.

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