

The Pillars of Registration

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If you attended religious instruction as a child, or have a fondness for old movies, you know the story of Samson, an Old Testament judge. Making a long story short, Samson ultimately used his superhuman strength to pull down two pillars supporting an arena full of people. Samson and lots of other people died.

The federal securities laws are based on the pillars of registration. Like Samson's pillars, registration is under pressure from two sources. First, it has been undermined by the modernization of clearing and settlement and some well-intended SEC decisions. Second, it has been buffeted by the forces of globalization. Together, these forces are threatening to bring the house down.

Our tale begins with the undermining process.

At its most basic level, registration is simply a form that is filed by a "registrant" with the SEC. In the case of Exchange Act registration, however, the registrant must also file annual, quarterly and periodic statements (Forms 10-K, 10-Q and 8-K) with the SEC. These statements are published on EDGAR, the SEC's publicly available Internet repository. This is the medium by which issuers of registered securities make disclosures to the investing public. It is through registration that the fundamental principle of federal securities law – namely, that "sunlight is the best of disinfectants" – gets translated into practical reality.

In the beginning, which for securities lawyers means 1934, registration only applied to issuers listed on a national securities exchange. In 1964, the rules were changed to include issuers with securities quoted in the over-the-counter markets that had more than 500 holders of record. Issuers that are registered are permitted to exit the registration system when they have less than 300 holders of record.

The intent of the 1964 amendments to the Exchange Act was to require registration of all the securities that traded in the OTC markets. It was thought that securities held by less than 500 investors were not likely to trade. In fact, more than half of the equity securities traded in the OTC markets today are not registered.

Early on, the SEC realized that it would have a difficult time having its way with foreign issuers. So, in 1968, it provided an exemption. As long as the foreign issuer didn't raise money in a public offering or list on a national securities exchange, it was not required to register. However, it would be required to file with the SEC the same information it made publicly available in its home country. This exemption became known in the legal trade as the "information supplying"

exemption. The SEC never really checked to see whether issuers were really supplying information. There has never been an enforcement action brought for failure to comply. So, as a result of this exemption and the SEC's relaxed attitude towards enforcement, foreign stocks, usually in ADR form, trade in the OTC markets without registration.

In 1970, DTC was established as a securities depository. Over the years since then, investors have been encouraged to hold their securities in street name with their broker. However, another decision of the SEC in 1965, before there was a DTC, determined that investors holding in street name would not be counted as a holder of record. Currently, issuers with thousands of shareholders are not required to register their securities because they don't have 500 "holders of record."

Finally, Sarbanes-Oxley has made registration more difficult and expensive. This has encouraged issuers to rethink the need to register their securities. Many issuers with less than 300 holders of record have decided it isn't worth the trouble and exited the system.

Now for the impact of globalization.

In the late 1990s, I attended a number of lunches where Richard Grasso, the former Chairman of the New York Stock Exchange, was the speaker. For the most part, Mr. Grasso gave the same speech every time. He would acknowledge the NYSE's competition with NASDAQ for listings. He would then point out that if all of the issuers on NASDAQ that would qualify for an NYSE listing made the switch, the business of the NYSE would increase by about 7%. On the other hand, the listing of only the top one-third of qualifying European issuers would triple NYSE's business.

The NYSE's European marketing efforts are stymied by registration. European issuers that wish to list on the NYSE, or NASDAQ for that matter, are required to register their securities under the Exchange Act.

At the same time, US investors are increasingly interested in the securities issued by foreign issuers. Foreign stock exchanges would like to accommodate that interest by making their trading screens available in the US. The SEC is under great pressure to allow this development. But, foreign stock exchanges are not registered with the SEC, and even if they were, the securities of issuers traded on foreign stock exchanges are not registered. And, there are no plans to make them register.

The SEC could solve this problem by providing an exemption for foreign stock exchanges and the securities listed on them, perhaps on a case-by-case basis. If they do, the NYSE and NASDAQ will howl to be allowed to compete for these listings. Dick Grasso was beating this drum at least a decade ago. Moreover, the advent of Reg NMS has resulted in a loss of business for the NYSE. The NYSE's officers are wearing war paint and dancing around the fire. They want this

business – they need this business. But if the SEC allows the NYSE and NASDAQ to list the stock of unregistered foreign issuers, US issuers listed on these exchange will demand that they not be required to register either.

Lawyers like to call this sort of thing a slippery slope. It reminds me of Samson's pillars.

The financial services industry has been modeled on federal securities regulation. The trading of securities is one of the most highly regulated activities on the planet. Pull down the pillars of registration, and most of those business models become obsolete overnight. People will lose jobs.

One thing every trader knows. Change almost always is a money-losing proposition.

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