Commentary: Making it Up as We Go Along

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President Franklin D. Roosevelt reportedly had a fondness for martinis and a prized technique for making them. FDR would carefully measure, following a favorite family recipe, precise amounts of gin and vermouth into a pitcher. Then he would take the remainder of the gin bottle and pour it into the pitcher.

Last week, the SEC proposed amendments to Rule 163 under the Securities Act of 1933. I had misgivings about the Rule when it was first adopted in 2005. The current proposal would toss the remainder of the gin bottle into the pitcher.

The cornerstone of the federal securities laws is Section 5 of the Securities Act. Traders generally operate under an exemption to Section 5 – Section 4(1) – and rarely confront a Section 5 issue. But, investment bankers know it well.

The basic concept of Section 5 is simple. A security may not be offered in the United States unless a registration statement has been filed with the SEC. The security may not be sold unless the registration statement has been declared effective.

Section 5 is important because the registration statement filed with the SEC contains a prospectus that describes the securities to be sold and their issuer. The idea is that between the time a registration statement is filed with the SEC and the time it is declared effective, potential purchasers will read the prospectus and use the information it contains to decide whether or not to invest.

In this business, we are fond of quoting this phrase uttered by Justice Brandeis: "Sunlight is the best of disinfectants." Section 5 translates this judicial platitude into a legally enforceable doctrine. Investors will be provided with adequate information to make a sound investment decision, and most important, will be provided with sufficient time to review the information before making a decision to invest.

Congress passed the Securities Act of 1933, and its companion, the Securities Exchange Act of 1934, during the darkest hours of the Great Depression. Congress intended to prevent some of the frauds that contributed to the collapse of the markets in 1929 and the resulting social calamity that followed in its wake. It was

thought at that time that investors had rushed to buy fraudulent securities in an effort to get rich quick based on bogus information. The Securities Act forced investors to take a deep breath and think about what they were getting into. It was also s upposed to give the SEC time to review the disclosure and hopefully stop an offering fraud before it could be sold to the public.

Investment bankers in the 1930s were so dismayed by the Securities Act that they declared it dead on arrival. Nonetheless, the U.S. capital markets have become the envy of the civilized world and its disclosure principles have been imitated by just about every other sophisticated capital market on the planet. The European Union, for example, has implemented the "Prospectus Directive," a high form of flattery from a continent that in some circles still thinks of the U.S. as "the colonies."

That said, the "wait, look and listen" concept will never be popular with issuers and investment bankers. It is inevitable that if investors are provided with time to think, some of them will think better of it and back out of making an investment.

So, Rule 163 changed all of that. A large issuer, defined as a "well-known seasoned issuer" and assigned the horrifying acronym "WKSI," is permitted to search for indications of interest in a public offering before filing a registration statement with the SEC. In an effort to save some part of the Congressional mandate, the 2005 version of the rule did not permit underwriters to perform the search. The new Rule 163 would now allow the issuer to use underwriters to make these offers.

Any way you slice it, Rule 163 allows offers of securities to be made prior to the filing of a registration statement with the SEC. This blows Section 5 of the Securities Act right out of the water, if you are a WKSI. I find this disturbing.

First of all, I don't see in Section 5 or anywhere else in the Securities Act that the SEC has the authority to modify the statutory command, passed by our elected representatives, that offers cannot be made prior to the filing of a registration statement. Congress created this rule, and if it should be changed, Congress should be the one to do it.

It is true that WKSIs already make lots of public disclosure through SEC filings. But, this is true of all issuers that have a class of securities registered under Section 12 of the Exchange Act. If this is a good idea for WKSIs, why not extend the same privileges to all current reporting issuers?

The SEC's release points out that WKSIs and most other issuers that are not smaller public companies can file shelf registration statements, which permit them to issue securities on a moment's notice. But, WKSIs are reluctant to file shelf registrations for common stock, because of "overhang" issues. What this means is that if current

shareholders realize that an issuer can dilute their interest at any time, they tend to value the stock lower.

Poor WKSIs. But, the threat of dilution is material to stockholders. Why shouldn't stockholders be made aware that their holdings may be diluted so they can value them appropriately?

Moreover, this is not a problem unique to WKSIs. The fact is that smaller companies have a much more difficult problem raising capital, and the threat of dilution has a much more depressing effect on their stock prices.

Lawyers for WKSIs sometimes claim they should have more latitude because larger companies are the vehicles for fewer securities frauds than smaller companies. Surely Worldcom, Enron and HealthSouth, all of which would have qualified as WKSIs, have forever put paid to that conceit. The amount of money lost to investors in just those three frauds dwarfs the amounts lost by investors in smaller companies over at least the last decade or so.

The federal securities laws should be revised. The federal securities laws have been around for over 75 years. Unlike the U.S. Constitution, they haven't aged well. Our recent financial crisis provides a strong reason to revisit them.

Moreover, the entire public offering process cries out for modernization. It is too expensive and cumbersome to raise capital in the public markets, particularly for smaller companies. Too many companies avoid the whole mess by engaging in private offerings, which are increasingly public in nature. Regulation of the offering process is inadequately integrated with the regulation of securities markets. The result is much less than optimal protection for investors. The resulting loss of investor confidence has an unfortunate side effect -- the U.S. capital markets no longer inspire envy among other global marketplaces.

However, Rule 163 is not the right way to make these changes. Instead, Congress ought to reconstruct the entire statutory scheme in light of modern technology.

The registration concept no longer works to protect investors. It should be jettisoned and replaced with a simpler, less cumbersome process. The idea, after all, is to make sure investors are receiving the disclosure they need, and sufficient time to make a proper investment decision, and to provide some way to notify the SEC that an offering is being conducted. The current rules are too burdensome for many public issuers, and not substantial enough to ferret out the bad behavior of others. Many issuers of publicly traded securities simply escape SEC regulation altogether.

Using modern technology, there is no reason why the SEC cannot track every issuer of securities from cradle to grave. More substantial regulatory obligations should be imposed as an issuer becomes systemically important and those obligations should be relaxed as the issuer descends into bankruptcy. Investors would be better protected by a set of rules that classifies issuers and makes investors aware of the difference between one issuer's disclosure and another, rather than a system that pretends foolishly that all issuers play by the same rules. Every issuer of securities traded in our public markets should fit somewhere into a comprehensive system of securities regulation and be supervised by an ever-watchful SEC. But, such a system, while technologically feasible, would mean consigning our current registration rules to the dust bin.

Reconstructing the federal securities laws cannot be accomplished by piecemeal rule-making outside the agency's statutory bounds, however well-intended. This is a project that requires Congressional action.

There is a difference between being governed by a rule of law enacted by our elected representatives and extra-statutory agency rule-making, which smacks of the autocratic and arbitrary approach of making it up as we go along. If this job is to be done correctly, Congress needs to do it, not the unelected SEC.

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