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COMMITTEE ON SECURITIES REGULATION

June 29, 1981

Chairman John S. R. Shad
Securities and Exchange Commission
500 N. Capitol Street
Washington, D. C. 20549

Dear Chairman Shad:

On the occasion of your assumption of the office of Chairman, this Committee wishes to call to your attention some matters arising under the securities laws administered by the Commission that we think merit your consideration. We have chosen areas in which our collective experience suggests that existing practices should be reconsidered or fresh thinking would be helpful. We have attempted to avoid pressing specific proposals on you in our discussion of these items. In any event, the points we make below are intended to encourage consideration and review by the Commission and the Staff and possibly other interested parties. Any suggestions for changes we make should be considered in that context.

Our comments cover certain aspects of the proxy rules, procedures and principles of the Enforcement Division, the role of the underwriter under current conditions and regulation of options.

I. Proxy Rules

In general. The rules are unnecessarily complicated, calling for much more detail than is useful. In processing filings under the registration requirements of the Securities Act of

1933, the Staff now takes the position, quite correctly, that filed documents are the responsibility of issuers who are liable thereon. Therefore limited review or no review may often be more appropriate than detailed analysis by the Staff. This is the basic theory of the federal securities laws. Liabilities are created for non-compliance with the substantive goals of these laws, not for non-compliance with administrative interpretations issued thereunder. Determinations of materiality for disclosure purposes are made by the issuer, at the risk of the issuer.

We suggest that the same philosophy be applied to the proxy solicitation requirements, which we think could simplify them and make them more useful. Detailed regulations should either be dispensed with entirely or simplified, and reliance should be placed on the general requirement for full disclosure of all material facts, with materiality depending on the circumstances of each case -- not spelled out in detailed, rigid regulations.

To cite but a few examples: Item 6(b) of Schedule 14A establishes unreal and arbitrary standards of materiality by its requirement of disclosure of relationships between director-nominees and the issuer; Item 7, relating to management remuneration, incorporates 15 printed pages of instructions. In these typical examples, the Commission has, in effect, decided what relationships are material. To correct the situation that leads to such examples, the Commission could rely on Rule 14a-9 proscribing false or misleading statements, rather than on detailed disclosure standards. It is therefore suggested that the proxy rules be reexamined in depth, with a view to eliminating or substantially reducing detailed disclosure requirements and emphasizing the issuer's liability for material misstatements and omissions. The emphasis should be on achieving compliance through enforcement by the private sector.

<u>Stockholder proposals</u>. The number of stockholder proposals has been increasing sharply (although the number of proponents has not). Many of the proposals, typically those

against doing business in South Africa, or with communist countries, or dealing with nuclear power, marketing of infant formula, etc, indicate that their proponents seek policy changes relating to public affairs or social conditions or personal advertising rather than improvement in corporate governance. No matter how carefully phrased to appear to relate to the subject company's business, the nature of the proposal generally makes it quite clear that the motivation of the proponent does not arise from his interest as an investor in the corporation, but is to obtain a forum for widespread dissemination of what may be broadly stated to be political views. We believe that an examination of a sampling of stockholder proposals will substantiate these criticisms.

These abuses can be corrected without substantial amendment of the proxy rules. A more rigorous interpretation of the rules would reduce sharply the abuses in the area of stockholder proposals. We suggest that the Commission review the standards applied by the Staff in dealing with stockholder proposals.

<u>Acquisition proxy statements</u>. This may represent the area of the proxy rules most clearly calling for reform. As you know, the Commission has made progress in simplifying the disclosure system under the Securities Act of 1933 and reducing the costs and burdens of registration through incorporation by reference of documents filed under the Securities Exchange Act of 1934. Expansion of the use of Form S-16 and the introduction of proposed Form A (Release No. 33-6235, September 2, 1980) are making the disclosure process a more meaningful one without diminishing the protection afforded by the securities laws to the investing public.

Unfortunately, while significant progress is being made in reducing the size of prospectuses, the length of acquisition proxy statements appears to have grown in inverse proportion. It is not at all unusual to find them exceeding 150 pages, with summary sections longer than most S-16 prospectuses. With the exception of the Commission's adoption of Form S-15 (Release No. 33-6232) for use with respect to certain small acquisitions for securities,* the Commission has devoted little attention to an extensive revision of proxy statement disclosure through increased utilization of incorporation by reference to 1934 Act filings.

This creates the anomalous situation in which an issuer qualifying for Form S-16 (typically a registration statement of three or four pages) unjustifiably must provide the wealth of data called for by a company going public when it proposes to issue its securities to stockholders of another corporation as consideration for acquiring that corporation. The Commission should direct the Staff to submit to it proposals to extend the use of incorporation by reference to proxy statements issued in connection with acquisitions by corporations that would qualify for Form S-16 or new proposed Form A. The proposals could include revision of the proxy rules with respect to such seasoned companies to require only the inclusion of a brief description of the acquiring and acquired companies, a more detailed description of the terms of the proposed transaction and pro forma financials illustrating the financial effect of the transaction, and permit incorporation by reference of the 1934 Act filings of the parties to the transaction. In cases where the acquired company is not a reporting company under the 1934 Act, the proxy statement could include a more detailed description of its business, together with financial information of the type included in an annual report to stockholders.

In cases where the issuer (or acquiring company) is not a reporting company under the 1934 Act, it could provide the same information required of it had it been issuing

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* Form S-15 is not available for cash mergers or for mergers involving the issuance of securities where the acquisition would increase the issuer's sales, net income, assets, or shareholder's equity by more than 10%.

securities for cash pursuant to an applicable 1933 Act registration statement. Where the transaction is a cash merger, information with respect to the acquiring company could be limited to a brief one-paragraph description of the company's operations, together with sufficient business and financial information about the acquired company (incorporating by reference 1934 Act filings where available) to permit its stockholders to decide whether to vote in favor of the merger.

II. Enforcement Division procedures and principles

During the last ten years, the Division of Enforcement has become increasingly active and increasingly controversial. We believe that the Commission should focus on several issues, most of which are matters of Commission level policy, not Division practice.

Litigation as a rule-making tool. The Commission often has a choice whether aspects of securities laws should be developed through rule-making or through litigation. An example of this is the law relating to trading on inside information where, notwithstanding a 1968 suggestion in the Texas Gulf Sulphur decision that the Commission promulgate rules with regard to the use of non-public information, the Commission has built the law in this area through litigation. We acknowledge that, in many instances, case by case development permits the law to be tailored more precisely to specific situations than does rule-making. However, being named as a defendant or respondent in a Commission suit or administrative proceeding can injure the reputation of the defendant or respondent, particularly if scienter must be alleged to state a cause of action. In addition, initiation of enforcement action by the Commission frequently leads to very costly private litigation. Frequently, enforcement action by the Commission does not contribute to development or refinement or interpretation of the securities laws, because litigation instituted by the Commission results in consent decrees. These considerations suggest that the Commission normally attempt to develop the law through rule-making rather than litigation.

Materiality. Traditionally, the federal securities laws have been viewed as requiring disclosure only of facts that are financially material. In a number of enforcement actions during the last several years, the Commission has attempted to require disclosure of matters that are not material to the financial condition or results of operations of issuers. This occurred, for example, in some of the improper payments cases, which involved matters that appeared to be of little interest to investors. In some instances matters that have no financial impact on issuers may be of importance to investors, but we urge that the Commission use great restraint in authorizing enforcement proceedings concerning disclosures of financially immaterial matters.

Wells Submissions. On June 1, 1972, the Advisory Committee on Enforcement Policies and Practices (the so-called Wells Committee) recommended that before the Commission decides to authorize the institution of litigation, the potential defendants be given an opportunity to submit information that may bear on whether the Commission should do so. The Staff has frequently indicated a resistance to Wells Submissions, and there have been some misuses of the Wells Submission procedures. Wells Submissions could be important safeguards, both in protecting potential defendants from the stigma and the expense of being sued by the Commission, and in saving the Commission the cost of prosecuting suits where there are no violations of the federal securities laws or where the violations are of minimal importance. We suggest that in any instances where a potential defendant has participated, by testifying or otherwise, in an investigation, the Commission not authorize litigation until it has received either a Wells Submission, a letter from the potential defendant or its counsel saying that the potential defendant does not want to make a Wells Submission, or evidence that the potential defendant has been given an opportunity to make a Wells Submission, but has not done so. We also suggest that Wells Submissions be made directly to the Commission, with copies to the Staff, rather than being made to the Staff for transmission to the Commission.

Termination of investigations. The Division of Enforcement rarely brings an investigation to an official end. Therefore, the target of an investigation frequently does not know whether the investigation is continuing or has been completed. Also, Division investigations sometimes move in sporadic flurries over periods of several years. Both these practices place firms and individuals in the position of being, or thinking they may be, under investigation for far longer than is justified. We suggest that consideration be given to requiring that orders of investigation limit the time during which the investigations may be conducted, and that if the Staff seeks to extend the period during which it can conduct an investigation, it be required to obtain an order of the Commission authorizing the extension. We also urge that when the Staff has decided not to take action against the target of an investigation, it notify the target of that fact, even if it reserves the right to seek a new order of investigation at a later date if a reason to do so arises.

The circumstances referred to in the two preceding paragraphs lead us to the recommendation that the Commission reconsider the actions it took (and those it declined to take) in response to the Wells Committee's June 1, 1972 report. It will be recalled that the Commission declined to adopt the Wells Committee recommendations that would have required the Staff to take steps to permit a person involved in investigations to submit statements of his contentions in the matter and would have had the Commission notify persons who are the subject of an investigation of its conclusion if no further action against them is contemplated. See Securities Act Release No. 5310, September 27, 1972. Rather, the Commission adopted informal procedures that left these matters to the discretion of the Staff. See 17 F.R.D. § 202.5(c) and (d). As indicated, these informal procedures have not worked well, and we suggest the Commission consider the Wells Committee recommendations in these two respects anew.

Orders of investigation. In many instances, an order of investigation is either so broad that the people being investigated cannot determine their alleged misconduct or so narrow that the investigation must inevitably go beyond the subject matter of the order of investigation. Orders of investigation should be drafted so that they will inform the targets about what is being investigated. If an investigation begins to expand beyond the subject matter of the order, the order should be amended to cover the expanded subject matter and the targets should be notified of this fact.

III. Role of the Underwriter

We urge the Commission to reconsider the role of the underwriter in the capital raising and disclosure process in light of the integration of disclosure requirements under the 1933 and 1934 Acts, the development of short-form registration and proposed Rule 462A, which would generally permit shelf registration for delayed and continuous offerings. At the time the 1933 Act was enacted, the investment banker was in many cases the primary source of public capital for an issuer and played a central role in the planning and preparation for a public offering, including the preparation of the prospectus. Although investment bankers continue to play such a role in the introduction of new issuers to the public securities markets, their role in relation to offerings by seasoned issuers varies widely. For example, in offerings registered on Form S-16, the managing underwriter in most cases has not participated in preparation of the

1934 Act reports that are incorporated by reference in the prospectus. With the S-16 Form increasingly utilized to provide rapid market access, there is in most cases insufficient time to undertake a due diligence investigation of the issuer and its affairs of the type undertaken in connection with traditional long-form registration. If the Commission adopts proposed Rue 462A, the role of the managing underwriter in the preparation of registration statements will be further diminished because issuers registering for the shelf may well not choose lead underwriters until shortly before an offering. Once the lead underwriters are selected and terms are agreed upon, it will be necessary to proceed quickly to take advantage of favorable market conditions.

In sum, affording issuers various vehicles for achieving rapid access to capital markets involves a trade-off -- a greatly lessened role for the underwriters in the disclosure process in return for a more efficient and accessible capital market for qualified seasoned issuers. In this regard, the Committee believes that in the case of such issuers that have substantial amounts of securities outstanding, the diminished underwriter role is not likely to have a significant impact on the issuer's disclosure.

We believe that the Commission should consider promulgating an express definition of the scope of the reasonable investigation for which underwriters are liable, to insure that underwriters will not be held to an unrealistic liability standard, possibly as a result of their more participatory, historic role. A rule that takes account of the concomitant limitations on the role of the underwriter to permit seasoned issuers ready access to capital markets would not significantly diminish the protection afforded investors under the securities laws, particularly because of the generally improving quality of the 1934 Act reports of qualified seasoned issuers.

Various parties who have reexamined the role of the underwriter in recent years have recognized its diminished significance in the preparation of disclosure documents in certain offerings. The Advisory Committee on Corporate Disclosures proposed that the Commission specify the factors that should be considered by a court in determining whether an underwriter has discharged its obligation to conduct a reasonable investigation of the affairs of the issuer. In the proposed federal securities code, there is an express provision that, in determining what constitutes a reasonable investigation of the issuer, courts shall consider, among other things, ". . . when the defendant is an underwriter, the type of underwriter arrangement . . . and the accessibility to information with respect to the registrant" and "whether with respect to a fact or document incorporated by reference, the particular defendant had responsibility for the fact or document at the time of filing from which it was incorporated." The Williams Bill, which would have subjected municipal securities generally to registration, expressly provided that underwriters in municipal competitive bid offerings would be liable only for having reviewed the offering documents and disclosure of any misstatements known to them.

It may not, in our opinion, be sufficient to recognize (as the Commission has done) that a court could take into account in determining underwriter liability pursuant to Section 11 of the 1933 Act the fact that certain information in the prospectus has been incorporated by reference from 1934 Act filings. It may take many years for appellate courts to develop more specific standards, and it can be unfair to underwriters to be compelled to proceed at their peril until specific standards are developed, particularly when the Commission can promulgate such standards now.

IV. Options

A number of years have passed since the initial approval of the pilot program for options trading and the completion of the Commission's Special Study of the Options Markets in 1978. Restrictions have been imposed on the options markets, and they should be reviewed from time to time. One such restriction is the position limitations on the number of contracts that any individual customer or firm may own.

Although position limits on exchange traded options have been increased from 1,000 to 2,000 contracts, further revision of the position limitations appears warranted. If position limits are to be retained, we believe that several approaches are available to provide for greater flexibility in the use of options, particularly by market professionals. For example, hedged positions could be treated differently from unhedged positions as suggested by the Special Study of the Options Markets. Special limitations also could be adopted for options market makers whose trading is subject to extensive regulation and supervision. Position limits for managed accounts should be based upon beneficial ownership by the managed accounts to increase the flexibility of options use by institutional investors. Finally, because of the plurality of activity occurring within the same broker-dealer firm, position limits applicable to broker-dealers should distinguish among positions taken in arbitrage activities, to hedge block transactions and in other options transactions.

Members of the Committee are available for any assistance we can offer in connection with the foregoing.

Sincerely,

Edmund H. Kerr

cc: Commissioner Philip A. Loomis, Jr.
Commissioner John R. Evans
Commissioner Barabara S. Thomas