Change, the SEC and …me: Reflections from the Loyal Opposition

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In my last year of law school, I visited a friend who had just become an associate in a prestigious Wall Street firm. In a cramped two-person office piled high with bound volumes from prior deals, I found him with a very sharp pencil marking up a printed document of more than 100 pages. I asked what he was doing. He told me that he was a securities lawyer and was preparing a trust indenture for a ship financing by marking up documents from a similar deal, changing only names, dates and similar deal-specific variables. I quickly concluded that I would not even read such documents, let alone write them, as my livelihood. I would sooner be a door-to-door salesman. When I graduated from law school, my only preference about specialty, affirmative or negative, was that I did *not* want to be a securities lawyer.

By happenstance, my first assignment on joining my current firm in 1958 was a novel IPO. A drug store chain and a chain of ladies ready-to-wear stores were forming a jointly owned company that acquired large farmers' markets. These two founders were to occupy anchor departments in what would be the prototype of the modern shopping mall, with many small specialty retailers to operate separate departments in the same building. The company initially intended to sell its stock over the counter — literally. Rather than use an underwriter, it expected to raise capital by selling shares over its store counters to its customers, and to anyone else interested.

That was out firm's first IPO during the new issue boom of the late 1950s. The project was very challenging, exciting, glamorous and anything but dull. The partner in charge asked me to prepare a first draft of the registration statement. He gave me a copy of the Form S-1 and a sample registration statement. Deciding to begin at the beginning, I spent the first day designing a beautiful S-1 cover page. It had many blanks — the company had not yet picked a name, state of incorporation, office address, capital structure or the officer to be agent for service. (I did know that my mentor partner would receive copies of communications fro the staff.) This was not overly challenging, because the sample filing showed how and where the required information was to be presented.

Where to go next? The prospectus cover page and contents were more challenging. My sample was of no help. It dealt with a plain-vanilla underwritten debenture offering of a well-established publicly owned cement company, with no similarity to the plan of distribution or business that I was required to describe.

This offering, along with many related projects, such as organizing the company, working on the real estate aspects, preparing agreements between the two founders and with the smaller retailers, etc., occupied most of my time for my first six months of practice. The company ultimately went public with a conventional underwritten public offering. It went bankrupt just a few years later. This experience should have taught me an important lesson about the hazards of being too far ahead of one's time.

About the time my first IPO was completed, we had a second IPO client. Because I had not much else to do and was then the only associated in the office with securities laws experience, I jumped into the second offering. For the next several years, I had every intention of diversifying into other work, as soon as the then-current IPO finished. However, there were so many offerings in our office that all experienced hands were needed to work on them, and I was usually working on at least two transactions at any time. Those were the days when lawyers waited several days after copy was sent to a printer in order to get a new proof. It could take 100 days to receive a comment letter. There was plenty of down time during the course of each transaction, allowing associates to work on multiple offerings simultaneously.

Suffice it to say, I grew to love the excitement of securities work. I especially enjoyed having successful entrepreneurs pay my firm so that they could teach me how their businesses worked. I, in turn, used my developing expertise to make the best-written presentation possible, within the many constraints and conventions of prospectus-disclosure practice. Despite my initial intentions, I accepted the reality that fortuities of life had led me to a practice focused on securities law.

A lucky series of chance occurrences resulted in my becoming a full-time consultant to the SEC during most of 1964. The then chairman, William Cary, concluded that the disclosure systems and the rules relating to corporate finance, as administered by the Division of Corporation Finance, were in need of reform. This view was not shared by the division, which was fairly complacent and generally satisfied with the status quo, as reflected in the evolved rules, forms and interpretations.

Although I was not looking for a new job, I was offered the position as special adviser to the Division of Corporation Finance, a division that felt no pressing need for outside advice. The offer was too good to refuse. I took a leave of absence from my firm — my only professional affiliation in 40 years of private practice following two years of judicial clerkships.

I had no assigned duties at the SEC relating to day-to-day operations. My mandate was to analyze the current state of affairs and recommend changes that I thought appropriate, first to the division and thereafter to the commission. I was cast in the role of the constructive critic. I did not consider myself a revolutionary (although some of the staff thought that my ideas were far out), but rather as the loyal opposition working within the system to bring about change.

Many of the ideas and recommendations that I developed were built on prior analyses — for example, Milton Cohen's landmark article which observed that the then-existing disclosure system would have been organized quite differently but for the historical happenstance that the Securities Exchange Act if 1934 was adopted separately, following adoption of the Securities Act of 1933, and not as part of an integrated disclosure/regulatory scheme.

Since leaving the commission, my love of the law and some inner drive to seek improvements have extended my role as a friendly and, I hope, constructive critic. Throughout my career, I have continued to work for changes in the securities laws, advocating specific changes that would lead to improvements. My advocacy had been through articles, speeches at bar meetings and continuing legal education programs and direct discussions with the staff. With only one exception, the major positions I have advocated have not been on behalf of any particular client. Indeed, I am sure I have endorsed some changes in areas where many clients preferred the *current* state of affairs.

With one exception, I have achieved at least partial if not complete success with respect to every major position I have taken, although sometimes there has been a delay of many years. The one project on which I have — to date — suffered a complete defeat was my effort to include an arbitration provision in a corporate-governance document. That was my only battle with the SEC undertaken on behalf of a specific client. Is there a message here?

I have authored or co-authored two books and about 70 articles, and have averaged at least a few speaking dates annually at bar meetings or on the CLE circuit dealing with corporate and securities law. My writing and speaking have been of two general types — advocacy and explanatory.

I rarely if ever wrote an article simply for the purpose of publishing something or because someone asked me to do so. On more than one occasion, I was so stimulated at an out-of-town meeting that I began organizing my thoughts, which grew eventually into an article or a letter to the SEC, on the plane ride home. In almost every case, my articles were written before arrangements were made for publication.

The advocacy material was designed primarily to bring about a change — from my perspective, a needed improvement or reform — in some aspect of statutes, rules, forms or practice. The advocacy pieces typically arose when I believed a change was needed and felt some compulsion to press the case with the relevant public.

The explanatory material was designed primarily to explain some area of law or practice to others, although many of the primarily explanatory presentations had more than a tinge of advocacy as well. Even when describing an existing state of affairs, I often stated what I considered the best practice, how ambiguities in the law should be resolved, the direction that future developments should take and aspects of the status quo that I considered undesirable.

Many of my explanatory articles have grown from materials prepared for teaching — either at the University of Pennsylvania Law School or for CLE programs. Among other matters, these writings cover the public-offering process, the consequences of public ownership, the definition of the term "security," MD&A disclosure, private placements, Regulation D, professional responsibility, registration rights agreements, various SEC rules and recent legislation. Other explanatory articles grew from materials prepared for clients, for use by lawyers within my firm or to explain the outcome of my advocacy efforts.

In several articles, I raised issues about the high degree of uncertainty in many areas of securities practice and the unwholesome result. The situation encourages clients to go opinion shopping and to rely on the lawyer who will take the most aggressive possible position in support of the client's objectives when the consensus among most reputable practitioners would not support the client's desired result. On the other hand, I decried one bizarre SEC interpretation of its own rules and noted at least two classes of lawyers who did not follow the interpretation — the unsophisticated who had never heard of it and the high sophisticated who simply did not believe in it.

I have participated frequently in comments on SEC proposals, typically as part of an ABA or other bar group, and occasionally as an individual (or by submitting an individual comment to supplement a group comment in which I participated — for example, if I wanted to take a position on a subject that did not have a group consensus). ABA member comments are considered highly authoritative and persuasive by the SEC — although their positions are not always accepted — because of the care, scholarship, practical experience and general objectivity the member comments reflect. I have also addressed a number of other subjects on which I disagree with the SEC position.

For example, it is generally recognized that a purchaser of privately placed securities who is unable to sell them publicly may be able to sell them privately. The statutory basis for such sale is unclear but it is generally understood to be an amalgam of Section 4(2), which covers sales *by an issuer* not involving any public offering, and Section 4(1), which covers transactions where the seller is not an issuer, underwriter or dealer. The principle of the exemption is referred to colloquially as "Section 4(1-2)."

In response, I published an article that articulated principles to determine when a private resale of privately-placed securities can be made without registration. The article urged the commission to publish an interpretation that would clarify the law in this area.

The final result was that the commission has never published an over-all analysis clarifying this area. However, staff members use my article for guidance and refer others to it. I receive occasional requests for copies from persons in the private section who are referred to the article by the staff.

I have brought my observations to the commission's or staff's attention, often with a specific suggestion on the course of action that I would consider appropriate. I have done so by a private communication. Occasionally, I have done so publicly either on the lecture circuit, at bar and similar meetings or through articles. For example, I addressed an issue that all lawyers face occasionally — the objectionable comment letter on a filing, such as the comment that is totally inconsistent with past practice in comparable situations.

Usually my responses were private, directed to an appropriate senior staff member. In one case, I was annoyed by a comment that was completely at variance with past staff practice on a recurring issue (disclosure about an underwriter's overallotment of "Green Shoe" option) that I published my objections and specific suggestions. My response to what I considered an overly timid small business capital-raising initiative was also detailed in print. I publicly criticized the commission's administrative ruling against an executive who gave nonpublic information to analysts. I felt that the SEC had distorted an important Supreme Court decision.

Along with other members of the bar, I have challenged various SEC positions (sometimes referred to collectively as its "metaphysics") applying integration principles to deny '33 Act exemptions for transactions prior to a registration statement or, alternatively, to deny registration for transactions that allegedly began before a registration statement became effective.

For example, when a client preparing for an IPO combined a few related and commonly owned family companies into a structure of a parent holding company and subsidiaries, the staff suggested that the pre-IPO issuance of shares of the new parent in the reorganization was to be integrated with the public offering, and therefore was not exempt under §4(2). The bar protested that the staff had pushed the integration and §5 analysis much too far in this instance and in a variety of other circumstances. The SEC has given clarifying interpretative guidance (not always to the bars' liking) on some recurring situations.

The general area continued to be plagued with uncertainty. The SEC resisted the proposal that it publish a more comprehensive no action or interpretative position, although the recently published "Aircraft Carrier" release may give some further guidance.

Here are some common-sense principles to follow if you are trying to advocate a position with the SEC:

-- Do your homework. Maintain credibility by presenting a solid and well-grounded position that is supported with relevant authorities.

-- It is helpful to have your position published, where other can focus on it and participate in the debate. Some of my ideas have affected the law precisely because they have appealed to other who have participated in the call for change. Similarly, I have often joined a call for reform initiated by someone else.

-- Understand the commission's viewpoint, even if you disagree. For example, recognize its understandable and legitimate, concern for precedents being created. It may not be sufficient to persuade the SEC that there is nothing objectionable in what you want to accomplish on your particular facts. Help them to understand how your case is distinguishable and will not create an unwelcome precedent that will have undesirable applicability beyond your specific facts.

-- Be persistent but use judgment and do not overstay your welcome.

-- Take the long view and be patient. A reformer ahead of his or her time may have to await long-term sea changes in an agency's assumptions and institutional culture before ideas once thought radical can be accepted as commonplace.

-- Do not complain frivolously or make an issue about matters that are not important.

-- If you object to the status quo, present a specific proposal (or proposals) for the change you advocate.

I have speculated about the reasons that have driven me to devote so much of my professional energies to changing, and hopefully improving, the area of law in which my practice focuses. The reward, if any, was definitely psychic rather than monetary. I have yet to be paid a fee to write an article or give a speech although, to be sure, good friendships and occasional pleasant expense-paid travel have been significant rewards. In the last analysis, I suppose I am one of those compulsives who cannot see something in the world important to him that is broken, without feeling the need to repair it.

Occasionally, I have lightened the tone of my writings with some verse. I once commented favorably on an SEC proposal to permit soft information in filings in one of the few poems in the English language published with footnotes by the author, not some later scholar. Open stanzas included:

Disclosure thought's in revolution
You've come up with a new solution
Let's look back in history:
The main theme, liability!

Prospectuses were much like shadows,
Distorted, dull and flat
We said of things we knew would happen:
"There's no assurance that…"

The picture was so negative
The registrant seemed dead.
The filings full of boilerplate.
Unreadable, unread.

Over the course of my 40-year practice, I have undertaken various projects, principally through writing, speaking and other advocacy efforts, to bring about changes — from my perspective, needed improvements or reforms — in the federal securities laws.

I detail in the charts on the following pages my involvement with five specific topics:

-- Administrative reform of the securities laws.

-- Inclusion of soft information in filings

-- Protection against civil liability from innocent and immaterial errors in exempt offerings — "The I&I Defense."

-- The duty to update.

-- Arbitration provisions in corporate governance documents.

ADMINISTRATIVE REFORM OF THE SECURITIES LAWS

The problem

By the early 1960s, the private sector saw urgent need for securities laws reform.

-- All offerings requiring registration, from the IPO to the small non-underwritten secondary of a seasoned public company, used the same Form S-1. There were no "leakage" rules for private placements. If a person was an "underwriter" — a term of uncertain meaning — no privately placed securities could be resold publicly without registration. When a private placee ceased to be an underwriter (such as, after a "change of circumstance" — another ill-defined concept, having no bearing on the public's need for disclosure), all of his securities could be sold without registration. The availability of the exemptions under §4(2) for private placements and §3(a)(11) for interstate offerings was uncertain. The '33 Act consequences of acquisitions turned significantly on the transaction's form and not more relevant policy considerations. The private sector was especially concerned about liability under Rule 10b-5.

In 1964, Professor Loss proposed legislative reform through a Federal Securities Code, to be drafted under American Law Institute auspices, to replace the six SEC-administered statutes. I was then a full-time SEC consultant, hired by the chairman as special adviser to the Div. of Corp. Fin. (The division was not dissatisfied with the status quo or interpretations it had evolved, and felt no need for outside advice.) The chairman requested my recommendation on the codification project.

My response

I concluded that most of the problems (possibly excluding civil liability concerns) could be solved, and many could be solved better, by administrative action rather than legislation. The SEC's power to adopt rules, promulgate forms, define terms, establish classifications and create exemptions of its own design for small offerings under '33 Act §3(b) gave it ample power to reshape the disclosure system. Indeed, key issues, such as the precise steps and disclosures need to accomplish registration and the contents of the

’34 Act reports, were for the SEC and not Congress to determine. I saw some disadvantages to codification.

At the SEC chairman’s request, I presented these views at a 1966 kickoff meeting organized to gain support for the codification program. See 22 *Bus. Law* 793 (1967). Others questioned whether the SEC had adequate power or the institutional will and/or capacity to accomplish significant changes. At a meeting by invitation of the leading securities practitioners and scholars — I was probably the youngest attendee by 10 years — my views on the potential for administrative reform were not particularly welcome.

I addressed the 1967 ABA Annual Meeting on a panel with Professor Loss, discussing the relative merits of administrative versus legislative reform. See *An Administrative Program for Reforming the Federal Securities Laws*, 23 *Bus. Law.* 737 (1968).

I published articles on the potential for administrative reform, such as, *Reform of the Federal Securities Laws*, 115 U. Pa. L. Rev. 1023 (1967); *Acquisitions Under the Federal Securities Act — A Program for Reform*, 116 U. Pa. L. Rev. 1323 (1968).

The bar reached a consensus that both administrative and codification reform projects should occur simultaneously.

Initial SEC response

In the early 1960s, the SEC staff saw no particular need for reform. The staff did not feel that the structure and interpretations that it had evolved were seriously flawed. Civil liability issues were primarily matters of court interpretation, not involving the SEC or SEC concerns.

Eventually, the SEC embraced the concept of administrative reform. It appointed an internal high-powered task force in late 1967, chaired by Commissioner Wheat. Its conclusions, the comprehensive “Wheat Report” of 1969, recommended numerous administrative reforms.

I consulted informally with the task force staff. They revisited some of the reform proposals that I had made in 1964 as a lone consultant.

Final result

Based on the Wheat Report and concepts evolving from the parallel codification project, the SEC undertook a massive reform initiative. New rules and forms included: Creation of the integrated disclosure system. Form 10-K grew from an insignificant document to an annual update of company disclosures. For established companies, disclosure focus shifted from ’33 Act to ’34 Act filings, with the former incorporating by reference the latter for liability purposes. Reg. S-K rationalized and established uniform disclosure requirements for various purposes. Rules 144 and 145 addressed resale issues and the definition of “underwriter.” Abbreviated Forms S-2, S-3 and S-4 were adopted and Form

S-8 was expanded. Reg. D adopted a new approach to the §4(2) exemption for private placements and provided other exemptions for small issuers. Rule 145 rationalized the consequences of acquisitions, based on the transaction's substance and not form. Rule 147 gave an intrastate offering safe harbor. Shelf registration was rationalized and liberalized. (Rule 415).

Coincidentally, the judicial trend of expanding civil liability slowed (or maybe reversed), with significant victories for the defense. Public pressure for legislative relief on liability exposure similarly abated.

I made a wildly optimistic prediction in 1968; that codification could take five years, while administrative reform could be accomplished in six months. The intense administrative reform efforts spanned about 15 years, to the early 1980s, with continuing refinements thereafter. The ALI's Code was not completed until 1978. It was never seriously considered by Congress, although various pieces were reflected in legislation. More significantly, the code's analysis and scholarship were very helpful in the administrative reform effort.

INCLUSION OF SOFT INFORMATION IN SEC FILINGS

The problem

Through the 1960s, the SEC confined filed information to hard "facts" that could be verified objectively. Forward-looking, predictive, subjective or evaluative ("soft") information was excluded from filings. The SEC was far more concerned with buyers than sellers. The SEC's traditional concern was that the issuers would hype their stock and buyers would not be able to enforce liabilities. (The staff did show some tolerance for soft information in prospectuses if the news was bad, but not for good news.) The SEC's historic position was based primarily on '33 Act concerns; '34 Act filings had no meaningful information in that era.

Comment letters routinely requested deletion of statements that were called "implied predictions," without further comment, since everyone knew the ground rules: no predictions! The staff exhibited a degree of zeal bordering on paranoia in finding predictive meaning in relatively bland statements.

Soft information was widely used in the securities markets, through nonfiled written material and orally. In connection with new issues, brokers regularly gave predictions of future earnings, although no forward-looking information ever appeared in prospectuses.

Many of the cases finding civil liability involved allegedly defrauded sellers in going private and tender offer transactions, who complained that *favorable* soft information had been withheld.

My response

I felt that the exclusion of all soft information from filings was poor policy. A prospectus was comparable to a shadow — it gave certain information about the general outline of the subject, but was lifeless, distorted and flat. Investors were being deprived of useful information that they could and would evaluate appropriately. Also, investors were receiving much soft information informally that was not being prepared and disseminated under appropriate standards.

One who likes the historic information in a prospectus cannot buy the stock as of an earlier date covered by the prospectus information. Despite repeated warnings that past performance does not assure future results, disclosure of historic information is required primarily to help predict the future, on the theory that "the past is prologue." I felt that management's future expectations, fairly stated and realistically evaluated, were a valuable basis for predicting the future that companies should be able to disclose.

My call for change was first stated in *Nits, Grits and Soft Information in SEC Filings*, 121 U. Pa. L. Rev. 254 (1972), which coined the term "soft information" in this context. I presented the same views in several meetings, seminars and additional articles. Other writers espoused similar ideas, including the late Professor Homer Kripke and Bruce Alan Mann.

My articles included *A Discussion of "Soft Information" and SEC Filings*, 28 Bus. Law 506 (1973) (Address to ABA Annual Meeting); *New Approaches to Disclosure in Registered Securities Offerings*, 28 Bus. Law 505 (1973); *Financial Projections*, 7 Rev. Sec. Reg. 907 (1974); *Disclosure of "Soft Information*," Tenth Annual Institute on Securities Regulation 169 (Fleischer, Lipton & Stevenson, eds. 1979); *Soft Information Disclosure: A Semi-Revolution*, Fifteenth Annual Institute on Securities Regulation 19 (Friedman, Nathan, Pitt & Santoni, eds. 1984); *Soft Information and Appraisal Disclosure*, 18 Rev. Sec. & Com. Reg. 215 (1985) (with Jason M. Shargel); *Soft Information and Timeliness of Disclosure*, Eighteenth Annual Institute on Securities Regulation 253 (Friedman, Nathan & Pitt, eds. 1987); *MD&A Disclosure*, 22 Rev. Sec. & Com. Reg. 149 (1989); and *Soft Disclosure: Thrusts and Parries When Bad News Follows Optimistic Statements*, 26 Rev. Sec. & Com. Reg. 5 (1993).

Initial SEC response

The SEC's attitude through the late 1960s was that soft information had its place, but its place was not in SEC filings. Filings were to have a higher order of credibility (if not usefulness) because they were confined to pristine "facts" that were subject to objective verification, and liability if not complete and correct. The SEC's initial response to my position was hostile.

Final result

Gradually the SEC's view shifted. Among other reasons, it recognized that trading markets needed fair and balanced information, not overly pessimistic information, to protect sellers as well as buyers. In 1973, it adopted a policy to permit projections and other soft information in filings. Rel. 33-5362 (Feb. 2, 1973). In 1976, it adopted safe-harbor rules ('33 Act Rule 1975 and '34 Act Rule 3b-6) to encourage the filing of forward-looking information. The safe-harbor rules apply by their terms only to disclosures made or repeated in SEC filings.

The safe-harbor approach, for filed as well as nonfiled forward-looking disclosures, was adopted by Congress in the 1995 amendments that added '33 Act §27A and '34 Act §21E.

The SEC's historic attitude toward forward-looking and other soft disclosure in filings has now gone through a complete (or maybe it could be called a 180 degree) reversal. It currently requires filings to contain a great deal of soft and forward-looking information, especially in the management discussion and analysis disclosures required by Reg. S-K, Item 303.

Relatively little forward-looking information has been included in filings voluntarily in addition to the disclosure otherwise required (such as, by the MD&A item, the half-truth prohibition, etc.), despite the safe-harbor rules designed to encourage such inclusion.

MINOR ERRORS IN EXEMPT OFFERINGS C THE "I&I DEFENSE"

The problem

Under a strict reading of the '33 Act, if there is a minor defect in an offering intended to comply with an exemption from registration, the issuer faces the horrendous consequence of recission, which may give a purchaser, who has no real basis of complaint, the windfall benefit of the right to a return of all of his or her investment. In theory, an intended intrastate offering would violate Section 5 if a single purchaser resided in the wrong state, and an intended Reg. D offering under Rule 506 would violate Section 5 if there were 36 nonaccredited purchasers, notwithstanding the issuer's reasonable belief that all of the purchasers were appropriate to qualify for the exemption.

Even if no recission claim had been asserted, an issuer aware of an imperfect transaction faced serious practical difficulties such as the need to disclose potential recission liability and difficulty in obtaining legal opinions (such as, relating to the validity of transactions and the existence of contingent liabilities).

My response

I published *Section 12(1) and the Imperfect Exempt Transaction: The Proposed I&I Defense*, 28 Bus. Law 1011 (1973) (with Charles C. Zall). We advocated a safe-harbor rule that would protect and issuer from civil liability for violation of Section 5 if the issuer made an innocent and immaterial error in establishing an exemption C which we called the "I&I Defense."

The I&I Defense did not preclude enforcement action or civil fraud claims.

Initial SEC response

The SEC vigorously opposed the concept. Its view was that an issuer relying on an exemption must comply strictly with its terms. It resisted venturing down the slippery slope of substantial or good faith compliance as being sufficient.

The private sector gave the I&I Defense overwhelming support.

Final result

The draft Federal Securities Code adopted the concept of the I&I Defense. The I&I Defense approach was discussed intermittently over the years.

In connection with a 1987 package of proposed amendments to Reg. D, Commissioner Edward Fleischman insisted that the proposing release solicit comments on the principle of a substantial compliance of I&I Defense. The private sector again gave overwhelming support for the concept.

The SEC adopted Rule 508 in 1989, which embodied the principle of the I&I Defense as part of Reg. D, 16 years after the publication of my article.

Ironically, the SEC provoked a storm of protest from NASAA with its original Rule 508 proposal. The states' Uniform Limited Offering Exemption (ULOE) effectively incorporated Reg. D into the state requirements. NASAA complained that proposed Rule 508, in addition to changing federal law, effectively would modify state law, without the SEC having consulted with NASAA.

I participated in negotiations between the SEC and NASAA that developed the mutually acceptable final version of Rule 508. See *A Substantial Compliance (I&I) Defense and Other Changes Are Added to SEC Regulation D*, 44 Bus. Law 1207 (1989).

THE DUTY TO UPDATE

The problem

A duty to disclose must have a specific trigger; there is no duty to disclose material information merely because it exists. The literature refers to a "duty to update" as such a trigger, often interpreted to mean that if a statement was accurate when made but would no longer be accurate if made currently, because the facts had changed in the interim, there is a duty to make a current disclosure updating the prior disclosure.

I felt that such a broadly stated duty was poor policy, because it posed a major deterrent to an issuer's volunteering information on the current state of affairs, especially if future factual changes are foreseeable. I felt that publishing an accurate and nonpredictive snapshot at one point in time should not commit the issuer to produce a motion picture by publishing a new frame each time the facts changed. Any duty to update should be confined to statements that were forward-looking in nature and were on their face not time-specific, but rather were reasonably interpreted as having continuing viability.

My response

I published *Duty to Update: Does a Snapshot Disclosure Require the Commencement of a Motion Picture?,* 2 InSights 3 (Feb. 1989). Analyzing all the cases I could locate, I found no clear precedent establishing a duty to update merely because a prior disclosure had become stale when the facts later changed. Every case using the updating concept and finding a disclosure duty turned on other facts — such as, the initial statement was incorrect when made (triggering a separate duty to correct), the defendant was purchasing or selling securities in violation of the well-established "disclose or abstain" doctrine or the person in question was subject to some other independent disclosure duty.

I proposed a safe harbor to encourage voluntary disclosure and place appropriate limits on the duty to update.

My worst fears were realized when *Backman v. Polaroid Corp.*, CCH 94,899 (1st Cir. 1990) (opinion later withdrawn), held that an accurate and nonpredictive nine-month 10-Q disclosure about an instant movie camera being developed triggered duty to update when problems with the camera emerged later. I then published an article: *Update on the Duty to Update: Did Polaroid Produce the Instant Movie After All?*, 23 Rev. Sec. & Com. Reg. 83 (1990).

Initial SEC response

An ABA group urged the SEC to adopt a safe-harbor rule negating a duty to update under certain circumstance in order to encourage voluntary disclosure. This effort and other advocacy activities produced no SEC interest in addressing this problem.

Fortunately, a later *en banc* opinion in *Polaroid*, 910 F.2d 10 (1st Cir. 1990), which followed publication of my critical article on the original panel decision, withdrew the earlier opinion and found for the defendant. The *en banc* opinion held that there was no duty to update except when the earlier statement had "a forward intent and connotation" — odd phraseology but, I believe, the court reached a correct decision on the facts. See *The Uncertain Duty to Update — Polaroid II Brings a Welcome Limitation*, 4 InSights 2 (Oct. 1990).

Final result

In adopting the statutory safe harbors for forward-looking information in 1995, Congress essentially left the matter of updating duties for further judicial development.

The case law is still evolving on when a duty to update should be recognized.

In an effort to focus attention on the updating problem and to clarify the issues, I have made occasional comments on further developments. See *The Duty to Update: Time Requires a Reevaluation of Basics*, 8 InSights 2 (1994).

ARBITRATION PROVISIONS IN CORPORATE GOVERNANCE DOCUMENTS

The problem

Shareholder litigation presents a major expense and distraction for publicly owned companies. The burden of many suits with little merit falls ultimately on innocent public investors.

Because potential damages and the cost of defense are so high, many companies feel forced to settle claims that they consider frivolous. Very few cases reach trial on the merits. Rather, most are settled if a pre-trial dismissal motion is refused, if not earlier.

My response

I concluded that as a matter of both state and federal law, as established by both statutes and judicial opinions, arbitration is favored over litigation as a means for dispute resolution if the parties agree. An appropriate provision in governance documents, especially one adopted pre-IPO before any public shareholders make their investments, would function as an agreement for this purpose.

For a company preparing an IPO, I included the fair, reasonable and balanced provision in its articles requiring arbitration of any dispute between the company and its shareholders. The prospectus made very prominent disclosure about the provision and its related risks and consequences. We committed to make continuing repeated disclosure in various public documents about the provision for the benefit of future investors.

To avoid surprises, before the filing I had described the arbitration provision to a senior SEC staffer. I suggested that an arbitration provision in articles raised no problems under the federal securities laws and should not be a matter of SEC concern, beyond the adequacy of disclosure. The staffer agreed. Naively, I anticipated no problems from the SEC.

Initial SEC response

After the filing, the commission itself, as well as the staff, expressed horror at the concept of a mandatory arbitration provision in our company's articles. Shortly after the initial filing, I was advised that the commission itself determined not to allow acceleration of the registration's statement's effectiveness if and when we requested acceleration — a preemptive strike, because acceleration had not yet been requested — unless we eliminated the arbitration provision.

I was unable to obtain a written statement of the commission's position or legal analysis. With permission, I recorded the telephone communication. The SEC found not fault whatsoever with the disclosure. In my view, the commission's basis for denying acceleration was replete with non-sequiturs and irrelevancies, and failed to establish any basis under the federal securities laws for the commission to frustrate our provision. See the details in *Arbitration in Corporate Governance Documents: An Idea the SEC Refuses to Accelerate*, 4 InSights 21 (May 1990).

Final result

The arbitration provision was withdrawn from the company's articles.

To my knowledge, a few public business corporations have considered including arbitration provisions in their governing documents, but I know of none that has done so. Presumably such a provision could be adopted by an amendment that the shareholders would approve. In the context of a proxy solicitation, the SEC has less leverage to frustrate the issuer's desire than it has in the context of a '33 Act filing requiring acceleration. It is also possible that a company would adopt a bylaw dealing with arbitration by action of its board, which typically has the power to amend the bylaws, without shareholder action.

All of my other major projects to change securities laws and practice have resulted in at least partial if not complete success. This project, the only one undertaken for a particular client, has resulted to date in a complete defeat. I still believe that the SEC's refusal to accelerate the registration statement was arbitrary, capricious, an abuse of its acceleration power and an unwarranted intrusion by the SEC of its notions of corporate governance in an are controlled by state law, beyond the proper statutory concerns of the SEC under the federal securities laws.

I continue to hope that corporate governance documents eventually will contain carefully balanced arbitration provisions. There has been a complete turnover of commissioners and an almost complete turnover of senior staff since my losing battle. The SEC has recently adopted a policy statement (Rel. 34-40306 (Aug. 5, 1998), favoring the use of ADR techniques including arbitration. Possibly the current commission would find no basis for frustrating a shareholder dispute-resolution mechanism, validly adopted under the issuer's controlling state law, as an alternative to conventional litigation.