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Symposium Transcript

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SYMPOSIUM TRANSCRIPT ON CURRENT ISSUES IN SECURITIES REGULATION

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Introduction

RONALD F. PHILLIPS, DEAN, PEPPERDINE SCHOOL OF LAW

Good morning. It's certainly a pleasure to welcome you to the Odell McConnell Law Center, and to this symposium on current issues in securities regulation, sponsored by the Pepperdine Law Review.

It is my assumption that you will find the program today both interesting and practical. Certainly the panelists are individuals who should be well-prepared to give you useful insight into the areas to which they have been assigned.

Because I think all of you who are present today are either lawyers or future lawyers, I thought it would perhaps be appropriate to share with you some news regarding the legal profession that would perhaps be of interest. I think it's not at all news to you that the legal profession is under attack from many quarters, and I'd like to share with you some frightening legislation that was shared with me by a fellow law school dean, Michael Kelly from the University of Maryland, recently. This is entitled "An Act to Establish the Season and Bag Limits on Attorneys." I'll share just a few of the key provisions.

Section 12A:

1. Any person with a valid Maine state hunting license may harvest attorneys for recreational, non-commercial purposes.
2. The taking of attorneys by traps or deadfalls is permitted. The use of currency as bait is prohibited.
3. Killing of attorneys with a vehicle is prohibited. If accidentally struck, remove dead attorney to roadside and proceed to nearest carwash.
4. It is unlawful to shout "whiplash," "ambulance" or "free scotch" for the purpose of trapping attorneys.
5. Stuffed or mounted attorneys must have State Department of Health inspections for rabies and other disgusting diseases.

Section 12-B. Bag Limits

The following bag limits are established:

a.	Yellow-bellied sidewinder	2
b.	Two-faced tortfeasor	1
c.	Cutthroats	2
d.	Backstabbing whiners	3
e.	Silver-tongued drug defender	$500 bounty
f.	Honest attorneys	extinct

We are engaged currently in trying to fight similar legislation which is being introduced in other states across the country.

Let me mention just a little bit about Pepperdine University School of Law to those of you who are not that familiar with us. Pepperdine is a very young law school, less than twenty-five years old, which is making excellent progress in any number of areas. Our students come from all over the nation and from foreign countries, and over the last dozen years, about half of our students have come from states outside of California. Interest in our law school continues to grow; this most recent year, we received 3700 applications for two hundred sixty places in the beginning class, so the competition is quite keen.

Much more important, though, than the quantitative figures regarding our students, though, would be their quality and character. It is in these areas that we are most grateful. Pepperdine students and graduates tend to be people who approach their work very seriously, they tend to be people who treat other people with respect and dignity, and who ultimately earn the confidence and trust of those people who depend upon them.

We are particularly pleased that member of our 1990 graduating class, Charles Eskridge, is currently clerking for U.S. Supreme Court Justice Byron White; another of our alums, Randall Kehl, just completed a term as one of the twelve White House Fellows chosen nationally; and other alums are distinguishing themselves in various ways.

The school attracts a great many high-visibility legal figures. Of the current nine justices on the United States Supreme Court, six of them have made recent visits to the law school, for a total of ten visits between them. Two of them have taught summer school for us here, one serves on our Board of Visitors.

Within the last thirteen months, the nation's two respective Attorney Generals who have served during that period have both visited the law school, as has the Solicitor General, the Supreme Court Chief Justice of California, and the current Chief of Staff of the White House. These are among many other distinguished visitors who regularly come to our school.

Our school has several distinctive characteristics, including the nation's oldest semester abroad program, which happens to be in London; the fourth Institute for Dispute Resolution among American law schools, and the first in the Southwest; a Distinguished Visiting Professor program that brings to our school members of the judiciary and other outstanding legal figures for teaching assignments; and a focus for promoting an understanding of, and appreciation for, a high level of professional responsibility and legal ethics. For a variety of reasons, our school has much to offer.

Unfortunately, though, Pepperdine clearly is not the school for everyone; it will be a very poor choice for those people who hate both the mountains and the ocean, and are allergic to breathing fresh, smog-free air.

Thank you very much for coming to be with us today. I trust that your day will be both productive and enjoyable.

PANEL ONE

PANELISTS:

MARC I. STEINBERG, RUPERT AND LILLIAN RADFORD PROFESSOR OF LAW, SOUTHERN METHODIST UNIVERSITY; OF COUNSEL, WINSTEAD, SECHREST & MINICK, DALLAS

GERALD BOLTZ, PARTNER, ROGERS & WELLS, LOS ANGELES

MARC I. STEINBERG

Thank you very much. I'm very pleased to be here. I wish to thank the Law Review, Dean Phillips and Professor Kerr for sponsoring this program. My topic is an overview of securities law developments, and for those of you who want case citations, I will be providing them.

This past year has seen many developments, and perhaps the case that has generated the most publicity is the Supreme Court's decision in *Lampf*, 111 S. Ct. 2773 (1991), dealing with the statute of limitations for Section 10(b) actions. The Supreme Court adopted a uniform statute of limitations for Section 10(b), namely, one year after discovery was made (or should have been made) of the facts constituting the violation, and in no event, more than three years after the violation occurred. As significant, if not more so than the Court's adoption of a uniform statute, was the Court's holding that Section 10(b) does not provide for equitable tolling. Therefore, the three-year period is an outside limit.

Also, to the surprise of many, the Court retroactively applied the principles of *Lampf*; however, that holding raised a great deal of controversy, and Congress passed legislation in late 1991 overturning the retroactive application of *Lampf*. [See Section 27A of the Exchange Act.]

There are a number of congressional proposals to modify *Lampf*. The Brian Bill in the Senate would basically impose a two-year/five-year statute, namely, two years after the plaintiff knew or should have known of the facts constituting the violation and in no event longer than five years; the Markey Bill in the House would impose a three-year/five-year limitations period. However, both of these bills have generated opposition, and many believe that if the *Lampf* decision is going to be overturned, there's going to have to be a quid pro quo. Some individuals think, for example, that RICO's application to securities fraud may be deleted as a quid pro quo. Alternatively, it has been suggested that legislation be enacted narrowing the scope of discovery requests and permitting the imposition of costs against the losing party in securities litigation. It remains to be seen what will be the effect of these congressional proposals.

Nonetheless, I think one thing is for certain and that is an increasing number of securities plaintiffs are turning to state court. For example, Texas has a three-year/five-year statute, namely, three years after discovery and in no event longer than five years. [Texas Securities Act Art. 581-33(H)]. My understanding is that California has a one-year/four-year statute of limitations contained in Section 15506.

Moreover, it is unclear under some of the applicable blue sky statutes whether equitable tolling may be permitted. Of course, it is not under Section 10(b), as decided by *Lampf.* In their treatise, Marsh and Volk apparently take the position that equitable tolling may be permitted under the California statute. [See Marsh & Volk, Practice Under the California Securities Laws § 14.08[2][a], at 14-67 (1991)] It seems as if the issue is open under California law; there are federal court decisions, interpreting California law, that disagree on this issue. [Compare SEC v. Seaboard Corp., 677 F.2d 1301, 1308 (9th Cir. 1982), with Dahl v. Gardner, 583 F. Supp. 1262, 1266 (D. Utah 1984) (interpreting California law)].

Also, I think we'll see state court actions coupled with 1933 Securities Act claims, due to the fact that claims can be brought under the Securities Act of 1933 in state court without the right of removal [See Section 22(a) of the 1933 Act]. For example, what I'm seeing in Texas are state securities claims coupled with federal securities claims under Section 12(2), plus of course your state common law claims.

Now, with respect to Section 12(2), that is an area that has generated a great deal of litigation during the past few years. Section 12(2) is the basic Securities Act of 1933 express remedy that goes to material misstatements or omissions contained in a prospectus or oral communication. Generally, under that provision, if there is such a material misstatement or omission, the purchaser may sue the seller, with the seller having the defense of reasonable care. As you probably all know, in 1988, the Supreme Court decided the *Pinter* case which defined the term "seller" under Section 12(1) [Pinter v. Dahl, 486 U.S. 622 (1988)]. Even though the Court's ruling was under Section 12(1), almost all courts have applied that definition to Section 12(2) actions as well, including the Ninth Circuit [Moore v. Kayport Express, Inc., 885 F.2d 531 (9th Cir. 1989)]. The Supreme Court in *Pinter* defined "seller" to include one who parts with title, an agent for the vendor, and one who solicits the purchase with the motivation to benefit him or herself or the securities owner. Several issues have arisen in view of *Pinter.* One such issue is whether aiding and abetting liability is appropriate under Section 12. Practically all courts after *Pinter* have said that it is not. Note, however, that controlling person liability under Section 15 is implicated for a violation of Section 12.

A second issue is whether professionals acting solely in their professional capacity are sellers under Section 12. The *Pinter* language basically sets forth that attorneys and accountants acting solely as professionals are not Section 12 sellers. The lower courts have unanimously agreed. The Ninth Circuit case is *Moore v. Kayport Express*, 885 F.2d 531 (9th Cir. 1989). The concern here is that if the lawyer takes on more of a promotional type-role, he or she may be called a seller. For example, in a Second Circuit case, the attorney mailed the private placement memorandum to prospective investors at the request of the promoter. The court said that this was not sufficient activity to constitute one a seller [Wilson v. Saintine Exploration & Drilling Corp., 872 F.2d 1124 (2d Cir. 1989)]. Therefore, it seems as if an attorney can engage in certain minimal efforts, although my advice would be for the attorney to perform solely within his or her professional capacity.

Perhaps the key issue involving Section 12 is whether Section 12(2) applies to secondary trading markets. It was assumed until fairly recently that oral communications that took place in the secondary markets could trigger Section 12(2). However, in a number of decisions handed down within the past few years, a number of courts, including the Third Circuit, have held that Section 12(2) is limited to the initial offering context [Ballay v. Legg Mason Wood Walker, Inc., 925 F.2d 682 (3d Cir. 1991)]. For example, one way in which Section 12(2) can be expansively utilized in the secondary trading markets is when a broker makes a material misrepresentation with respect to recommending a security that is traded in the public markets. Instead of the plaintiff relying solely on Section 10(b), having to show reliance, causation, scienter and the like, the plaintiff also can invoke Section 12(2) and recover without many of the burdens that Section 10(b) demands.

Professor Maynard over at Loyola has written a very good article on this subject that was recently published in the *William and Mary Law Review* [32 WM. & MARY L. REV. 847 (1991)]. Moreover, she is scheduled to publish an updated article on this subject in the Summer 1992 Issue of The Securities Regulation Law Journal [20 Sec. Reg. L.J. 152 (1992)].

Let me give you other examples where Section 12(2) can be used.

Perhaps the provision is most frequently invoked in private offerings, such as Reg. D deals. Also, although rarely used in this situation, Section 12(2) may be employed in public offerings against a dealer. As you know, a dealer, unlike an underwriter, is not subject to liability under Section 11. But a dealer normally is a seller, and would come within Section 12(2)'s reach.

The *Virginia Bankshares* case [111 S. Ct. 2749 (1991)] decided last Term in some ways seems to have broad application, and in fact in some respects the decision does. In certain other ways, the decision has what I foresee as relatively narrow application.

I will first turn to the decision's broad application. The Supreme Court has made it clear by this decision that it does not favor implied private rights of action. There were a series of cases in the late '70s such as *Touche Ross v. Redington* [442 U.S. 560 (1979)] and *Lewis v. Transamerica* [444 U.S. 11 (1979)] where the Court adopted a narrow construction to implied rights. And then in the early '80s, with such cases as *Huddleston* [459 U.S. 375 (1983)], for example, the Court seemed to have adhered to a more flexible approach. In the *Virginia Bankshares* case, the Court once again returned to a rather restrictive view, basically saying that if implied rights of action are to be adopted, one must look at the congressional intent as embodied by the particular statute's language and the pertinent legislative history. Applying this standard, implied rights are likely to be recognized on rare occasions.

Another key aspect of *Virginia Bankshares* goes to the "true purpose" cases. The true purpose cases not only arise in proxy litigation, which this case involved, but also in your run-of-the-mill, Section 10(b) fraud litigation. These cases generally stand for the proposition that the disclosure mandates focus on objective facts and not subjective revelation; that there is no requirement for management to disclose the transaction in pejorative terms. In *Virginia Bankshares*, management opined concerning a squeeze-out merger that the price offered to the minority shareholders was fair. What the Supreme Court said was that this statement was actionable, if two things were satisfied: First, that management believed that the price was not fair, and second, that objectively the price was not fair. In other words, to be actionable, the opinion or belief asserted by management must misstate the fiduciary's actual belief or opinion, and secondly, must be untruthful with respect to the subject matter addressed. Of course, when disclosure documents are disseminated, there frequently is no requirement or need to have management give its opinion. But I might add that this decision will have application in going private transactions under SEC rule 13e-3. This is because Schedule 13E-3 requires management to provide its opinion whether the price offered is fair and the grounds for this opinion. When that happens, of course, the rationale of *Virginia Bankshares* is going to apply.

Now I'm going to address what seems to be the narrow part of the opinion. Although the majority in *Virginia Bankshares* had the votes to carry the merger, they nonetheless solicited the shareholders. The plaintiffs argued that there was a material misstatement and that the requisite causation was shown. The Supreme Court rejected that argument, reasoning that under the facts presented because the majority had sufficient votes, the proxy solicitation was not an essential link in the consummation of the merger. The decision can be read to mean that, whenever the majority has sufficient votes to carry the merger, the minority cannot show causation even if there is a material misstatement or omission. However, such a reading would be inappropriate, for the reason that the Court expressly left open a key issue. The issue is whether adequate causation may be shown if the majority's proxy solicitation induced the plaintiff minority shareholders to forego an otherwise available state remedy.

In *Virginia Bankshares* the plaintiffs did not have a right to appraisal under the language of the Virginia statute. That's very unusual in a squeeze-out merger. For example, in California, under the *Steinberg v. Amplica* case [42 Cal. 3d 1198, 729 P.2d 683, 233 Cal. Rptr. 249 (1986)], a shareholder in a squeeze-out has the right to appraisal. Therefore, the argument after *Virginia Bankshares* is that the materially misleading proxy solicitation induced the minority shareholder to forego his or her right to appraisal, which would have been otherwise available. [But see Barth v. Nova Sensor, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,494 (N.D. Cal. 1991).] Also, the misleading proxy solicitation may have lulled the plaintiffs into inaction, thereby bypassing an opportunity to enjoin the merger in a state court action [See Kidwell ex. rel. Penfold v. Meikle, 597 F.2d 1273 (9th Cir. 1979)]. In sum, by foregoing a state remedy that was otherwise available, the materially misleading proxy solicitation caused the shareholder loss.

I want to speak for a moment on the Section 16 changes, and I'm going to address only a couple of them [Securities Exchange Act Release No. 28869, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,709 (1991)]. As a former SEC enforcement attorney, I am bothered by some of these revisions. For example, the new rules with respect to derivative securities treat the acquisition of a derivative security, rather than its exercise, as a purchase for Section 16 purposes. In other words, the purchase for Section 16 purposes occurs at the time of the purchase of the option, rather than at the time of the option's exercise. Look at the following scenario where there is no Section 16 liability: First, the insider purchases the derivative securities, such as stock options. The insider holds for six months, and then buys the underlying securities by exercising the options. The very next day, or in fact the very next moment, the insider thereupon sells the underlying securities. There has been opposition in the Senate criticizing the SEC on this revision. The Commission's rule change also goes against judicial authority on this subject. [See, e.g., Colan v. Monumental Corp., 713 F.2d 330 (7th Cir. 1983)] It remains to be seen how the courts will react to this revision.

These Section 16 rule changes come at a time when the SEC has declared war on insider trading. As we all know, proving insider trading under the *Chiarella* [445 U.S. 222 (1980)] and *Dirks* [463 U.S. 646 (1983)] tests frequently is based upon circumstantial evidence and can be very difficult for the Commission to prove at times, as shown by the recent *en banc Chestman* decision by the Second Circuit. [947 F.2d 551 (2d Cir. 1991) (en banc)] Section 16(b), however, is a rule of strict liability and is not based upon circumstantial evidence.

Every single court decision that I am aware of has held that one need be an officer or a director only at the time of either the purchase or the sale to come within Section 16 [See, e.g., Adler v. Klawans, 267 F.2d 840 (2d Cir. 1959)]. What the SEC did with its recent rule amendments is simply change the law: That is, with certain exceptions, before one becomes an officer or director of a publicly-held company, one can engage in a purchase or sale. Then, if one subsequently becomes an officer or director within six months and engages in an offsetting transaction, such trading does not invoke Section 16. Therefore, the SEC has changed the law. In so doing, it has failed to provide sufficient justification.

For those of you who have a Section 16 practice, the *Gollust* case is a very important decision [111 S.Ct. 2173 (1991)]. There, the Supreme Court granted standing to a shareholder who instituted suit prior to the merger of the issuer into the surviving corporation, concluding that the shareholder can continue the action if he retains stock in the surviving corporation. The decision seems to be broad — but it's not. It's not for the reason that the Court stated that the plaintiff must be a shareholder of the issuer at the time the suit was instituted. What does that mean? For practical purposes, this means that if the shareholder institutes suit after the merger is effected, it may be that he or she does not have standing to bring the Section 16(b) action. In sum, it may be that although *Gollust* granted standing to the plaintiff, that in fact the ramifications of *Gollust* will be to narrow the scope of plaintiff standing under Section 16.

I want to bring to your attention two cases, one of which Professor Kerr will talk about in her discussion, out of the Ninth Circuit. One is *SEC v. Reynolds Enterprises* [[1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,464 (9th Cir. 1991)], which defines the term security in an expansive way. She'll be talking about the "family resemblance" test as applied to that decision [See Reves v. Ernst & Young, 110 S. Ct. 945 (1990)]. I simply want to point out that the Ninth Circuit once again reaffirmed its adherence to vertical commonality as being sufficient to satisfy the common enterprise requirement. And, of course, all of you know that the Supreme Court has granted cert in the *Holmes* case out of the Ninth Circuit. There, the Ninth Circuit held that the Section 10(b) purchaser-seller requirement of *Blue Chip Stamps* [421 U.S. 723 (1975)] does not apply to RICO actions [the Supreme Court subsequently handed down its decision declining to resolve this issue. 112 S. Ct. 1311 (1992)].

I wish to conclude by briefly addressing attorney liability. As we are aware, attorneys are being sued for malpractice and securities fraud to a much greater extent. In the opinion letter context, liability exposure is magnified. The Seventh Circuit's recent decision in *Ackerman v. Schwartz* [[1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,460 (7th Cir. 1991)], from a court that narrowly construes attorney liability, stands for this proposition. Moreover, many of these actions are brought pursuant to state law, under the applicable state securities statutes and for common-law malpractice. In several states, including California, the attorney-client privity requirement has been abandoned; under certain circumstances, third parties can sue an attorney for malpractice [See Goodman v. Kennedy, 18 Cal. 3d 335, 556 P.2d 737, 134 Cal. Rptr. 375 (1976); M. Steinberg, Corporate and Securities Malpractice (PLI 1992)]. And with that, I'll turn to Gerry.

GERALD E. BOLTZ

Mr. Boltz's Symposium comments are replaced here by his article, "The Impact of Recent Legislation on Federal Securities Law Enforcement"

In this article, I want to address some trends in the enforcement program of the Securities and Exchange Commission resulting from three pieces of federal legislation enacted during the last eight years. It's well-known that the Commission has had one of the most effective enforcement programs of any federal agency. More recently, the Commission has been successful in obtaining additional funds for enforcement purposes. The Commission's statutory tools prior to recent legislation were already quite awesome. These included the power to bring injunctive actions with a wide variety of ancillary relief, including disgorgement, accountings, receiverships and other specifically designed relief; administrative proceedings, including special proceedings such as 2(e) proceedings to bar or sanction professionals, stop-order proceedings on registration statements, 15(c)(4) proceedings to correct filings; trading suspensions, foreign restrictive lists; and last, but certainly not least, criminal reference. It was an imposing array of weapons.

Several things have happened which resulted in Congress providing even greater weapons to the Commission. One was the proliferation of insider trading, which became a phenomenon of the '80s. In the '70s, while I served the Commission in Los Angeles, insider trading cases were rare. But in the '80s, as the takeover phenomenon caught fire, stock prices often jumped—ten, twelve points on takeover news. The advent of stock options also helped insider trading become a very, very popular pastime.

Two pieces of federal legislation, the Insider Trading Sanctions Act of 1984 (the "Sanctions Act") and the Insider Trading Securities Fraud Enforcement Act of 1988 (the "Enforcement Act"), were specifically directed at curbing these abuses. A third piece of legislation, the Securities Enforcement Remedies and Penny Stock Reform Act of 1990 (the "Remedies Act") arose out of a growing perception that the sanctions and enforcement remedies available to the Commission were not flexible or not tough enough. While not specifically enacted to address insider trading abuses, the Remedies Act clearly has also provided the Commission with yet additional recourse in curbing this abuse. Many laymen assume that the SEC previously had the power to fine—but of course it did not. It could seek ancillary relief in injunctive actions, but in recent years the courts had shown a growing reluctance to grant such relief. The cordial atmosphere that the Commission enjoyed in the courts in the '50s and '60s, and perhaps even into the '70s, changed dramatically as courts more frequently questioned the Commission's claims. Further, defendants and their counsel found that the collateral consequences of an injunction posed great problems. As a result, more cases were contested. (Such collateral consequences can permanently prevent an enjoined person from being associated with a broker/dealer, becoming a director of an investment company, and if entered against a lawyer or other professional, from practice before the Commission.) These concerns came into focus with the publishing of the Treadway Report. This study, headed by a former SEC commissioner, recommended that civil money penalties be imposed by the Commission.

Let us examine further this legislation which has greatly impacted the Commission's enforcement program. In the '80s, insider trading was akin to drug abuse in that while the penalties increased, the practice became more prevalent. The Commission made insider trading a priority in its enforcement program and sought help from the Congress. The Sanctions Act of 1984 provided penalties that put teeth in the Commission's program. Briefly, the Act for the first time provided that in addition to disgorgement, the Commission was entitled to seek civil penalties of three times the profits realized or loss avoided in insider trading cases, which amounts were based upon the difference between the transaction price and the price after dissemination of the information. (In practice, these cases have often been settled with disgorgement and a one-time penalty or occasionally a two-times penalty.) As I read the Sanctions Act, it allows the Commission to seek disgorgement of the profit in addition to the three times penalty or a total of four times the profit realized or loss avoided. The Commission has however not, to my knowledge, sought that quantum of relief.

In Commission injunctive actions generally, there's no statute of limitations; however, civil penalties under the '84 Act can be obtained only for violations charged within five years of the transaction involved.

In 1987, the Supreme Court decided the *Tull* case (*Tull v. United States*, 481 U.S. 412), which held that, under the Clean Water Act, a jury trial must be afforded a defendant where civil penalties are sought to be imposed (although the court can determine the amount of the penalty). Thus by analogy it appears that defendants against whom civil penalties are sought under the '84 Sanctions Act are also entitled to a jury trial.

Double jeopardy questions have also arisen as a result of the passage of the Sanctions Act, since criminal prosecutions involving both incarceration and fines occurred in cases where the Commission sought civil money penalties. In the *Halper* case (*U.S. v. Halper*, 109 S. Ct. 1892), the Supreme Court examined that question. In *Halper*, the criminal prosecution occurred first, and later the government sought to impose a civil penalty. The court held that under such circumstances the action constituted double jeopardy. But it also seems to be clear that the mere imposition of a civil fine or penalty does not prevent a subsequent criminal prosecution because of double jeopardy protections.

In 1988, Congress enacted the Enforcement Act, which expanded insider trading penalties to controlling persons and employers. For the first time, it also gave the Commission the right to pay bounties to informants, codified a private right of action for contemporaneous traders, and required broker/dealers to establish "Chinese Wall" policies to prevent insider trading and to monitor compliance. This legislation brought most public companies (as well as many private firms and companies) who had access to insider information to adopt policies designed to prevent employee trading on inside information. Today most law firms, accounting firms, and public companies have such policies.

I believe the Remedies Act, in the long run, will have a much greater impact upon securities law enforcement than the other two pieces of legislation mentioned herein. Indeed, I think it ushers in a new era of enforcement. While the "penny stock" provisions were specially and narrowly designed to curb abuses in the penny stock market, the remaining provisions of the legislation have broad applicability. The penny stock provisions regulated "blank check" offerings, and authorized the Commission to adopt fraud rules affecting brokers and others offering and trading in penny stocks. The enactment of those provisions have immediately dealt a crippling blow to abusers of the penny stock market.

The impact of the other provisions is only now beginning to be felt, perhaps because most of the enforcement cases the Commission had brought previously involved violations that occurred prior to October 15, 1990, the effective date of the Act. Today, the new Act is being utilized by the Commission as it deals with more recent violations.

The features of the Remedies Act, in summary, include the right of the Commission to seek in federal court civil money penalties and to also seek such civil money penalties in administrative proceedings against professionals in the securities industry (including broker/dealers, investment advisors, and their associated persons) upon a proper showing of a violation. In court, civil money penalties can be sought against anyone for any federal securities law violation. The Remedies Act, for the first time, gives the Commission the right to issue administrative cease and desist orders and to apply to federal district court for orders enforcing such cease and desist orders. The Act appears to give the Commission the power, not only to issue cease and desist orders, but also to specify steps which the respondent must take to comply with a cease and desist order. Such administrative proceedings can be brought not only against the primary violators, but also against individuals who are deemed the "causes" of such violations.

A controversial provision of the new Remedies Act gave the Commission the express right in federal court to seek an order barring persons from acting as officers or directors of a public company. There were some important changes from earlier versions of the legislation as proposed which initially gave the Commission rather than the courts this power. Many argued that issues of who shall serve as officers and directors of corporations are matters of state law or at least matters which shareholders and not the Commission should determine. The revised provision, as enacted, gives this power to the federal court only for *scienter*-based violations where the court finds the officer or director is "substantially unfit" for the officer or director position.

The money penalties which can be imposed under the Remedies Act in court and administrative proceedings generally fall into three specific tiers, depending on the seriousness of the offense. In instances where the Commission seeks such penalties in federal court, the court can go beyond those tier limits and impose a money penalty equal to the defendant's gross illegal pecuniary gain. Otherwise, fines within each tier are as follows: where there is no fraud, deliberate, or reckless conduct, the limit is $5,000 for individuals, and $50,000 for other entities. The second tier provides that if there is fraud, manipulation, or reckless conduct, the maximum fine is $50,000 for a natural person, and $250,000 for other entities. The third tier is applicable where there is fraud with *scienter* plus a significant risk of substantial loss to others. In such instance, the maximum fine is $100,000 in the case of a natural person, and $500,000 for other entities.

Assessment of money penalties in administrative proceedings requires a finding that such is in the "public interest." Certain factors are to be considered in determining whether a case is appropriate for such penalties, including: (1) whether or not there is deliberate fraud; (2) the degree of harm to the public; (3) the degree of unjust enrichment to the respondents; (4) whether or not the respondent is a recidivist; (5) whether there have been past offenses of similar nature;

(6) what is the deterrent value overall; (7) is the need to set an example and deter others from similar conduct; and (8) the ability of the respondent to pay a penalty. Respondents in such proceedings have the right to demonstrate that they do not have the financial ability to pay a particular fine or penalty.

The Commission has the right in either court or administrative proceedings to seek a cease and desist order, a disgorgement of illegal profits and an accounting. With regard to persons and entities in the securities industry, the Commission also has the right to issue temporary cease and desist orders, including ex-parte orders.

Some members of the defense bar anticipated that this legislation would provide greater flexibility in fashioning settlements. The Commission sought passage of the Act, in part, I believe, because it thought that the legislation would deter recidivists and make the enforcement process more effective. In that regard, both the bar and the Commission had a concern that the administrative proceeding machinery which the Commission had used for many years was antiquated, slow, and the subject of a fair amount of criticism from the bar. As a result, the Commission embarked on a study headed by Commissioner Shapiro which recommended major revisions in the rules for administrative proceedings in an effort to address those concerns. Due process concerns remain, however, as many feel that the Commission's additional powers are so great that they give undue advantage to the agency. This perceived advantage, coupled with the current Commission's aggressive bent in imposing sanctions, makes settlement of enforcement proceedings quite difficult today. If this situation continues, we may see more instances where Commission enforcement cases are litigated. Notwithstanding the reforms of the Shapiro Commission, Commission administrative proceedings continue to be criticized, in part because the Commission utilizes its own "employed" judges. As a result, there remains, in some quarters, a lack of confidence in the impartiality of such proceedings. The final impact of the Remedies Act depends in large part on how this Act is administered by the Commission in the days ahead. Based upon experience to date, however, the Remedies Act ushers in a new and much tougher era in securities law enforcement.

PANEL TWO

PANELISTS:

HENRY LESSER, PARTNER, IRELL & MANELLA, LOS ANGELES

STEPHEN BAINBRIDGE, ASSOCIATE PROFESSOR OF LAW, UNIVERSITY OF ILLINOIS

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HENRY LESSER

Good morning, everyone. We've decided to use the podium, a reflection on our stature maybe. First, Ken has asked me to say that he will actually be speaking on nothing, because virtually everything he might want to say about anything to do with proxy regulation is embargoed, except on the part of maybe Linda Quinn and her direct deputy in D.C., who are the only people authorized to say anything about the proposals that were issued for public comment last June, and withdrawn for reissuance last November, after the SEC was barraged by over six hundred letters. So Ken is really here in his individual capacity to talk, and I think this is preeminently suitable in an academic institution and I am going to do some of it too, to talk about more esoteric theoretical issues, and he has asked me to act as a buffer between you and him on any kind of question that he might not appropriately be able to answer, except by saying, by pleading the Fifth or whatever . . . so he is really here for the beach.

Steve is going to talk about an issue which I think is a subset of the issues that I am going to try to outline here, which is of extreme importance. That is, the statutes that attempt to say or purport to say the boards of directors owe fiduciary duties to people other than people who elect them. This panel could easily occupy the entire day; actually we might, yet, except for Ken. In fact, last December in New York City, the ABA had a two-day institute on this subject. It is, in my judgment, the cutting edge corporate securities issue, or set of issues, of the 1990s. It is a direct follow-on to the takeover wars of the 1980s. At the ABA Institute, there were some people who believed, with maybe a degree of prescience, that executive compensation, which is part of what is subsumed under this topic, was going to be the Willie Horton issue of the 1992 elections. I think there may be some of overstatement in that but nevertheless, that issue has significantly intruded into election-year politics as a result of President

Bush's trip to Japan and the people he chose rightly or wrongly to take them with him. You can't open a newspaper today, whether it's a regular newspaper or Business Week, without seeing reference to the issue of executive compensation, and the broader issues of corporate governance that stand behind that issue. There are bills in Congress dealing with corporate governance issues, and there are probably more bills to come. So what is this issue, or set of issues, that we are talking about here that we conveniently label corporate governance? They deal with some pretty fundamental questions, like who runs and who should run a corporation? Who votes for the people who run the corporation, and who should vote, and how should they vote, and how should their votes be tabulated? To whom should those people owe their duties, their residual, non-statutory duties, in other words the duties that aren't legislated for by specific legislation that deals with environmental liabilities to the public, plant closing obligations to the employees; I am taking about the residual common law/equitable duties. And, how should those people running these corporations and owing these duties be paid, and should who determine that, and by the way, who should determine how they even get nominated. These are pretty fundamental questions. Why have they become so significant? How has this topic gotten to be so hot? Well, I think there are at least three broad explanations for how this topic has come to be the cutting edge issue of corporate and securities law today.

First, we had the takeover boom of the 1980s. One of the by-products of that long, and by we MNA practitioners, fondly remembered, era that we all hunger to see again . . . we want to resurrect our own field of dreams and have all those cars piling down the highway with clients, whether they are insider traders or not. A by-product of that era was this seemingly endless line of cases with an infinitely variable set of fact patterns that was dealing with the question of to whom do the directors owe their duties, and to what extent are the directors entitled to be proactive on behalf of the people to whom they owe their duties, principally the shareholders in the context of those cases, and in effect, interpose themselves between raiders and the shareholders, and proactively take measures that would bar the raider from proceeding with its bid. And in the course of those cases, we really wrestled with some very fundamental issues, concerned with the duty of loyalty, the duty of care and the business judgment rule, and I know Steve's paper, and presumably his remarks, are going to talk about the potential application of some of those cases, particularly the *Unocal* case, in an analysis of state shareholder constituency statutes.

I was saying to somebody at dinner last night as a person involved in the Unocal/Mesa Petroleum war on behalf of Unocal, that at the time the *Unocal* decision of the Delaware Supreme Court came down in 1985, for us who were involved in the matter it was a clear victory inasmuch as the Delaware Supreme Court had vindicated the actions of the Unocal Board in defending itself against Boone Pickens' takeover by making itself a so-called discriminatory self-tender, in which everybody who was a shareholder of Unocal except Mr. Pickens and his affiliates was entitled to tender their shares and Mr. Pickens and his affiliates were not eligible to tender their shares. And we gave a lot of thought before launching that tender offer as to whether or not we might have significant federal court litigation from the SEC on the basis of an implied obligation of non-discrimination in the federal tender offer regulatory scheme. We were confident that any such litigation was not very likely to be successful, and that there was not likely to be held to be an implied obligation of non-discrimination, and we were right.

Judge Tashima in the federal district court, down the road in Los Angeles, didn't really have much trouble coming to the conclusion that there was no implied obligation of non-discrimination in the federal tender offer rules; there now is an express rule, 14(d)(10), and a corresponding rule for self-tenders, promulgated directly as a result of that ruling.

But we never really thought about the possibility of state court litigation under state corporate law doctrines, and I don't know if there's anyone from Skadden here, but I gave them credit at dinner last night for finding a fairly abstruse and ancient Delaware case as a basis for litigating that issue in state court, and Vice Chancellor Caroline Berger was impressed by the theory to no end, and then finally the Delaware Supreme Court said it was perfectly okay to discriminate against Boone Pickens—I mean that was basically the rationale of the case. We won, but it turned out with the benefit of now seven years of hindsight that that seminal case was really about narrowing the scope of the board's ability to proactively interject itself into a takeover bid by tightening up the burdens that were placed upon the board of directors if it wished to invoke the business judgment rule, and that case has spawned a vast progeny of case law. Now we don't have hostile takeovers around anymore, for awhile, I hope—I mean I hope it's only for awhile—but we nevertheless have that debate up and running about directors' rights, directors' duties, the abilities of shareholders to put a tight rein on directors. And yet at the same time, we're in a recession, and we're in an environment in which many people feel that inadequate corporate performance over maybe ten to twenty years is now reaping its sad return, especially relative to performance of our international competitors in Europe and Asia, particularly, of course, Germany and Japan. And so these issues that were framed in the context of the "go-go" takeover boom days of the '80s are now being reframed in terms of the "go-slow" days of the 1990s. But they are essentially the same issues.

And finally, of my three—and there could be and probably are more but I've identified three—factors that are making this topic so hot is the phenomenon of the institutionalization of the stock market. Perhaps this is the single most important factor of all. When you get the papers that were written in connection with this program, you'll see that I cite some studies that have been done on this topic, and the statistics are really quite staggering in terms of the growth of the percentage of publicly traded securities of any one public issuer that are in the hands of the institutions. And it is clearly now the case that a majority of the publicly traded stock of a majority of public companies is in the hands of institutions.

Now, what do I mean by institutions? They don't constitute some monolithic block. In that group you have short-term holders and long-term holders, you have public pension funds and private pension funds who have very different characteristics; you have insurance companies, you have brokers, you have arbitrageurs; it's an array of professional shareholders, and they don't all have the same goals and they don't all act in concert, and if they did act in concert there would be very significant violations of SEC regulations about failing to file 13D's for five-percent-or-greater groups of shareholders, and no one of these institutions typically holds more than about one or two percent of a company's stock. But nevertheless, in the aggregate what you have is a situation in which professional investors, with all of the tools available to them, the computerized tools, the tools of a staff of MBAs, the tools of much greater access to senior management of public companies, by working the network, are in control of most public companies. So the Mom-and-Pop perspective of who is the typical shareholder and what is the relationship between that typical shareholder and the company's management has dramatically changed.

Now I would suggest to you . . . and now I'm moving from the practical side to the theoretical side because we are under the umbrella of an academic institution and can do a little bit of theoretical speculation . . . I would suggest to you, and this is the central thesis of my paper, that it is time for us at least to seriously question in light of what I have talked about whether or not the basic paradigm of corporate law is adequate to deal with the kinds of issues that we are wrestling with. By the phrase "the basic paradigm of corporate law" I mean the following: very simplistically put, going back to Corporations 101: the shareholders elect the directors; the directors have oversight and stewardship over the affairs of the corporation; the directors have a significant amount of delegated authority, because the shareholders aren't in a position to familiarize themselves with the all data that is relevant to decision making with respect to the affairs of a corporation; the shareholders' remedy lies in the ballot box, at least once every year, or if the company has a staggered board in effect over the course of a three-period when the totality of the board of directors have come up for election. Recalls are possible, but typically very hard because the corporation is permitted, and most have, to institute into its charter and by-laws procedures which make what I am calling recalls but of course in the corporate law context aren't—I'm trying to draw a very crude analogy to the political process. They're possible but they're very hard. The directors owe their duties exclusively to the shareholders, except that they may take into account non-shareholder interests and here I'm not talking about statutes, I'm talking about the basic paradigm as reflected in our case law, in our common law/equity thinking. They may take into account the non-shareholder constituencies to the extent that there is an articulable, rational relationship between the shareholders' interests and the interests of those other constituencies. So, for example, they may give money away to charity to the extent that they make a rational determination that this enhances the corporation's profile as a good corporate citizen and redounds to the benefit of the corporation and therefore ultimately to the shareholders' pocket book. Similarly, they may take into account the interests of the employees, because to the extent that the corporation isn't a kinder and gentler employer, it may lose its lifeblood and that will redound to the detriment of the corporation and its shareholders. But essentially the twin duties of care and loyalty are owed exclusively to the shareholders. That's the fundamental paradigm.

Now, you begin to ask yourself, 'Well, how does that paradigm work in the 1990s in terms of the stock market?' Is it enough to say that the shareholders are all one group, and the board of directors owes its duties exclusively to that group, or do we need to consider the possibility that maybe there are different groups of shareholders with different interests and maybe just conceivably they need different representation which our system is not designed to create, different kinds of directors elected by different groups of people, and with different levels of role. Take the part of the paradigm that deals with the activist powers of a board of directors. One of the things the *Unocal* case did hold that was not limiting was that it reaffirmed the proposition that the directors have an activist role to play in the corporate governance structure, and specifically in the context in that case of a takeover defense, but the language is broader; that our model, unlike models in other countries like the UK for example, does not expect the directors to stand pat, announce their views and let the shareholders decide. We have a quite expansive view of what directors can do, and if you take the typical corporation statute, the kinds of transactions which are subject to a shareholder vote are fairly limited.

Look, for example, at one of the most important cases in that progeny of *Unocal* that I referred to earlier, the *Time-Warner* case. In the *Time-Warner* case, Time's board of directors was held entitled to restructure a merger with Warner into a tender offer for Warner in combating a hostile tender offer that Paramount made for Time after the Time-Warner merger agreement was announced. The Time-Warner merger would have required shareholder approval. An acquisition by Time of Warner through a tender offer in which the Warner shareholders would tender their shares to Time, did not require the approval of Time's shareholders. And part of the rationale of the case in the Delaware Supreme Court—and it's a complicated opinion and seemingly no two lawyers can agree on what it actually holds—but part of the rationale of the case was that buying Warner was an exercise by Time's board of the conventional power of a board of directors to buy businesses without having to get a shareholders vote, and to deploy corporate funds to do so even if it meant going out and borrowing 15 or 20 billion dollars to do so.

Now, time is short, we have to move on and as I said we could easily occupy an entire day talking about these issues. I hope that the paper that I have written on the subject when you get it will kind of elaborate on these issues that I'm raising, but essentially what I'm here to say here today is that lying behind the SEC's initiatives on expanding the access of shareholders to proxy process, lying behind the bills in Congress that deal with caps on executive pay and a greater role for shareholders in executive pay, lying behind essentially all this tinkering, it seems to me are some very significant questions which we lawyers, from the academic sector, from the in-house sector, from the outhouse sector, are all uniquely qualified to deal with and we have a special responsibility to deal with them. And this is what I want to leave you with. And I was very impressed when Bayliss Manning, who is a doyen of the corporate and securities bar, and who's written extensively on this subject, made this point at the ABA program in New York in December. He made the point that it was our predecessors, one hundred and fifty, two hundred years ago, lawyers working with their clients, who created a vehicle called the corporation, or the joint stock company, or the limited liability joint stock company—whatever you want to call it—a vehicle built out of bits and pieces of all sorts of other theories, such as trusts and church charities and the like, that was adequate, more than adequate, to deal with the capital-raising and the capital-deployment needs both of the industrial revolution in the United Kingdom and the burgeoning independent United States. We've essentially lived with that paradigm for a hundred fifty, two hundred years.

It is time for us to consider how adequate that paradigm really is, and stop trying to fit square pegs into round holes and stretch concepts to or beyond their breaking point by engrafting in my view things that just don't work, like non-shareholder constituencies statutes and the like, or slipping in a piece of legislation that deals with executive compensation. It is time to step behind that, and we should be doing that. We should be doing what our forebears did. And if we don't, I would suggest to you that what we are going to end up with will be an absolutely horrendous, unworkable system, which is going to be a typical product of the political process, which is going to be a mess, which isn't going to work well, and which is ultimately not going to serve the needs of the business community or of the people who invest in corporations, or of the employees that work there. So with that exhortation for us to all sort of think about these issues and hopefully the academic institutions, including this great law school, can take a lead in visiting how these issues should be handled, I'm going to turn it over to Steve.

STEPHEN BAINBRIDGE

Thank you. Non-shareholder constituency statutes are a species of state corporate law. Why, you might reasonably ask, am I speaking about state corporate law at a securities regulation symposium? Largely because acquisition work arguably has been for many years the most important component of securities practice and, despite the recent slowdown, it seems unlikely that takeovers, even hostile takeovers, are going to become extinct. There's too much money to be made and too many of us that want to make it. In today's legal environment, however, the success or failure of a takeover bid is more often determined by state corporate law, particularly state takeover laws, than it is by federal securities law. Accordingly, I want to direct our attention this morning for a few moments at what may be the single most important category of state takeover laws: the non-shareholder constituency statutes.

These statutes come in various forms; some have more bells and whistles than others, but when you strip them down to their common component, they all share a single feature: they permit boards of directors, when making corporate decisions, to consider the effects of the decision on various non-shareholder constituencies. These so-called stakeholders typically include employees, customers, creditors, suppliers, and the like.

As Henry suggested, non-shareholder constituency statutes have profound implications for corporate governance, the structure of corporate law, and the societal role of corporate takeovers. As such, whether the statutes represent sound social policy is a critical question, but you will be relieved to know that it's not the one I'm going to talk about today. As the academic on the panel, I thought it would be appropriate for me to talk about some very practical issues.

These statutes are now on the books in over half the states. Twenty-eight to be precise, the last time I counted, but that was a couple months ago and there may have been some more since then. In any case, none of these statutes is likely to be repealed any time soon. Unfortunately, the statutes raise almost as many questions as they answer. We rather urgently need an interpretation of the statutes that resolves some of these issues.

While my article in the symposium issue will describe the statutes' implications for a variety of corporate transactions, my remarks today will focus on their role in hostile takeovers because it's here that they present the most interesting and challenging questions. Consider then the following scenario, one we all came to know and love in the '80s, but have not seen in a while: Bidder Co. makes an unsolicited tender offer for Target Co. at a substantial premium over market. Bidder's state and federal disclosure documents indicate that the bid will be highly leveraged. Bidder also intends to close two of Target's U.S. plants and open new plants abroad. Target's board of directors rejects the bid, arguing that the detrimental impact on the Target's employees and creditors will outweigh whatever gains the shareholders are going to reap. The board puts teeth into their decision by adopting a poison pill and the usual other defenses.

The board's decision is problematic at best under Delaware law. Delaware expressly forbids management from protecting stakeholders at the shareholders' expense. Rather, anything the directors do to make stakeholders better off also must shareholders better off.

The non-shareholder constituency statutes clearly reject that approach. Let me suggest that there are two plausible extreme interpretations of the statute. One is that they permit directors to disregard shareholder interests entirely. This seems an unlikely interpretation. For one thing, it's contrary to the statutory language. In many states, the statutes expressly require the board to consider shareholder interests. In many other states, the statute at least implicitly requires the board to consider shareholder interests. Moreover, an interpretation that permits the board to totally disregard shareholder interests would be contrary to some of the received norms of corporate law that Henry talked about. In particular, the basic goals of management accountability and shareholder wealth maximization would be called into question. It's unlikely that the legislatures would have rejected—notice I use the word rejected—these basic norms—assuming they knew what they were doing, which at least in Illinois is an assumption that one makes at one's own risk—without doing so more explicitly.

At the other extreme is an interpretation under which these statutes merely codify the existing common law rules, by which most people mean the existing Delaware rules. This interpretation also seems unlikely. Why would twenty-eight legislatures have bothered to adopt these statutes if they did nothing? Moreover, consider the context in which these statutes were adopted. While most apply to all corporate decisions, they were all adopted in the context of an ongoing takeover fight. Clearly, they were intended to make takeovers harder. Well, how do we do that? By modifying the shareholder wealth maximization norm just enough to permit directors to make trade-offs between shareholder and stakeholder interests.

Indeed, this trade-off interpretation is effectively mandated by the statutory language: the right to consider non-shareholder interests is of little utility if you can't act to protect them. In other words, what the statutes do is to permit the board to say, "We're going to take a reduction in shareholder welfare because that will permit us to capture greater gains for stakeholders."

Having said that, most of the statutes simply do not address the critical question of how courts should review a board of director decision that is supposedly premised on a concern for non-shareholder constituents. This omission is especially troubling given the nature of the transaction in question. In my scenario, Target's board of directors may have been legitimately concerned for their workers and employees. But they may also have been worried about their own positions. The conflict of interest faced by Target's board of directors in this situation is too well-established, and too well-documented, to need elaboration here. Suffice it to say that there's good reason to be suspicious when management claims to be acting in the best interests of either the shareholders or the stakeholders.

My point is not that Target directors have no role to play in corporate takeovers or that Target directors should ignore stakeholder interests. Whatever the theoretical merits of such an approach, the non-shareholder constituency statutes plainly do not allow it. At the same time, however, everything we know about the legislative history of the statutes suggests that the drafters—and by drafters I mean the legislators who adopted the legislation, not the corporate lawyers who wrote it—did not intend to provide a cloak behind which selfish director behavior can escape scrutiny. We see this, for example, in the legislative history of the Pennsylvania statute, where the question was explicitly asked, "Won't this let directors protect themselves?" and the answer by bill's sponsor was no. So if we take the legislators at their word, courts need to come up with an interpretation that permits us to distinguish legitimate concern for stakeholders—what the statute allows—from false concern motivated by self-interest—which the statute does not, or at least should not, allow.

Happily, such a mechanism is close at hand; namely, a modified version of the *Unocal* rule to which Henry referred earlier. Recall that in *Unocal v. Mesa Petroleum* the Delaware Supreme Court adopted a two-pronged standard for reviewing takeover defenses. First, the board must show that they had reasonable grounds for believing that there was a threat to the corporation or its shareholders. Secondly, the directors must show that the defense they adopted was reasonable in relationship to that threat. Only if they satisfy both prongs of the test do they get the protections of the business judgment rule.

I propose that courts modify the *Unocal* standard for use as a mechanism to review director action under a non-shareholder constituency statute. Under the first prong, the directors must show that they reasonably believed the bid poses a threat to non-shareholder interests. Obviously that task should not prove too difficult. In the scenario I painted earlier, for example, they can point to plant closings, with resulting layoffs, and the highly leveraged nature of the bid, with in all likelihood subsequent downgrading of the firm's pre-existing debt.

The second prong is a requirement of proportionality between the threat the board identifies and the board's response. Specifically, the board must show that the defense is reasonable in relationship to the threat to non-shareholder constituencies. This prong is the critical one if we are going to control management behavior. Absent an effective proportionality standard, any threat to non-shareholder interests, no matter how mild or how insignificant, would permit bid preclusive defenses.

Under this approach, management does not have unbridled discretion to disregard shareholder interests in the face of a threat to non-shareholder interests. Rather, in making the trade-offs the statute permits, the board must minimize the impact of their decision on the shareholders. In other words, their decision must impose no greater burden on the shareholders than is necessary to protect the non-shareholder constituencies. If the court finds that less restrictive measures would have adequately protected the non-shareholder interests at stake, the defense should be invalidated.

Some will object, I suspect, that courts rarely engage in this sort of substantive review of board decisions. And that's true, but so what? Judges are not doctors, but they review medical decisions every day. Judges are not engineers, but that certainly doesn't preclude design defect litigation. The traditional justification of the business judgment rule, that judges are not business experts, thus simply makes no sense. There are good and sufficient prudential reasons, I believe, for the business judgment rule, but not all board decisions should be exempt from review. In cases like this one, where the conflict of interest is so pronounced, strict judicial scrutiny of the board's conduct seems perfectly appropriate, as demonstrated by cases like *Unocal* and *Revlon*.

In any case, judicial review under my proposal can focus mainly on questions of process, which are well within the courts' traditional competence. In conducting proportionality review, then, a court should closely scrutinize management's arguments. For example, when did the board know about the threat? When did they consider the threat? Was it at the time they decided to resist the bid, or is the threat really an *ex post facto* justification for their decision? The court also should consider the history of the firm's treatment of its non-shareholder constituencies. A long history of concern for stakeholders lowers the likelihood that the board is now cobbling together an argument out of whole cloth.

An effective proportionality standard will not only help detect and punish management misconduct, but should also give management incentives not to cheat in the first place. Dishonest management, if they have to meet this proportionality standard, will find it difficult to construct a plausible story of non-shareholder injury. It will be difficult for dishonest management to find experts who can credibly support their story. Indeed, stakeholders themselves may decline to support a dishonest management story. Independent directors may be unwilling to risk the reputational injury and litigation that would result from supporting a false story. And, finally, of course, the hostile bidder will be seeking to rebut management's story and perhaps seeking to recruit stakeholder support.

In conclusion, the test I've proposed will deter management misconduct, but more important, will give management incentives to determine whether or not stakeholder and shareholder interests in fact diverge. The model I've set forth today thus gives directors incentives to act in precisely the manner that the statute's drafters claimed to envision: as leaders of the corporate community, balancing the interests of all of their constituencies. Thank you.

HENRY LESSER

Thank you very much, Steve. Before I ask Ken to make his "nonremarks," let me just say that one of the states that does not have a non-shareholder constituency statute is the great state of California. We almost had one three or four years ago, SB 503, which would have said, in typical California broad-brush style, something broader than any statute I think Steve has reviewed, that the directors may consider and act in the public interest in any decision that they make. The state bar corporations committee would have written an incredibly effective letter authored by I wonder whom but the letter was so effective that without ever having to be written, the bill was abandoned. That's not to say that we might not have one in the future, and so you should keep a watch for what goes on in Sacramento these days.

KENNETH LEHMAN

Against the backdrop of Henry's grand new corporate order, I'm here to discuss some tinkering. At the outset, I'd like to emphasize that I am here as an independent commentator; the views I express are my own and not necessarily those of the Commission. I do not represent the Commission, and as a matter of policy, the SEC disclaims responsibility for the private statements of any of its employees. I should also point out that I haven't been involved in the Commission's rule-making proceedings in the area of proxy rule revision.

I'm going to be looking at federal securityholder communication rules, as affected by the recent tremendous increase in institution, including pension fund, ownership of publicly traded equities. I will sprint through the current rules in a few minutes and then try to distinguish two basic types of securityholders: average securityholders, and control securityholders and management. Then I'll try to fold in the new pension fund shareholders that we're seeing a lot more of these days. Finally, I will propose a few revisions in this area.

The first question that comes up in this area, from a practical standpoint, is when does the solicitation occur? For example, when shareholders communicate, at what point do their communications change from a mere discussion of the performance of their securities' corporate boards to solicitation of support for proposed changes in the corporate board? In this context, I will discuss the tension that arises in terms of advocacy or preliminary testing the water types of communications. The seminal case in the area is *SEC v. Okin*, a 1943 case which considered communications that were part of a continuous plan that was to end in a solicitation and which prepared the way for its success. The importance of *Okin* is that it held that a solicitation occurs very much earlier than most people had thought; in fact it occurs in the early policy-formulation stages.

Jumping from 1943 to the present, the recent cases in this area have been particularly unhelpful. Some cases say that a solicitation occurs where there are attempts to influence shareholder opinion. The Commission's rules, on the other hand, are very arbitrary and technical, but at least they're usually very clear.

First of all, there are two safe harbors in the case of a solicitation. Solicitations of fewer than ten shareholders don't need to comply with the Commission's solicitation rules, and second, there is an exemption for the furnishing of proxy voting advice by a financial advisor to persons with whom the advisor has a prior business relationship.

If there is a solicitation, then two primary rules kick in. The first one is what I will refer to as the contemporaneous requirement, which requires that, with two exceptions, a solicitor provide information specified in Schedule 14(a) to those to whom he solicits, and that he file this information a few days before he uses it. The two exceptions are for "stop, look and listen" material, in the case of election contests, and second for preemptive solicitations by an opposing party in non-election situations. These communications alert securityholders that a solicitation is imminent and tell them of matters that are to be addressed.

The information that must ultimately be provided I'll refer to as Schedule 14 information. The amount of information required by Schedule 14A depends on the scope of the matters for which securityholders' proxies are being solicited. Schedule 14A requires general information about the date, time and place of the meeting, revocability of the proxy, dissenters' rights of appraisal, and identification of the person making the solicitation and his interest in the transaction concerning which he is soliciting. In the case of mergers, consolidations, and acquisitions and similar transaction, Schedule 14A will require historic and pro forma financial information.

So, to step back and look at the practical consequence of the rules we've just talked about: when more than eleven shareholders begin talking among themselves, their communications are likely to be deemed solicitations quite early in the dialogue. At that point shareholders must break off all communication unless they gather Schedule 14A information, prefile it with the Commission (as we'll discuss) and present it to the ten other shareholders who are engaged in the discussions.[1]

The second requirement that kicks in upon a solicitation is the prefiling requirement; the initial solicitation generally needs to be accompanied by Schedule 14A information that was prefiled. Schedule 14A information usually must be filed with the Commission ten days before it is given to securityholders in the initial solicitation. The "stop, look and listen" material that I referred to earlier has to be prefiled five days; additional material has to be filed for two days before it's used; and speeches, press releases and scripts must be mailed to the Commission on the day on which they are used.

The exception in this area is for "plain vanilla" proxy statements. Plain vanilla proxy statements are basically proxy statements that don't cover much more than the company's slate of directors that will be voted on at the annual meeting, as well as shareholder proposals required to be in the proxy statement under 14(a)(8). Interestingly, management is able to use the plain vanilla exception even if it lobbies against the shareholders' proposal.

Now I am going to try to distinguish two types of shareholders that are affected by these rules. In the early 1900s, Berle and Means suggested that in the modern corporation, as voting power becomes dispersed, control is consolidated in the hands of management. After a while, management alone controls the corporation. On the other hand, many corporations have not evolved into the Berle and Means model of the modern corporation, and in these corporations large shareholders continue to exert influence over the corporation. Under both of these models, small shareholders are disenfranchised in favor of either large shareholders or management.

The manner in which small shareholders can benefit from owning securities is through marginal increases in the value of their shares. Small shareholders generally will be unable to communicate to bring

1. In this context, the Commission's "group" rules may be even more oppressive than the solicitation rules.

about this effect because the costs of communicating will bring about only a small increase for them since they own a small number of shares. For this reason, small securityholders generally will not communicate. On the other hand, large shareholders, including management, are able to engage in activities that benefit them more than just by the marginal increase in the value of the shares. For example, control shareholders can engage in roll-ups, merger transactions, self-dealing transactions, green mail and that sort of thing. These activities will frequently harm individual shareholders.

Under this model, control shareholders and management have a great deal to gain by communicating. Average shareholders, however, have an interest in restrictive securityholder communication rules; they are not going to communicate themselves, and so they want the rules to be restrictive so that large shareholders who do communicate will be limited in their ability to engage in control activities or otherwise act in a manner that harms the individual shareholders.

Along with the two basic types of shareholders I've identified, we've recently seen a third: pension funds. Commentators estimate that up to thirty percent of all public equity is held by pension funds. Pension funds have the resources of control shareholders, and are likely to engage in shareholder activism. But unlike control shareholders, this activism will frequently benefit average shareholders. Pension funds are not able to engage in control transactions because of general trust restrictions, state fiduciary laws, and the portfolio theory. Rather, like average shareholders, they benefit from marginal increases in the value of the securities that they hold. Their communications and activism will have a goal of increasing the value of each individual share; and to the extent that this goal is realized, average shareholders benefit.

One of the primary types of communications that pension funds will make and that is likely to benefit average shareholders is the preliminary testing the waters that I talked about earlier. These preliminary conversations will probe to determine mutual interests. As I discussed, in a lot of cases average shareholders and pension funds will have common interests. Further, the polled parties will often have suggestions that may be incorporated into the ultimate solicitation by the person who is conducting the preliminary communications. Moreover, those who are going to engage in control activities frequently will not use this type of preliminary conversation; it's pointless to poll other shareholders to get their view on a control transaction that will only benefit the polling party. Of course, there are control blocks of shareholders, but typically these are going to be smaller than eleven, and they already have the benefit of the ten-person exemption from the communication rules.

In my view, the courts and the Commission should foster these preliminary communications and still protect average shareholders. They can do this by focusing on the individual who was solicited rather than the individual who solicits, or even the content of the communication; after all, the primary purpose of the communication rules is to protect the individual who was solicited. I join others in proposing that the Commission exempt solicitations of only sophisticated investors. If they're sophisticated, they probably already have the Schedule 14A information; if they don't have it, they will require it before they will execute a proxy. Second, the Commission should expand the ten-person safe harbor to fifty shareholders; this would encourage preliminary testing the waters among persons who have the same sort of interest in increasing the marginal value of shares.

Third, the Commission should revisit the contemporaneous requirement in the context of preliminary communications, or in this case, communications that occur prior to thirty days before the shareholders' meeting or the final date for the receipt of consents. These rules should be relaxed for three reasons. First, as commentators point out, requiring Schedule 14A information so early in the course of what eventually may turn out to be a solicitation requires great expense very early on, and discourages preliminary discussions among shareholders who have a common interest in increasing corporate performance. Second, it ignores the reality that opposing parties are likely to point out inconsistencies; although opposing parties won't have the Schedule 14A information against which to compare the solicitation as it occurs, they will probably eventually get it. Under the rules that I'm proposing, they'll eventually be able to compare inconsistencies and point them out in solicitations in opposition. Finally, when combined with the preclearance requirement, the contemporaneous requirement prevents timely solicitations in opposition. For example, management generally under state law must mail their proxy statements only ten or twenty days before the meeting to which it relates. If management prefiles their materials in non-public form, anyone opposing the solicitation has a very short time in which to formulate their own opinions, prepare a proxy statement that complies with Schedule 14A, file the proxy statement and wait up to ten days before soliciting in support of their own proposal. My proposal would be to free communications from having to be accompanied by Schedule 14A information. If the communicator wants to give the proxy card, however, he could do so only if it is accompanied by Schedule 14A information.[2] If he wants to communicate within the thirty days, he would also have to provide Schedule 14A information.

The final proposal that I would put forth today is in preclearance area. As we talked about, generally proxy materials need to be filed ten, five, or two days before they're used. We talked about the delay in the case of management's filing and then going out with the material a very short period of time before the annual meeting. Also, a number of commentators argue that the preclearance requirement is a violation of the First Amendment, because it's a more extensive restriction than necessary. And finally, the preclearance requirement results in a number of inequities, particularly where management is able to mail their plain vanilla without prefiling, even if dissidents have said or indicated that they intend to run their own slate. If management does not refer to that slate, they are able to mail their own materials without prefiling, whereas the dissidents must prefile their 14A information and wait ten days. And finally, in the plain vanilla proxy statement, management is also able to comment on shareholders 14(a)(8) proposals that are included in the plain vanilla materials, and shareholders who would like to solicit in support of that shareholder proposal have to prefile, so it is kind of an inequity in that situation.

To address these problems with preclearance, I would propose that only the 14A information be precleared, and that in the case of management, the prefiling be for ten days but the material would be public upon filing. This would give dissidents a number of days to look at the material before finally filing their own pieces. Dissidents would only be under an obligation to prefile for five days, which would give dissidents and management the opportunity to mail on the same day.

The Commission's proxy rules are basically fair and evenhanded. But the presence of pension funds that will police the markets for the benefit of the average shareholders makes some of the restrictions obsolete. Hopefully, the Commission's recent activity in this area will result in some loosening of these rules, to the benefit of average shareholders.

HENRY LESSER

Thank you very much, Ken. Before we take just a couple of ques-

2. The Commission's proposed rules have a similar requirement.

tions . . . we are running late, but this is hopefully an interesting topic . . . let me just make a couple of observations about what Ken said in supplementing them.

First, his proposal would focus on the nature of the recipient of the solicitation; the Commission's June 1991 proposal would focus on the nature of the soliciting party, and would have adopted, and I think will be re-proposed to adopt, some concept whereby disinterested persons as solicitors would be exempt. Disinterested persons would be defined to mean people who are not management and do not have certain enumerated financial interests in the solicitation. So, Ken as an individual would focus on the opposite end of the spectrum, so to speak, from what the Commission would. By the way, in an hour now you've heard Steve make a concrete proposal for how non-shareholder constituency statutes should be interpreted, Ken make some very interesting individual proposals about the proxy rules, and me suggesting we tear up the corporate laws and start all over again, so don't say you didn't get some unusual and possible even heretical thoughts here. The other thing I wanted to mention that I know, from speaking to Ken ahead of time, he was a little leery about getting into in his non-individual capacity, was—and you really should focus on this—that at a press conference (not this past Thursday, but the Thursday before, the week before last), Chairman Breeden unveiled his eagerly awaited Commission initiatives in the area specifically of executive compensation that I alluded to earlier, and there are three parts to it and they're extremely important, so I just want to very briefly mention them to you and alert them to you. There's not written texts yet available.

First, it is going to be a lot easier for shareholders, under the Rule 14(a)(8) guidelines that Ken referred to, to be allowed to get into management's proxy materials proposals that deal with executive compensation review by shareholders, so long as those proposals are put forward by a shareholder who is otherwise eligible for a 14(a)(8) proposal, which is basically dependent upon how much shares you own, how long you've owned them, and the size of the proposal, the number of words in the proposal. It'll be easier to do that provided the proposal is precatory in nature, i.e., is advisory and not binding on the Board. This reverses an extremely longstanding position of the staff that proposals relating to executive compensation are within the "ordinary business of the corporation" exception of Rule 14(a)(8), (c)(7). That position has been taken in letters that have been mailed out to ten public companies that had received such proposals and had sought to get the SEC's permission to omit them for the 1992 proxy season. Those letters reversed that position, those companies are now stuck, they can't omit them, and this will probably open the floodgates.

Secondly, the commission, when it comes back out with its new, revised proxy reform proposals, is going to include a fairly controversial idea for a table that values non-cash compensation, under a formula yet to be unveiled, and to include a chart that compares corporate performance over a three-year period to chief executive pay over the same three-year period, on what some would say is a simplistic notion, but I don't want to be editorializing here—some would say that you can draw meaningful inferences from that kind of a comparison.

Thirdly, the SEC has asked its new chief accountant to work with the financial accounting standards board, and report back within 120 days to the commission chairman his conclusions with respect to whether or not the present accounting treatment of stock options is appropriate. Under the present accounting treatment, if a stock option is granted to an executive, and the exercise price of that option is at least equal to the market price of the stock on the date the option is granted, the issuing company does not have to take any charge against its earnings, notwithstanding the fact that if the stock price of this stock increases, and the option becomes exercisable and is likely exercised, that the company will in fact then at that point be issuing below-market-price stock. If, in fact, the chief accountant recommends, and the SEC adopts, a rule that companies granting market price or above options will take a hit to earnings on the date that they grant the option, stock options will, I suspect, very largely, not exclusively, but very largely become a thing of the past, and Chairman Breeden has indicated he wants to be cautious because he recognizes just how significant that could be, especially since the shareholder activists want management to have a larger stock-related incentive compensation, not smaller. So, look out for these three initiatives and how they're written up; they're very significant.

STEPHEN BAINBRIDGE

First, I think that Ken's proposal is very interesting, and perhaps more practical than the SEC's own suggestions in this area. Let me suggest, however, that proxy reform is much ado about nothing. I am very skeptical of the extent to which pension funds are going to become active corporate governance players. In addition to significant communication costs, there are a host of other costs that pension funds face in participating in corporate governance, such as informational asymmetries between management and shareholders, coordination and collective action problems, free riding problems and the like, that will affect the ability of pension funds to participate actively in corporate governance. The political process is also likely to constrain pension fund activism, especially for public funds. The same corporate managers who got state takeover laws passed, after all, will be able to get state politicians to pressure public pension funds.

Second, with regard to executive compensation, if any of you are representing clients who receive a Rule 14a-8 proposal dealing with executive compensation, let me urge you to challenge the validity of Rule 14a-8. I can't imagine anybody will actually do this, but the *Business Roundtable* case opens the door for a challenge to the SEC's authority to adopt Rule 14a-8. In particular, the Commission's recent 14a-8 decisions in the area of executive compensation mark what I regard as a substantial and unwarranted intrusion into corporate governance areas that *Business Roundtable* teaches are a matter for state law.

HENRY LESSER

Well, I think that that is an issue we're going to have to watch. Clearly the Commission has sought to address this by disclosure; in other words, its rationale is, 'Let's at least let the shareholders get these things on the ballot.' It is not purporting, and I think there would be an even more serious *SEC v. Business Round Table* issue if it were purporting, to actually cap executive compensation. Dan Rostenkowski, among others, is talking about legislation to actually cap executive compensation by eliminating the deductibility for tax purposes of compensation paid to senior executives above a certain level; Congressman Szabo has a proposal that if the top person in the corporation earns more than 25 times what the bottom person in the corporation earns, that excess above the 25 times will not be deductible. Rostenkowski would do it with I think a flat one million dollars, which is probably more generous than some would like. This is an example of the explosive nature of what we're dealing with here. Do we have any questions before lunch? At the back there.

Audience Question

Yes. This is on corporate governance, and I was directing it toward Mr. Lesser. My question is whether the institutionalization of the stock market that you talk about which is a big trend and you can see it in the way that the corporate trading was around the stock market . . . is cause for shareholders and corporations to become activist, that's the first part; and then, if that's the case, because institutions have been somewhat muted by SEC rules, and all these billions of dollars of funds of individual investors are buried in these pension funds, insurance funds . . . since the institutions are not allowed to be activist, people that have all those funds in these are sort of unrepresented and that allows the boards to become more activist, and that's sort of the two trends you talk about in your section, they go hand in hand. What kind of laws can be created to allow the individual investors to have as much say as shareholders?

HENRY LESSER

Well, that's a very meaty, three-part question that none of us could possibly do justice to, and I think my paper attempts to deal with some of it. Let me just address one part of it to try to correct a misconception.

Ken is not saying, and nor are any of us saying, that institutions are not allowed to be activist. On the contrary, they are. In our own great state, if you look at what CalPERS is, they are the ultimate activist institutional shareholder, until this year, when in a kinder, gentler mode, they've abandoned the program of pursuing shareholder proposals under 14(a)(8) in favor of a different and more effective form of activism, which is calling the chairman of IBM or the chairman of Apple Computer, and sitting down with him and saying, "Now what are you going to do for me?" That's all going on behind closed doors. Shareholders are allowed to be activist, they are allowed to introduce proposals, they are allowed if they have the money to pay for their own shareholder solicitations; what they're not allowed to do, or what is restricted, is (a) solicitation as defined without compliance with the federal rules governing solicitation, and (b) concerted activity among shareholders who in the aggregate own five percent or more of the stock without filing a Schedule 13D, which discloses exactly what they're doing. So there are some limits. There have been some limits on the books for a long time that have facilitated shareholder activism, and the first part of your question to do with whether shareholder activism has made it easier for boards to be proactive, the axiom that Steve and I have referred to—he calls it a norm and I call it an axiom of corporate governance—has encouraged Board activism for a long time; if anything, institutional investor activism has been somewhat of a curb on Board activism rather than a catalyst to it. Steve, do you want to comment?

Audience Comment

I disagree that the rules facilitate shareholder activism, or that they're fair or evenhanded. [In the case of] individual shareholders in the smaller 12G company who want to do something, possibly a single-issue campaign, these rules exert a tremendous chilling effect on exercise of First Amendment rights, and I really think that people on the commission staff should read the First Amendment and maybe some of Hugo Black's writings on the First Amendment. Free speech means free speech. I've been involved in several shareholder organization efforts, and the rules are pro-management all the way down the line when you're in that position.

HENRY LESSER

Comment on that?

STEPHEN BAINBRIDGE

To respond flippantly, I wonder where the SEC appears in the Constitution. In addition to the First Amendment issue you raise, which has been hanging out there for a long time, there is also still the question of whether the independent agencies have any constitutional basis. So I think you raise a very valid point.

HENRY LESSER

Every one of these I chair ends up with a Commission-bashing approach, and since we're very, very pleased to have three members of the staff—two come from D.C., one is in an individual capacity here today—I think that we should all go and eat the attractive-looking chocolate cake that I saw out in the cafeteria before we engage in any more bashing.

PANEL THREE

PANELISTS:

ROSALIND TYSON, ASSISTANT REGIONAL ADMINISTRATOR, SECURITIES AND EXCHANGE COMMISSION, LOS ANGELES

JOHN MAGUIRE, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, D.C.

BRYANT EDWARDS, PARTNER, LATHAM & WATKINS, LOS ANGELES

ROSALIND TYSON

Let me say that I am delighted to be here. Just a reminder that both myself and John Maguire want to join in the disclaimer that Ken Lehman gave earlier, that we are not here as representatives of that most beloved of institutions, we are here as individuals. I will be talking about the investment advisory industry. My job in the regional office is to manage the examination and regulation staff, and part of our job is to examine the mutual funds headquartered here, and the money managers and advisors headquartered in our region. The investment industry has grown tremendously over the past ten years and has posed a serious resource allocation dilemma for the Securities and Exchange Commission. I will outline a few proposals that the Chairman of the SEC, Chairman Breeden, outlined last Thursday in his testimony before Congress that would help remedy the dilemma that we see in regulating advisors.

First of all, in general the Investment Advisors Act of 1940 defines an investment advisor as any firm or individual who, for compensation, is engaged in the business of providing advice to others about securities or who issues reports or analyses about securities. This definition covers a broad range of registrants from individual financial planners who prepare investment strategies on a fee-only basis, to financial planners who are dually registered as brokers, who receive their compensation mainly from selling products which they have in their drawer, or from a broader range of products. It covers business managers, large and small; money managers; mutual fund switch timers; it is a very diverse industry. There are currently 17,500 registered investment advisors. There is another universe out there, some commentators believe, of financial planners who in fact do give advice about securities and who technically should be registered, who are not. Some people have put that number at 20,000 to

30,000 additional people. Of the 17,000 registrants we have now across the country, 3,000 of them are in the region in which I carry out my duties. This, in 1991, represents a 12,000 percent increase over the population of registrants only ten years ago. In 1981, there were 5,000 registrants, as opposed to 17,000 today. In 1981, there was 450 billion dollars under management by registrants; today that number has exploded to 5.4 trillion dollars. That includes one and a half trillion dollars of investment company assets, as well as money outside investment companies.

Now, when you look at the segments of the industry that need to be regulated, it's important to remember that approximately fifty percent of the 17,000 registrants have only one employee, and have no assets under management. Those are the financial planners. Of the 17,500 registrants, a small number relatively speaking, eight hundred fifty registered advisors, have any substantial amount of assets under management. Eight hundred fifty registrants have at least half a billion dollars under management. Nevertheless, for the SEC to try to inspect even those is a stretch of the resources that we have. The current program under the Investment Advisors Act of 1940 for regulating this industry provides simply for a $150 fee to register . . . it's the last thing you can be for a hundred and fifty dollars. The registration form that you fill out and send in to the SEC automatically becomes effective in 45 days, unless we take action to stop it. The program next envisions that there will be periodic inspections by SEC examiners. However, therein lies the dilemma: the SEC staff responsible for examining advisors has not kept pace with the explosive growth of the investment advisor industry. In 1981, there were thirty-six nationwide staff years devoted to inspecting advisors, in 1991, forty-six, an increase of twenty-eight percent over ten years, as opposed to the industry growth of 12,000 percent in assets under management. This obviously poses a serious under-inspection problem. The general accounting office, the GAO, did a study at Congress' request, and issued a report in June of 1990. The title says it all: *Current Level of Oversight Puts Investors at Risk.* They went around to several offices, regional offices, ours included, and counted up how many advisors there were and how long had it been since we'd been in there to do an inspection, how we structured our program, etc., and they found that at that time, under the program we were operating under, it was at least twelve years, or an average of twelve years between inspections for advisors, which meant that many were never inspected at all. Rather than examine a mix of two hundred fifty money managers and financial planners in the Los Angeles region every year, which was a losing battle anyway since more registered every year than we could examine, we have shifted our focus to examining advisors with the most assets under management, and those who have discretionary power or custody in possession of investor assets. That allows us to inspect a large percentage of assets under management. While only three percent of advisors were inspected last year, thirty percent of the assets under management were managed by those advisors, so that over a three-year period, the plan is to have actually covered almost ninety percent of the assets under management through our program. Unfortunately that leaves us, for the rest of the advisors, with a thirty-year time span between exams. There are no resources left over to go and examine financial planners. That is regrettable, and investors are at risk, because as the GAO study has pointed out, and as Chairman Breeden has pointed out, as well as numerous others, when investors see that their advisor is registered with the SEC, they envision a number of things. Perhaps investors believe that these advisers are being inspected, that they have some competence, or that they have met some qualification requirements, and perhaps none of those are true. There is a high-profile case which we have recently brought in the Los Angeles regional office; I know at least one person in the audience who's intensely interested in it, as I am. This is the Steven Wymer case: Institutional Treasury Management. Here was an advisor who, over the period of about five years, had gone from managing almost no assets to managing 1.2 billion dollars of assets, all from small municipalities or from pooled trusts of small municipalities. Wymer's niche was that he would take investors' surplus funds, their payroll funds, their cemetery management funds, or whatever, and invest them in government treasury securities, and get them a one to two percent higher return than they could get anywhere else. However, we discovered that about a hundred million dollars was not there. Right at the moment, we have a staff of examiners from our office locked in a room in the Federal Building downtown with one hundred and fifty boxes of documents, and some more documents they're collecting from the broker in New York, trying to figure out where the money went. We hope we'll see them back in the office one of these days, but this is definitely a gargantuan project. The fraud tells us about what can happen, and why additional scrutiny is probably justified in this investment advisory industry. I'll spend just a few more minutes telling you about the case, because it's sort of an amazing story. Steven Wymer, by the way, was indicted January 2nd on thirty counts of fraud; he is currently out on bail with an electronic surveillance bracelet on his ankle, and can't be more than one hundred fifty feet away from his phone, except to visit his attorney or go to church. Federal prosecutors have confiscated about 15 million dollars of assets of his, including thirteen cars, four homes, several other properties, four boats, the list goes on. But that is a drop in the bucket of the 100 million dollars that is missing.

To our credit, our staff actually found this fraud before it collapsed of its own weight. No one tipped us off that this particular fraud existed. We did have a complaint letter asking about the risk involved in options for Marshalltown, Iowa. This advisor was trading options for Marshalltown, Iowa, and the complainant questioned whether options were actually an authorized investment for the city. We went and did a "cause" exam of the advisor, and it took us a little while, because we were initially focusing of course on "What's the options trading going on here, and is it authorized by the city?" However, we did not stop there, and we did eventually do some additional checking. We went directly to the broker, we got the trading record, and compared it to the account statement that Steven Wymer was sending to the City of Marshalltown, which showed that they had a cash balance of six million dollars at Refco, plus three million dollars in treasury securities, and that they were doing one to two options trades a month that were nicely profitable for the city. Wymer was making a performance-based fee: thirty percent of any profits that Marshalltown made would go to Wymer. When we compared this scenario that Wymer was presenting to Marshalltown with the actual brokerage records, we found a vastly different story. We found that there was a total of about $100,000 in the account, not the six million in cash and securities. We found that there had been hundreds of bond trades over a several-month period, none of which had been disclosed to Marshalltown, and which cumulatively were losing money. Anyway, that caused us to get a temporary restraining order and asset freeze all of Wymer's client money. So for about ten days, there was a temporary receiver appointed, and we were sitting on 1.2 billion dollars in assets of people who wanted their money. That was quite a lot of pressure, and basically what the receiver did was to count up the money that was in the accounts and look at what clients thought they had, and what the custodians actually had. In fact, most of the money was there. There was only 100 million missing. The 100 million missing was primarily or almost exclusively from twelve municipal accounts who had no formal custodian agreement, who had permitted the broker to send account statements directly to Wymer, not directly to the customer. They depended totally on Wymer for all of their information, and of course, he took their money. Now, the receiver released the money to the other accounts, where there was money, with the understanding or with the express statement that, their getting the money was without prejudice to any claims that the SEC or other clients of Wymer might have. We are presently now in the disgorgement phase of the SEC's proceeding. We obtained a permanent injunction against Wymer earlier this month, and we are now looking at coming up with a figure for disgorgement or penalties against Wymer, which is why we have these six people downtown with one hundred and fifty boxes of documents and six computers. But we're attempting to discover whether, possibly, the money from the Refco account customers was put into other client accounts to make up, possibly, trading profits which he actually couldn't deliver, but which he had promised to all of his clients. So we're going to be working on that for awhile, and the U.S. Attorney will also be proceeding with the criminal case at the same time.

The fact that this type of large-scale fraud even exists is, I think, an important argument that we try to find some better solution for examining advisors than we have found so far. Several solutions have been proposed; one in the past was that the SEC exempt small advisors from federal regulation and registration, and let the states take over. That proposal did not meet with a lot of success. States were responding that they did not have the resources to examine all of these small advisors either. Another proposal several years ago that the SEC made to Congress was that Congress establish a self-regulatory organization for this industry, as broker/dealers have the National Association of Securities Dealers. There is no corresponding SRO for this industry, and the NASD was willing to take on this task. The SRO proposal, which would have required Congressional action, did not proceed. Several objections were made, not the least of which was that this would add another layer of cost and bureaucracy to the system that was not necessary. Many people or some people felt that perhaps the SEC should do the examining, and might be able to do it more cost effectively. Last Thursday, February 20, Chairman Breeden presented a proposal to Congress, again for Congressional action, which would impose a fee, an annual fee, on every registrant, ranging from a small fee of $300 per year for eighty percent of the advisors, up to a maximum of about $7,000 a year for those who have five billion or more under management. This fee, according to the staff's calculations, would net us an amount which would permit us to examine all registrants: the biggest ones, every three years, and everyone else, once every five years, so that we would have some reasonable cycle of exams, and have a source of funding to do it. The fees would go into a trust fund, which would be used by the SEC for this program. I think that that sounds like a great idea, but it requires congressional action in an election year, so we'll have to see what happens. I think I'd better keep my remarks brief; I'm probably already over my time.

JOHN MAGUIRE

Well, I think I'd like to continue with the SEC praising in my remarks as opposed to the bashing that occasionally goes on with respect to the commission. The remarks I'm going to be speaking on today, for my own purposes I find them very interesting and exciting, yet you may not because it doesn't impact your own practice. For my own purposes, it does impact it; I've been working in this area on rules and proposals for the last year and a half, so I've devoted a significant amount of time, both personal and Commission staff time as well.

The beginning of the final decade of this century has seen tremendous changes not only in the political environment in which we live, but also in the developing international environment which the U.S. capital markets operate. In my remarks this afternoon, I would briefly like to outline the developing international environment in which the U.S. capital markets operate, and what I believe is the Securities and Exchange Commission's response to the internationalization of the world's securities markets in the corporate finance area, which is the area that I work in.

For the past several years, the term "internationalization of the securities markets" is probably one of the most publicized and discussed financial trends in the United States; only to be superseded by the discussion that went on the previous panel; corporate governance now seems to take up a bit more time in the press than internationalization does. But during the '70s and '80s, the internationalization of the securities markets have been driven by what I believe are a number of factors. Many corporations sought to enter markets outside their home country, or state of incorporation, to compete in the global marketplace, in order to increase their market share, revenues and profits. But most importantly, technological advances have also provided a major thrust toward the internationalization of the markets. With technological advances, corporations have sought to increase their presence in these foreign markets, and investors, whether individuals or institutions that we've heard about today, have become acutely aware and interested in acquiring the securities of the most profitable enterprises in order to diversify their own portfolio investments. In many respects, the issues raised by the internationalization of the securities markets are the same for every market, regardless of size, complexity and volume. A market supervisory oversight in enforcement regulations, clearance and settlement systems, capital standards and, most important for purposes today, disclosure and financial reporting requirements, should be fundamental aspects of every market. Although the standards for governing these elementary requirements arise in different contexts, both established and emerging markets face the same questions: What trading, clearance and settlement systems, and reporting requirements will work most efficiently on a national and international foundation? What information should a bidder or an issuer be required to disclose? What are the common prerequisites that must exist in order to facilitate international transactions between issuers of different countries?

Both established and emerging markets also face broader questions. From my discussion, and my remarks today, though, the most important is how much or how little government regulation is appropriate or politically feasible with respect to the facilitation of international tender and exchange offers. No matter how much we would like to think that the political environment shouldn't play a role in the financial markets, it oftentimes does.

The last decade, more than any other time in the world's economic and financial history, has seen an explosive and dramatic growth in the internationalization of the world's securities markets. Securities markets around the world have become increasingly global as foreign investors expand their use of the U.S. capital markets, domestic issuers increase their use of the foreign markets themselves, and tender and exchange offers are made internationally. While at one time it was possible to discuss the U.S. capital markets from a predominately domestic vantage point, this is really no longer possible. And although I think most staff members at the Commission and persons that work in the financial community, or for the securities bar, would like to believe that the U.S. capital markets remain the largest, the fairest, and most innovative in the world, we must now recognize the driving force of international trends in the financial industry.

For example, in fiscal year 1990, thirty-three tender offers worth approximately $18 billion were commenced by foreign bidders in the United States for the securities of issuers registered with the Commission. U.S. investors purchased $130 billion in foreign equities in 1990, a more than tenfold increase over 1980. For the first nine months of 1991, U.S. investors made total net purchases of $25 billion. This amount is nearly double the previous record of $13 billion set in 1989. With net purchases in the third quarter, U.S. investors have extended their succession of adding to their overseas equity holdings to thirteen consecutive quarters. Aggregate holdings by U.S. persons of overseas stocks rose forty percent to almost $125 billion from $89 billion at the year-end of 1990.

The prospect of a unified European market this year has also led to a significant amount of multinational investing in acquisitions within the European community itself. In 1990, EC companies made themselves $51 billion in acquisitions of other EC companies. In the past, a significant majority of this activity was focused on the United Kingdom because of their capital markets being in a much more advanced stage than many of the other European countries, but other countries such as France and Germany have begun to increase their cross-border purchases versus prior years. For example, French companies in 1991 entered into two hundred twenty cross-border transactions throughout the EC worth $12.5 billion. In comparison, in the U.S. last year we only had about thirty tender offers made between U.S. companies.

So what does this hold for international tender and exchange offers? The Commission in the past has recognized that conflicting regulations of international tender and exchange offers is a significant and increasing problem. As noted above, as corporations become international in their operations and marketing, their security base in many instances has also become international in stature. A result of the globalization of the capital markets, and the desire to expand, is an increase in corporate acquisitions in order to accomplish the desired penetration into the foreign market. However, by penetrating a foreign market in this manner, a corporation necessarily implicates laws of more than one country because of the international shareholder base, and the foreign domicile of the target corporation.

The core of the problem is essentially the nature and the degree of the legal protection that should be afforded to security holders in international tender and exchange offers, at least from a regulatory standpoint. For most of the 20th century, international security regulation in general has been perceived as offering a different and less desirable form of protection due to the perceived lack of quality. While the United States has favored regulation emphasizing rules governing the securities distribution, trading processes and disclosure, most other countries, especially those in western Europe have endorsed rules regulating the organization of the corporation as opposed to the organization of the securities market. Securities regulation by the various international regulatory authorities in the '90s and beyond, I believe, will turn on answers to two significant questions.

First, how much and how quickly should the U.S. regulatory system change in response to the significant cross-border capital movements and the economic integration going on throughout the world at this time? And second, with regard to regulating international capital movements, and international transactions, what should the appropriate legal standard be: national treatment, reciprocity, or some other treatment?

As we all know, the securities regulation in the United States is conducted under laws that were promulgated in the early 1930s, with only minor amendments since that time. Historically, the U.S. capital markets have been viewed as self-contained and dominant, a view that today ignores reality. However, this historical view has fostered a belief that U.S. investors, wherever they may be, or wherever they may have invested, need the protections afforded by the federal securities laws. With this in mind, the starting point for any discussion on international tender and exchange offers is jurisdiction, and the extraterritorial application of the federal securities laws.

The territorial principle of jurisdiction provides that a state has the power to proscribe, adjudicate and enforce rules of law for the conduct that occurs within its own territory, essentially what is known as the "conducts test," or for conduct which occurs outside the territory, but which has effects within the territory, essentially what has become known as the "effects test." Jurisdiction, though, should be measured by its reasonableness in light of various factors, such as the party's contacts and links with the forum court, and their justified expectations. Unless this is the case, multinational corporations would be subject to potentially multiple conflicting rules of law. For my own purposes, with respect to the Williams Act, which is the area that I work in, and for that matter the anti-fraud provisions of the Exchange Act, which are probably the most important to international corporations, as applied to an international tender and exchange offer, the Commission has previously stated that jurisdiction will depend on the facts and circumstances of each case. It's not a very bright line test that people can go to the bank with . . . but it has been the Commission's view that if we do create a bright line test, because lawyers are creative, they'll create ways to get around that bright line test. The U.S. courts have backed up the Commission in most respects, and have found that jurisdiction over extraterritorial conduct in general by using the two previously stated standards, the conduct test and the effects test . . . in this way, the U.S. courts have given a broad interpretation to the jurisdictional provisions of the Exchange Act in order to "protect domestic investors [who] have purchased foreign securities on American exchanges, and to protect the domestic securities market from the effects of improper foreign transactions in American securities."

The Commission, however, in the past has recognized that the jurisdictional reach of the Williams Act is not unlimited. We like to think of ourselves as being astute, and in most instances have declined to require a number of corporations to make or extend the offer into the United States. In the context of the Securities Act, for registration of securities in an exchange offer, the Commission has since 1964 declined to exercise its regulatory authority and jurisdiction with respect to a securities distribution that is "affected in a manner abroad." Even where the federal securities law may have been triggered by the use of the jurisdictional means.

In order to clarify this extraterritorial reach of the securities act, the Commission recently adopted Regulation S, and in adopting the regulation, the Commission took a territorial approach to the enforcement of Section 5 of the Securities Act, by establishing a non-exclusive safe harbor for those parties that desire to make a transaction solely abroad. However, it should be noted that the Commission, in adopting the regulation, emphatically stated that this territorial approach would not affect the broad reach of the anti-fraud provisions of the federal securities laws.

In this context, the regulatory framework for the application of the Williams Act in international tender and exchange offers, which also was conceived primarily for domestic application, I believe should be understood in a similar fashion to the Commission's policy expressed in Regulation S. Consequently, when a foreign corporation extends a tender offer for the shares of another foreign entity, the applicability of the Williams Act should turn on the extent to which the conduct in question occurs, or affects the United States or U.S. investors. Thus a foreign bidder should be permitted to avoid the application of the federal securities laws if and only if permitted by the home jurisdiction, by tailoring the terms of the transaction to minimize its context with the United States which, for most of the late '80s and early '90s most corporations have done.

The way this has been accomplished is by ensuring that tender offer materials are not mailed to U.S. shareholders, or a U.S. shareholder is not allowed to use the instrumentalities of interstate commerce and mail the tender offer document back to the home jurisdiction of the target corporation, wherever that may be. In such a manner, a foreign bidder, by excluding U.S. persons, avoids the jurisdiction of the U.S. courts, but only so long as U.S. holdings of the target are not substantial.

I'd like to make the point that although this occurs often, from my own standpoint and I think from the Commission's, it's not a desirable result. Instead, the Commission during the '80s has essentially taken it upon itself to make a concerted effort to address the globalization and the integration of the financial markets around the world. The Commission, through its rule-making ability, has attempted to accommodate the various international policy issues that arise as the world's securities markets have become interdependent. Inasmuch as complete cooperative regulation may be a long-term goal, requiring a long period of transition by the international regulatory authorities, more immediate measures should be considered which resolve current problems and point in the direction of cooperative regulation, and the harmonization of various methods of regulating securities markets. The Commission in the '90s has taken some small, and some large, strides toward cooperative regulation and a more reciprocal approach to the application of the federal securities laws. An example of the cooperative approach is the recent adoption of the multijurisdictional disclosure system with Canada. What we refer to as the MJDS has attempted, among other things, to harmonize minimum disclosure and procedural requirements for simultaneous multinational securities offerings, tender and exchange offers, and business combinations in the United States and Canada. The Commission in adopting the MJDS has taken a significant step by permitting Canadian corporations to use disclosure documents and offering documents adopted by the Canadian authorities for compliance with the Commission's rules and regulations. This is pretty much an unprecedented step in the Commission's history, since the Commission has essentially always mandated that issuers comply with our own rules and regulations.

More specifically for our aspect today, the Commission published for comment last June proposed rules, order, and forms that would permit tender offers for a foreign issuer's securities to proceed in the United States on the basis of the applicable regulation of the target's home country, where a small percentage of those shares are held here in the United States, whether they are registered with the Commission pursuant to Section 12, or were purchased on an exchange in one of the foreign countries. The rules, forms and order proposed would permit single jurisdiction regulation with respect to both the tender offer and registration requirements, so that international tender and exchange offers can be made, and they can be made hopefully more efficiently and at less expense. In proposing the international tender and exchange offers, the release suggests that the Commission is very concerned with working out a reciprocal approach that would permit these offers to be made here and be made to U.S. holders, instead of what we view as the more troublesome of excluding them. With that result, shareholders have to make a decision as to whether to sell into the market with either no information or very little information with respect to the offer.

The most troublesome aspect of the international tender and exchange offer release, from the commentator's point of view though, is the continued application of the anti-fraud provisions of the Exchange Act, and the civil liabilities that would continue to apply to the form that was proposed for registration of those securities here in the United States. As presently set forth, the anti-fraud provisions would continue to apply, much as they continue to apply to any transaction that relies on Regulation S that is undertaken today. Foreign purchasers may well continue to avoid extending offers into the United States because of this concern, rather than because of concerns about certain line item requirements. Unfortunately, because the anti-fraud provisions are statutorily based, the Commission is under no power to change those rules unless it goes before Congress to have them change it, and in the days of Japan-bashing and other aspects of our foreign trade, I'm not quite sure that that would be a decision that Congress would want to make at this time.

I'd like to say in conclusion that corporations and their shareholders have become international in character during the '80s and the '90s, and countries vary widely, not only in their requirements as to takeovers but also in their application of their takeover requirements to offers for target corporations incorporated in their jurisdictions or in a foreign jurisdiction. A number of regulators take the view that investors need the same protections they would be entitled to have, had the offer been made entirely in that country—national treatment, or what is referred to as the U.S. viewpoint. Other regulators are of the view that investors making portfolio investments outside their territorial boundaries should be prepared to be governed by the rules and regulations of that country of incorporation—reciprocity, or the European viewpoint. Until there is greater international harmonization of policies, though, the international tender and exchange offer will continue to be a legal nightmare for purchasers, but a significant source of employment for international securities lawyers. The recent initiatives by the Commission, the takeover panel in the UK and the Canadian authorities have been helpful in solving the regulatory headaches caused by international tender or exchange offers. But they are only a first step in what will surely be a long process.

However, as the Commission gains further knowledge and understanding of the rules and regulations governed by foreign regulatory authorities, hopefully in the future we'll be able to make certain decisions that have to be made, the rules that we propose will hopefully be adopted soon, and will be a small step in facilitating these transactions in the future. Thank you.

BRYANT EDWARDS

Good afternoon. I'm happy to be here. To understand corporate reorganizations in America today, you have to understand one little sentence tucked in one provision of the Trust Indenture Act. Section 316(b) of the Trust Indenture Act requires that qualified indentures contain a provision that prohibits an issuer from making changes to fundamental payment terms—that is, changes in interest rate, principal and maturity—without the consent of each affected bond holder. In order to amend the payment terms of an entire issue of debt securities, therefore, an issuer must obtain the consent of all the bond holders. Because a typical issue of bonds may be held by dozens or thousands of bond holders, such amendments are virtually impossible. Unlike many provisions of the Trust Indenture Act, this one can't be contracted around. And, if you think about it, it's a remarkable restriction on the freedom of a borrower and its lenders to contract freely. Bank agreements typically will have a majority action provision that permits a majority of the banks in the syndicate to make a number of changes, including, in some cases, fundamental payment changes. Public bond holders can't do that. And, like most regulations, this is one that I believe has had the exact opposite of the intended effect: it hurts bond holders. This restriction is particularly troublesome for companies that get into financial trouble. Even if a financially troubled issuer can reach agreement with the majority of its bond holders to a consensual restructuring, it still faces a severe holdout problem. Bond holders who don't participate in a voluntary exchange get to retain their bonds (with the original payment terms) in a company whose health has been rehabilitated because of the financial concessions of the other bond holders. In effect, the participating bond holders are transferring wealth to the non-participating holders. While holdouts are irritating to issuers, they are highly objectionable to other bond holders. That's a real obstacle to effectuating restructurings out of court.

The Bankruptcy Code of 1978 solved this problem by including provisions that permitted confirmation of a plan of reorganization that binds an entire class of bond holders with the approval of one-half of the holders if they own two-thirds of the principal amount of the bonds. That means that if a company achieves substantial agreement with the bond holders, it can use Chapter 11 to require all bond holders to accept the terms of such agreement. The problem is that an unstructured Chapter 11 is often a disaster, especially for the bond holders. Eastern Airlines is a good example. The Chapter 11 reorganization of Eastern was recently converted to a straight Chapter 7 liquidation, but not before bond holders lost 2.2 billion dollars that was sqandered in an ill-fated attempt to operate Eastern for the benefit of the flying public for an eighteen-month period. LTV is another example of a disastrous Chapter 11 proceeding. It filed for relief under Chapter 11 in June of 1986, and five years later it still had not proposed a plan of reorganization. LTV senior bonds, which were trading at about $85 at the time of the Chapter 11 filing, are now trading at about $10.

The Bankruptcy Code's superior legal features have prompted the development of new techniques, one of which is called a "prepackaged" bankruptcy. A prepackaged bankruptcy is an attempt is to marry the benefits of a consensual out-of-court restructuring with the superior legal benefits of the Bankruptcy Code. In a prepackaged plan, an issuer will propose a plan of reorganization, solicit the requisite creditor and shareholder approvals, and file for Chapter 11 relief only after it has received all the consents it requires to confirm a Chapter 11 plan. The idea is to get in and out of Chapter 11 quickly with the least amount of harm to the underlying business. The technique has been successful in a number of cases. *JPS Textile* was in and out of Chapter 11 in forty days; Southland was in and out in about four months. However, the prepackaged plan approach, which is the current rage, has a number of problems. First, when you file for relief under Chapter 11, your trade creditors are out of luck because their payments are suspended until the plan is approved or other orders are entered. An issuer that solicits a Chapter 11 plan may scare the trade. The suppliers and the vendors that keep the company in business get worried. If trade credit dries up, the company's financial condition could worsen further. There are other risks. After Southland had solicited all the consents to its prepackaged plan and was in Chapter 11, the judge determined that even though the plan had been solicited in compliance with existing bankruptcy rules, it had been improperly solicited because such rules were inadequate. The court required the company to resolicit the entire deal. Fortunately, Southland was successful, but one can easily foresee dangerous resolicitation scenarios. If the deal that a company had struck with the bond holders does not survive the resolicitation, the issuer would be stuck in an unstructured Chapter 11, which could ruin the business.

Another problem is the SEC. In a prepackaged plan, even though a company has to deal with the bankruptcy court, it generally also has to be declared effective by the SEC. Before Chapter 11, an issuer doesn't have the benefit of Section 1145, which exempts offers and sales of securities after a Chapter 11 filing. Therefore, pre-Chapter 11 offers have to be done pursuant to a registration statement or an exemption. The SEC has been all over the restructurings, and I believe this has interfered with the ability of companies to work out their debt. For example, in Southland, the company receives sixteen rounds of comments (totaling more than four hundred comments) over an eleven-month period, from the time it filed until it went effective on its registration statement. *Forest Oil* had four amendments. *Las Colinas*, which was another big prepackaged plan, had six amendments over a six-month period before it went effective; *Republic Health* had six amendments over a twenty-three-month period before it was able to go effective. Issuers have enough trouble dealing with a troubled business, their creditors and other constituencies without having to deal with hundreds of SEC comments. Most of the bond holders in these deals are big institutional holders and they can fend for themselves; regulatory delay hurts their intents directly.

All of this has caused consideration of other legal techniques for reorganizing companies. One idea was to use a class action lawsuit under Rule 23 of the Federal Rules of Civil Procedure as a vehicle for restructuring companies without ever having to file for bankruptcy. Some class actions permit class members to opt out, but in other types a court will certify a binding or mandatory plaintiff class, meaning that every member of the class is bound by the results of the lawsuit, including a settlement of the lawsuit. Mandatory class action lawsuits are particularly appropriate in certain situations. For example, where there is a risk that separate lawsuits would produce inconsistent and impossible obligations on the defendant party, a mandatory class is appropriate. An example was a lawsuit brought by some bond holders against Burlington Northern Railroad. In that case, a $117-million issue of non-callable bonds issued in 1896 was secured by property which by the 1980s was worth billions of dollars. The company wanted to release the lien and substitute collateral with a value more appropriate for such an issue, but that violated the indenture. The bond holders sued, and the court certified a mandatory class because if every bond holder went into court separately, the issuer might be subject to different injunctive orders that might very well be inconsistent. Another appropriate use of a mandatory class is where there are multiple claimants to a limited fund, such as an insurance fund, or a limited pool of assets. We believe that a suit by bond holders to effectuate a distressed company restructuring falls into that line of limited-fund cases, because there is a limited pool of assets and a need for an equitable distribution of those assets. Generally, actions for injunctive or declaratory relief can be certified as mandatory, non-opt out class actions. However, the use of mandatory class actions as a restructuring technique raises additional questions. For example, do federal courts have the power to bind a class of bond holders to a settlement that impairs their payment obligations notwithstanding the Trust Indenture Act? After some consideration, we think the answer to that is yes. It goes to the fundamental, equitable jurisdiction of the federal court. An examination of Rule 23 shows that mandatory class actions under Rule 23 had their historical origins in an equitable remedy called the Bill of Peace, an equitable remedy meant to avoid a multiplicity of lawsuits. This was the same equitable remedy that served as the foundation for thousands of railroad reorganizations at the turn of the century. These cases are interesting because federal courts in the United States reorganized most of the railroads in the country without ever going into bankruptcy. They did this through a technique called equity receiverships. In an equity receivership, a friendly creditor would sue the company after it didn't get paid, and obtain the appointment of equity receiver. The company would consent to the appointment, and through the receiver's power of sale, would effectuate a reorganization. From the early 1990s till about 1923, federal courts issued a series of opinions that clearly established the power of a federal court to effectuate reorganizations that were binding on all bond holders, including dissenting bond holders. Although the Trust Indenture Act was adopted in 1939, we don't believe that the Act changed this result. First, the legislative history of the Trust Indenture Act indicates that William O. Douglas, who was the principal author, wanted to assume that reorganizations occur under the supervision of federal courts; he didn't seem to care that it was bankruptcy versus an ordinary federal judge. Second, 316(b) of the Trust Indenture Act required nothing more than what in 1939 was in most American indentures. Most American indentures, because of concerns about negotiability, already had a provision that provided that an issuer can't change fundamental payment terms without individual consent. We also think that the class action technique passes Constitutional scrutiny; the contract impairment clause is one provision that comes to mind, but a look at the clause and the case law shows that the clause restricts state—but not federal—action. Due process is another consideration, but we think that if you follow the Rule 23 procedures, you've satisfied the due process requirements. And the icing on the cake here is that by settling a federal class action lawsuit, you can take advantage of Section 3(a)(10) of the Securities Act, which exempts the whole thing from Securities Act registration. It provides an exemption for issuances of securities whose terms have been approved by a court after a fairness hearing. In conclusion, we think that by avoiding both the SEC and the bankruptcy courts, the class action restructuring technique has a chance of better effectuating a consensual arrangement between an issuer and its bond holders.

JOHN MAGUIRE

I'd like to quickly say that although I worked on the Southland transaction, I only dealt with the Williams Act aspect of it, and then also I think in deference to the staff attorney that did work on it, the Southland transaction was essentially the first prepackaged plan that came into the Commission. I think that because of the amounts of money involved, and the newness of the issues, we did not have the time period that Latham & Watkins and others working on the transaction had prior to going to the Commission, so we had to come up to speed on the transaction.

PANEL FOUR

PANELISTS:

DOUGLAS BRANSON, PROFESSOR OF LAW, UNIVERSITY OF PUGET SOUND

MARK SARGENT, PROFESSOR OF LAW, UNIVERSITY OF MARYLAND

JANET KERR, PROFESSOR OF LAW, PEPPERDINE UNIVERSITY

DOUGLAS BRANSON

Let me start the timer here. I don't want to keep at it any longer than I'm allotted. A collateral participant is a secondary defendant. Typically when a plaintiff in a securities action files against the issuer, the issuer is judgment-proof. So, if you use a sports metaphor, the name of the game is kind of "rope a dope." So the plaintiff names the lawyer, the tax lawyer, the banker, the directors, the general partner, the officers, the celebrity spokesperson—we call that the "Pat Boone" defendant—or Beau Bridges' father, what was his name?

What the plaintiff attempts to do is work the "prisoner's dilemma," because these defendants are all represented by lawyers, and of course, lawyers are macho. They don't want to cooperate with one another. The plaintiff will take a round of depositions, find out which defendants have some culpability, but are less culpable than others, and pick them off, and obtain a good settlement. The bank is always a good place to start, because that's where the money is. The plaintiff then fattens his or her war chest, and then proceeds, works the prisoner's dilemma, maybe settles out against two of the directors, and the like. The key for defendants is to cooperate, but they never do.

I did an empirical study of securities litigation filed in the Western District of Washington in 1980 and 1981. The most common phenomenon actually is a single defendant: it is securities firms' collection actions that are filed in federal court, and SEC enforcement of subpoenas. But the second-most common phenomenon is this type of action. I've found that the median range of collateral participant defendants was ten to fourteen defendants.

Now the way, legally, plaintiffs—I have a plaintiffs' bias, so I'd better put that right out in front—the way plaintiffs proceeded after these defendants originally was an aiding and abetting allegation under rule 10b-5. That changed of course with *Ernst & Ernst v.*

Hochfelder in 1976, which said that you have to prove scienter but left open the question whether recklessness would suffice. Later federal court decisions have held that recklessness but only of the high-conscious disregard sort will suffice. And still later, at least as to secondary defendants, federal courts have been holding that knowledge is the state of mind requirement for aiding and abetting.

After *Ernst & Ernst v. Hochfelder*, attention then shifted to the 1933 Act. Section 12(2) has been discussed a lot today. One proxy for the change in activity was that in all the law reviews and periodicals after *Hochfelder*—I think there was one aiding and abetting article, and maybe a dozen all on so-called participation, or expanded seller status, under Section 12(2) of the Securities Act of 1933.

Now that train pulled on the siding with the 1988 Supreme Court decision in *Pinter v. Dahl*, *Pinter v. Dahl* held that to pinion liability on an expanded seller theory, the collateral participant had to have engaged in the sales transaction or participated in the solicitation, with some benefit, potential benefit redounding to them, and probably that they had to have done so at or around the temporal time of sale. That development really cut off the ability to name collateral participants in federal cases.

The attention now is shifting to state securities law. Before *Pinter v. Dahl*, there were maybe two or three good collateral participant cases reported opinions under state securities laws; since 1988 there are at least 15 reported decisions. What do we find when we look at those decisions? Well, I had to write a seventy-two-page article that I thought was going to be about twenty pages. We find a patchwork. Very difficult to sum up.

We find that some are very broad. Oregon has a 1988 decision interpreting its securities secondary liability statute, a version of the Uniform Securities Act Oregon has modified. Oregon's statute says literally anyone who "materially aids or participates" in the violation is also liable. But Oregon courts had always tempered that with the state of mind requirement; they required knowledge, if you read your cases. But Judge Hans Linde, in his precise way, said there is no knowledge requirement on the face of the statute, so a lawyer who drafted documents, provided what could be considered routine legal services, was held liable. That's the case *Prince v. Brydon* case in Oregon. The organized bar has attempted to overrule it, but they have not been able to do so.

The other extreme is California. You're safe in California. If you do an office practice, you're very safe because the California courts, mainly federal courts, interpreting California's securities laws, have held it requires strict privity. The only person who can be liable when there's a low state of mind is the issuer, essentially—almost a passing of title privity. The decisions are not clear whether it's a passing of title, or a very narrow transactional privity, but the liability is very constrained in California. If you want to reach a a collateral participant, there is a provision of the California Corporations Code section 25504.1, that says anyone who "materially aids or participates" can be held liable, but a plaintiff must prove intent to deceive or defraud—this is very tough to prove. So the state law cases are all over the place.

I have to make a disclaimer: the foremost expert on state securities laws in the United States is Mark Sargent, so I'll have to defer to him on anything that I say, and he can jump up and bop me over the head if I go astray. I get into these cases a lot, as a consultant, expert witness—I've done perhaps fifteen cases. I have done cases involving ski resorts, fishing boats with crews, Norwegian red bulls, airplane deals, apple orchards, wine grapes, wheat farms, Christmas trees, semitruck trailers with drivers. For the most part, they're being filed as state securities actions. The avenue is closed off on the federal level, but potentially the avenue is open on the state level. The benefits on the state level are, one, you get attorneys' fees under most state securities laws. Under the states' general anti-fraud rules, the *scienter* standard is probably negligence. All the courts that have faced that issue have decided that negligence will suffice; the open question is whether there's implication of a private right of action under the anti-fraud rule, or whether the express civil liability provision is exclusive.

The question, then, post-*Pinter v. Dahl*, is will states adopt that case as their own law of how far they will expand seller status? Three or four intermediate appellate courts have done that. *Zindel v. Newport Oil*, in New Jersey in 1988, *State v. Williams*, North Carolina Appellate, 1990, *Allen v. Columbia Financial*, South Carolina, 1988. Now, of course, I should back up—what we're talking about is the Uniform Securities Act of 1956, or the new one, which is 1985. About forty states have that statute, thirty-nine or forty. It's neither uniform—I guess it is securities—but it is not a very uniform "uniform" act. Under that act, at least two state supreme courts, on the other hand, have refused to follow the narrower *Dahl* approach. The *Ridenour* case in Kansas, and Washington Supreme Court, three times refuse to apply *Pinter v. Dahl*. Of course we had the ultimate collateral participant liability case in Washington—the *WPPS* litigation, *Washington Power & Public Supply*—seven hundred seventy named defendants, five hundred John and Jane Doe defendants.

Depositions were held in auditoriums in New York. Whole 747s of lawyers were flying back and forth . . . those were the days . . . .

The question, then, is if states refuse to follow *Dahl*, what approach will they adopt, or what approach should they adopt to expanded seller status? And then, what policy arguments support expanded seller status, and what policy arguments oppose it? Probably the test that you'll see states adopting is the version of the pre-*Pinter v. Dahl* approach, that is, was the collateral participant a substantial factor or, in the words of the Washington Supreme Court, was it a "substantial contributive factor," in the transaction constituting the violation? The difficulty with that approach, and I have articulated this in an article in the 1986 *Oregon Law Review* on collateral participant liability under federal law, the difficulty is they don't say, or they use differing terminology as "substantial contributive factor." In what? In the sale? In the solicitation? In the violation? In the transaction? And we find the courts intermixing all those terms. In Washington we have three decisions now, post-*Pinter v. Dahl*: *State v. Hoffer II*, *Heves v. Data Line Processing*, and *Schmidt v. Cornerstone, Inc.* The Washington court reconsidered *Hoffer I* after *Pinter v. Dahl* came down. And the Washington court confuses the terminology. Substantial factor in what? If you say substantial factor in the transaction, is the printer a substantial factor in the transaction? Is the paralegal in the law firm, who did a lot of the legwork, is he or she a substantial factor in the transaction?

The second problem is that courts have said, "Well, our test of substantial factor is the tort law test of proximate cause." But then the federal courts have always said, "Well, the test of proximate cause is substantial factor." And substantial factor, of course, is only the test of cause in fact. A tort law analysis proceeds to a further narrowing, given that it's a substantial factor, cause in fact, is it the proximate cause?

Washington courts have refused to follow *Pinter v. Dahl*. Oregon courts have refused to follow *Pinter v. Dahl*. Kansas courts have refused. Their reasoning is that state securities law is to fill in the gaps in the federal law. It is kind of a parachute: on the local level, it can be wider, and it can also be a gap-filler, in relationship to federal law. Both the Supreme Court of Kansas and the Supreme Court of Washington have stated that. I think that another problem with the *Pinter v. Dahl* approach is that with lawyers and accountants and appraisers and other collateral participants, I think they are culpable not just when they become over-involved in the wrongdoer's conduct. I think that's what the Supreme Court had in mind in *Pinter v. Dahl*. The one who solicits, the one who makes the call on the client, the would-be investor, they're over-involved. But in the cases I see, a lot of collateral participants are under-involved. That is, like Horatio Nelson at the Battle of the Nile, they put the "long glass up to their blind eye": I don't see the wrongdoing.

I was involved in a $25-million apple orchard syndication case, and the lawyer was approached by the syndicator, as every lawyer who represents a repeat syndicator has been, and says, "Teach me how to do this in-house." The lawyer did. He calculated that he would make money on the other business—he did; he billed $350,000 in three years. He went through some training sessions where he red-lined their private placement memoranda for them. Then every time the state securities commission called them on the carpet, the syndicator would come directly back to the lawyer, and the lawyer would write the state securities administrator a letter. He'd say this office represents this issuer in this transaction, and the state securities administrator therefore thought the documents were the product of a reputable law firm, and they would back off. There was a lawyer being under-involved, rather than over-involved. The lawyer said, "Well, my job is to do what the client requests." My response to that is that there's a certain minimum engagement. You just don't write an offering circular, you just don't teach somebody else how to write an offering circular. The minimum engagement, it seems to me, is to attempt to get the exemption for the client, which means writing an offering circular, a due diligence exercise, and other things.

A case of a lawyer being overinvolved is the Norwegian red bull case. In that case, a promoter would buy bulls for $2200. He would bring them up to the Northwest, put a million-dollar valuation on them, and then convey them to a general partnership. The general partners would take the investment tax credit, and first-year depreciation on a million-dollar valuation. They would receive whopping tax refunds. They'd keep one third, kick one third back to the promoter, and use one third for buying bull feed. The investors were all tax rebels. The lawyer, a woman lawyer, very competent, NYU L.L.M., refused to give an opinion letter on that valuation. But they went ahead, and when they got in trouble with the Service, she said "I'll represent you." Well, she was changing from her role as a preventive law lawyer to an advocate. But here comes the fatal mistake: they had a meeting to organize their defense efforts, and she showed up in a cowgirl outfit, and one of the expert witnesses, when this came up in conference, quit at that point. It was a very damning piece of evidence. It was tried as a state securities action against a collateral participant, and the jury was not able to differentiate between a lawyer's role before the fact, as a preventive law lawyer, and her role as an advocate cheerleader. Then of course she, by her cowgirl antic, did it one better—I thought it was a pretty good joke—but she was held liable for $2.2 million. It's on appeal now to the Washington intermediate appellate court, but she's got a Chapter 11 petition in the trunk of her car, ready to file.

So I have a thick article that you'll be able to read. It is a topic that I found a book could be written about it. Two books, actually: you could write a book about tactics and strategy, both on the defense side and the plaintiff side, and write a book about the substantive law in the fifty states.

MARK SARGENT

Thanks, Doug. It's really a pleasure to see scholars as accomplished as Doug Branson working on a blue sky topic. I've been laboring in that dusty vineyard by myself for many years, and to see someone else taking it seriously warms my heart.

I want to talk today about the question of whether limited liability company interests are securities. This is probably something that hasn't occurred to anyone here, because there are no limited liability companies in California yet, although I suspect that there will be before the end of the year. By the end of this year there will be at least, I predict, fifteen states with limited liability company statutes, and probably more within the next two years, unless there is a radical change in policy toward LLCs. I think there are going to be limited liability company statutes everywhere, and I think the standard form for organization of the small, closely held enterprise is going to be the limited liability company. That raises, of course, the question of whether interests in LLCs should be considered securities. Let me proceed by giving you some background on what limited liability companies are before I get to the securities question, because that discussion will be incomprehensible unless you've got some sense of what these are.

The LLC is probably the most interesting form of business organization that has been developed in recent memory. At first glance, it seems to be just another over-clever tax dodge that will eventually get squashed by the IRS or Congress, but upon closer inspection, it actually seems to be worth taking seriously, because it accomplishes two very fundamental things. First of all, it permits the planner to choose, quite freely, between entity level taxation and pass-through taxation, allowing selection of the optimal tax status without sacrifice of limited liability. By allowing the planner to choose entity taxation, which is done by forming a corporation, or pass-through taxation, by forming an LLC without submitting to the substantive limitations and intellectual gyrations of qualifying for S-corporation or limited partnership status, the LLC is really bringing some order to a disordered situation. Secondly, the LLC permits a planner great freedom to tailor governance and financial arrangements to the owner's needs (as in a general partnership) while maintaining limited liability (as in a corporation). This flexibility unleashes ingenuity, allowing the limited liability-seeking owner to escape the straitjacket of the mandatory provisions of the corporation and limited partnership statutes, and to develop structures more suitable to the reality of life in a closely held enterprise. I think the LLC statutes may fulfill much of the promise that was left unfulfilled by the special close corporation statutes of the 1960s and 1970s.

All of this great promise, however, rests on pretty tenuous foundations. In order for the LLC to be treated as a pass-through entity for federal tax purposes, it has to be classified as a partnership, and not as an association taxable as a corporation. Until recently, the IRS' position with respect to the LLC seemed to be that it should not be classified as a partnership, because no member of an LLC is liable for the entity's debts. In 1988, a small crack was opened when the IRS issued a revenue ruling that recognized a Wyoming LLC as a partnership, and this position was confirmed in a series of private letter rulings between 1990-92 that have consistently classified LLCs as partnerships. Now, these rulings were highly specific and contingent, but they have triggered a wave of legislation that led to eight LLC statutes so far, and will lead to many more within the next eighteen months. Of course, the significance of all of this will depend on the IRS maintaining its current position, and upon Congress not deciding to step in, but if there is no major change at those levels, the LLC is going to become increasingly important. The other contingent factor, of course, is that federal tax rates will have to continue to favor pass-through status for small business entity formation.

The LLC raises lots of fascinating questions. It introduces a new complication into the traditional choice of business form analysis. It creates interesting planning opportunities, because you can basically do whatever you want with these entities. There are some very knotty and arcane tax questions, because everything is balanced on a razor's edge in order to qualify for partnership status while meeting your organizational and governance goals. But I don't want to talk about any of those things other than in passing, because there's also an important question of whether these interests are going to be treated as securities. There is no law directly on point. Whether my interpretation of this issue is correct will be seen fairly quickly, because the stakes obviously are important. If limited liability interests are securities, they cannot be offered or sold without registration or exemption under the federal or state securities laws. If they are securities, their sale also will trigger disclosure obligations and create the risk of liability under the antifraud provisions of the securities laws. If they are not securities, business planners will have a field day. Now they can organize the closely held enterprise as a limited liability entity, but without having to comply with the securities laws. The planner can (usually) avoid the securities laws by organizing the entity as a general partnership, but at the loss of limited liability. Limited liability can be obtained through incorporation, but subject to the cost of securities law compliance. The stakes thus really are very high with respect to this question.

Let me begin my analysis of the definition of the security question by giving you more detail about what the LLC actually is and what its advantages might be. Basically, it is a non-corporate business form in which each of the members has limited liability, and in which the members can actively participate in management. Those of you who are familiar with limited partnership law are probably already starting to see a key advantage here with respect to the control issue. As a non-corporate form of business, the LLC has been designed to avoid double taxation, and to permit pass-through of income and losses for tax purposes. It also avoids the application of the mandatory provisions of the corporation statutes that require boards of directors, officers and the attendant paraphernalia relating to meetings, voting rights and so on. As a non-corporate entity, the LLC can also avoid the application of legal capital provisions relating to par value, stated capital, capital surplus, and all those dreadful antiques. The LLC thus gives an enormous amount of flexibility to the person who's trying to structure a closely held enterprise. It is very similar to partnerships in that regard. Unlike general partners, however, the members of the LLC have shareholder-type limited liability, so in essence the LLC is a hybrid: like a general partnership, an LLC is highly flexible, tailorable, and not taxable at the entity level; like a corporation, it provides limited liability to its owners. Of course, there are other partnership/corporation hybrids—that's in essence what the limited partnership is, and that's been around for a long time—but a great advantage of the LLC over the limited partnership is that its members have no restrictions on the their right to participate in control. In addition, there's no need for any participant to have unlimited liability, unlike a general partner in a limited partnership. Of course, the use of corporate general partners can, to some extent, minimize the impact of the general partner's unlimited liability, but the LLC is a far simpler and more complete solution.

Flexibility of the LLC form requires some emphasis. The LLC statutes contain no rules restricting the issuance of ownership interests, the creation of classes or series of interests, or the allocation of equity contributions to capital accounts. There are no statutory rules concerning differential treatment of holders of the same class of interest, as there are under the corporation statutes. This is a hands-off approach, and it leaves virtually all of the essential elements of the capital and governance structures to be determined by the parties, with the results reflected in what is usually called an operating agreement, an instrument roughly analogous to a general partnership agreement. These statutes also junk the traditional corporation statute hierarchy of shareholders, directors and officers; they thus eliminate all the numerous mandatory distinctions as to who has the authority to amend the articles or the bylaws, to elect or remove the managers of the organization, or to authorize distributions of earnings. Whole bodies of corporate law doctrine, such as the rule invalidating board sterilizing agreements, are thus rendered totally irrelevant. In essence, these statutes allow the owners of the business to use the operating agreement to set up the entity pretty much as they please, and in a manner far less restrictive than that of the special close corporation statutes, which have some of the same goals of LLC statutes but which are far more limiting in their eligibility criteria and in their use of unanimity requirements.

In short, business planners now have a simple option: they can have the members manage the entity directly (a "member-managed" LLC), or they can create a governing group roughly analogous to a board of directors (a "manager-managed" LLC). This is a distinction that might be important for securities law purposes, so you might want to keep that in mind.

The foregoing is not to say that LLCs are entirely informal vehicles. They require a filing in order to be created. Sometimes the statutes require substantial disclosures with respect to the entity's financing to be included in that filing. Sometimes the statutes limit the duration of the entity to thirty years. Some statutes have fairly specific record-keeping requirements. The LLC thus is not as purely informal as a general partnership can be. There are some formalities.

The limitations on what can be done with an LLC come from tax law, not from the statutes themselves or from any desire on the part of their drafters to impose mandatory rules. There is a complex analysis of the LLC's tax status we don't have time to go through; I'll simply mention the three pressure points. If the LLC has centralized management, there is a greater risk of having an LLC characterized as an association taxable as a corporation. Therefore, there is an incentive not to have a board of directors-type management, but rather to have member-managed LLCs. That is one of the factors that will tend to make LLCs less attractive for public enterprises, although it is by no means an absolute bar. In addition, to the extent that there is free transferability of LLC interests, the entity will look more like a corporation than a partnership from a tax perspective. The safest course is to require unanimous consent on the part of all members to the transfer of interests. Some statutes, however, permit consent to transfer by a simple majority of the members. That is obviously preferable from a planning standpoint, but it makes the LLC more vulnerable from a tax standpoint. The third problem relates to continuity of life. This issue is particularly dangerous. The greatest risk arises when there is a continuity agreement that kicks into play upon the dissolution of the relation by one of the members and provides for automatic continuation of the business without post-dissolution agreement by the non-dissolving members. It is safer from a tax standpoint to rely upon post-dissolution consent to continuation, particularly unanimous consent by the remaining members of the LLC.

The net effect of these constrants is to reduce the LLC's usefulness for public enterprises. A principal effect of the tax law will be to keep LLCs closely held. That's also significant from a securities standpoint.

With that background, let me focus on the securities question. The narrow question, under federal securities law, is whether LLC interests are investment contracts. While LLCs possess certain corporate-like characteristics, they are not corporations. They thus do not issue stock, which is of course one of the instruments listed in the federal statutory definitions of security. If they did, the question under *Landreth* would be whether the stock possessed the common characteristics of stock, and not whether it constituted an investment contract. Because LLCs do not issue stock or any of the other instruments included on the statutory laundry list, they, like general partnerships or limited partnerships, must create investment contracts in order to create securities. That requires us to apply the *Howey* economic reality test to LLC interests to figure out whether they are investment contracts. I think it is clear that LLC interests meet most aspects of the Howey test. LLC members typically invest money in exchange for their interests. They thus do not create the kinds of uncertainties associated with more unorthodox forms of investment. They also usually invest in a common enterprise, in which there is a pooling of funds between promoters and investors subjected to a common fate. Investments in LLCs are also likely to meet the more rigorous horizontal commonality version of the common enterprise requirement. Most LLCs are likely to be structured around the joint contributions of two or more members in a "horizontal" partnership-type relation. In addition, LLC members are ordinarily going to be expecting profits, and not some unconventional form of benefits. So, those basic elements of the *Howey* test—investment of money, common enterprise, expectation of profits—are all likely to be satisfied in most cases.

The real question, of course, is whether LLC members are relying on the efforts of others, as is required by the final element of the *Howey* test. That is, of course, also the central question with respect to whether analogous forms of enterprise such as general partnerships and limited partnerships are investment contracts. General partnership interests are virtually presumed not to be securities because general partners retain ultimate control over the enterprise by means of their statutory authority as general partners. This presumption seems to operate even if the partners, as in a typical large law firm, have delegated substantial managerial authority, or have otherwise not participated in control of the enterprise. The only way to overcome this presumption is to show that the partners had no legal or practical ability to exercise their rights of control. That is the message of *Williamson v. Tucker* and its progeny.

In contrast, limited partnership interests are presumed to be securities because state limited partnership law theorectically precludes limited partners from exercising control. Limited partners are thus presumed to be dependent upon the efforts of others. This presumption is very strong; it seems to operate even under the Revised Uniform Limited Partnership Act, which gives limited partners substantial rights to participate in control without running the risk of losing their limited liability. There are only a very few cases that have held that limited partnership interests are not investment contracts. In those cases there was invariably an extraordinary degree of limited partner involvement in control, combined with a lack of potential for common trading. Only those unorthodox circumstances overcame the presumption that limited partners relied on the efforts of others.

The question is thus where LLCs fall in this polarity between general partnership interests, which are not presumed to be securities, and limited partnership interests, which are presumed to be securities. I think LLCs are probably least analogous to limited partnerships for purposes of this question. One of the structural advantages of LLCs over limited partnerships is that LLC members can achieve the tax benefits of the entity's pass-through status without risking their limited liability by participating in control. Thus there is no state law prohibition or restriction on participation in control of the LLC. That means that there can be no limited partnership-like presumption that LLC members are dependent on the efforts of others. Thus we can conclude that the traditional presumption about limited partnership interests is not applicable to LLC interests.

The analogy is closer to general partnerships. Most LLC statutes provide that LLCs will be managed by the members unless the articles of organization provide otherwise. There is also substantial incentive for member management, because of the tax risk associated with delegation of authority to managers. Even if an LLC does have managers, the LLC members have the authority to elect and remove the managers. In essence, LLCs and general partnerships both seem to be entities in which member/partner participation in control seems to be the essence of the relationship.

As I suggested earlier, the LLC statutes permit considerable leeway in structuring management arrangements. In the real world of LLCs, there is thus a continuum ranging from almost total deferral to managers to no deferral to managers and including everything in between. These variations in the degree of participation in control should not tip the balance so that limited liability company interests are treated as securities. I think the same presumption should apply here that applies in partnership law. Under *Williamson v. Tucker*, it is clear that a general partner will not be considered to have purchased a security unless that partner is so unsophisticated, inexperienced, inexpert, uninformed or dominated by the managers that he or she is incapable of exercising a partner's authority and is wholly dependent on the manager. That seems to me to be the standard.

And I think that this conclusion can be supported by the line of reasoning in United States Supreme Court cases about the non-securities status of LLC interests such as *Marine Bank* and *Reves*, in which the courts are reluctant to find the presence of a security unless there is a possibility for some sort of "common trading" in that security. In other words, the Court has begun to define a market-based element in the definition of security. This definition is still somewhat incoherent, and the Supreme Court has never really explained what it is trying to do, but I think the clear message in *Reves* and *Marine Bank* is that there is no good reason to apply the federal securities law to transactions that have been privately negotiated and involve interests for which there is little if any trading market. I think that this tendency should reinforce the characterization of LLC interests as non-securities, at least so long as the interests are not marketed publicly.

The response to the argument I am putting forward will probably be something like this: Let's assume we've got a manager-managed LLC with a governing group something like a board of directors, several classes of ownership interests, articles of organization filed in a state office (i.e., virtual "incorporation"), a high degree of continuity of life, and only residual authority in the members. That seems to have something like the "look and feel" of a close corporation: it walks like a corporation, talks like a corporation, squawks like a corporation. The only thing that seems to be missing from this picture is stock. The argument thus could be made that such LLC interests are closely analogous to stock in a close corporation, and hence should be treated as securities, since stock in a close corporation is universally regarded as a security. I think this is dead wrong, and I think that it is an argument that proceeds on the basis of an erroneous assumption. Stock in a close corporation is a security, technically, because stock is listed as a security within the statutory definition of security. The fact that it is listed as a security, however, does not mean that it makes sense from a policy perspective to treat that form of ownership interest in a closely held enterprise as a security subject to the coverage of the securities laws.

This issue was at stake in the sale of business cases. Since the Supreme Court resolved that dispute in the *Landreth* decision, however, it has become clear that stock will be treated as a security (at least stock bearing the common characteristics of a security) largely because it would be a tremendous waste of time to try to figure out on a case-by-case basis whether stock is a security. That kind of case-by-case determination would be too upsetting to commonsensical expectations that this very familiar form of instrument will always be treated as a security, and it would probably inject just too much uncertainty into routine transactions. Those are very powerful considerations. But only such powerful considerations should be permitted to overcome what should be the basic presumption, i.e., that interests in closely held enterprises—whatever their form of organization—should not be treated as securities. Sales of these interests in private, informal and negotiated transactions, regardless of whether the parties are called partners, shareholders, or members, take place outside of the context of public securities markets, and thus should be governed by the common law of fraud, fiduciary duty and contract. We thus should not assume that LLC interests should be considered securities because they are analogous to stock in a close corporation. We should recognize instead that the status of close corporation stock as a security should be regarded as an unfortunate exception, a historical anomaly that can be justified, if it all, only by profound considerations of convenience and historical expectations. We should not make the same exceptions with respect to LLC interest, with respect to which there is no historical baggage (and no inconvenient statutory language). The analogy of LLC interests to corporate stock thus should not enhance the risk of securitization of LLC interests, but should rather call into question the theoretical underpinnings of the traditional assumption that stock in a close corporation is a security.

In any event, I could go on and on with this, but I'm taking entirely too much time, so I'll stop there. I should add that there is a nasty little wrinkle in states like California: the risk capital test for the definition of security. It's possible that there might be somewhat greater exposure under that test. To the extent that the risk capital analysis, however, requires a showing of some dependence on the efforts of others, the same analysis that applied under *Howey* should apply, and should cut against the finding that an interest in an LLC is a security. There is, however, a tendency in risk capital jurisdictions to read the definition of security more broadly, particularly when a transaction involves the initial capitalization of an enterprise, and when there is no guarantee or collateralization intended to mitigate the risk that the purchaser might incur. So, arguably, you may have some greater exposure under a California risk capital analysis, but whether you should or not is another story. Thank you.

JANET KERR

The purpose of this presentation is to provide a summary of the *Reves* case and then review some of the more important cases which have been decided following *Reves*. Additionally, I will talk about the problems which have arisen in applying *Reves*.

In *Reves*, the Supreme Court determined when notes are securities. Prior to *Reves*, there were conflicting approaches used in the circuits to determine this issue. Even though notes are specifically mentioned as being securities in Section 2(1) of the 1933 Act (although certain short-term notes are exempted for registration purposes) as well as in Section 3(a)(10) in the 1934 Act, (*i.e.*, those notes which have a maturity of more than nine months), many circuits and lower courts ignored this express statutory language and determined that notes were not securities in all situations. The courts felt that unlike stock, notes may be a part of many different types of transactions, not all of which may be covered by the securities law. Many courts preferred to look at the economic reality of the underlying transaction to which the note was attached to determine if the note was in fact a security. In doing so, four different types of tests or approaches resulted. Some circuits applied the *Howey* investment contract test to notes while others applied a commercial/investment dichotomy test. Still other circuits applied a risk capital test and finally the Second Circuit applied the family resemblance test. All of these tests essentially ask the same question—that is, what is the economic reality of the underlying transaction that the note represents (*i.e.*, is it a consumer/commercial loan transaction or, on the other hand, is it an investment)? If it is the former, then it is probably not a security.

The Court in *Reves* resolved what the test should be for notes but before the four-factor test was discussed by the Court in *Reves*, the Court accepted the Second Circuit's interpretation of the statutory definition of a security to include notes as a security. Therefore, *Reves* affirmed that notes carry the presumption of being securities. Secondly, the Court provided defendants two possible ways to rebut that presumption. One way was for defendants to state that their transaction was one of the specifically mentioned transactions on the family resemblance list. In that case, the note representing the transaction was not a security. The second avenue of rebuttal was if the defendants did not find their transaction on the list, they could argue using the four-factor test that it should be on the list and, therefore, found not to be a security.

Now I will discuss the four-factor test. The first factor in the *Reves* case is the motivation of the buyer and seller. The *Reves* case said that if the motivation of the buyer and the seller are primarily investment oriented, then it's going to be a security. But if not, the motivation will be representative of a loan transaction such as a consumer loan transaction, or a commercial lending transaction, where a security would not be found. The Court said that if the seller's purpose is to "finance substantial investments" or "to raise money for the general use of a business enterprise," then it's probably going to be found to be a security. If the buyer's intent is an expectation of profit, *i.e.*, an investment, then this motivation is more indicative of a security.

The second factor of the *Reves* test determines whether the note was given pursuant to a plan of distribution in which there was a secondary kind of trading intent or what the Court called "common trading for speculation." The Court did not define what "plan of distribution" meant, but it probably excludes transactions that are negotiated one-on-one. If there is a widespread plan of distribution, then it is more apt to be a security.

The third factor in the *Reves* case tries to ascertain what the reasonable expectations of the investing public are, *i.e.,* what does the public think this note/transaction represents? Would the public think it is an investment or, on the other hand, a commercial lending kind of situation, such as a consumer loan situation?

The last factor of *Reves* determines whether there are risk-reducing factors present in the transaction at hand. The Court felt that if risk-reducing factors were present, then it was less likely to be a security. The Court didn't really define what those factors would be, but the Court did mention these factors could be regulatory in nature and even perhaps non-regulatory in certain situations.

Some issues were not resolved in the *Reves* case and have caused problems. In *Reves*, the fact situation involved demand notes. The Court did not determine whether demand notes would be considered to be notes that were nine months or less in maturity and therefore fall within the exemption language of the Exchange Act. Secondly, the issue was raised but not resolved as to whether all notes nine months or less should be automatically exempted under the Exchange Act. It was posited that perhaps only high-quality commercial paper with such a maturity should be exempted. If this is true and all short-term notes are not exempted, then should those notes that are not exempted carry the presumption they are securities as do other notes that are not short-term?

Besides these areas that are unaddressed, I want to discuss some common problems that have arisen from cases decided since *Reves*.

Since *Reves* there have been some circuit court cases, as well as some lower court decisions. One common problem seen in all of these cases is a lack of uniformity in application of the *Reves* four-factor test. The Court in *Reves* did not state that all four factors *must* be applied. As as result, some of the cases since *Reves* have used only two or three factors. The Supreme Court, in failing to make clear if all four factors should be used, has left open another problem: if not all four factors are used, which one or ones should be used? A collateral question is, what weight do we give to the various factors? Are they the same or different?

Another problem in the post-*Reves* cases involves confusion over some of the terms used in the *Reves* factors. One area of confusion involves the second factor. Distribution and trading involve concepts that appear to be used by the Court to mean the same thing but in reality are two different concepts. Some of the courts in the post-*Reves* cases have felt that one must actually have a secondary trading market in order to have a security. Other courts have said that even if you have just a few investors, and the notes are given to those investors, then you have a plan of distribution.

Another post-*Reves* problem involves the fourth factor and the definition of risk-reducing factors. Some courts have defined this to mean the presence of another federal regulatory system. Other courts conclude that if a common law cause of action exists, this is enough. Finally, other courts posit that if collateral for the note is given, this may be enough of a risk-reducing factor.

As mentioned before, another problem area is how to handle short-term notes. I already stated the issues that are unresolved pertaining to this area and, sure enough, they have arisen in the post-*Reves* cases. For short-term notes, at least under the 1934 Act, are all notes that are nine months or less automatically exempted?

Moving away from short-term note issues are other problems relating once again to the factors in *Reves*. Another problem arises from the third factor of the *Reves* test involving the reasonable expectations of the public. What does that mean? As you know, if one took a poll of the investing public, one would find a diverse group. One would find the general, non-sophisticated public, as well as the sophisticated public, *i.e.*, the institutional investors. Also, there are investors in between. The *Reves* case doesn't define who the investing public is. That is problematic, especially if there is an esoteric transaction that is represented by a note. In this situation, nine times out of ten, the expectation of the general investing public is that they've never heard of it.

Still another problem area relates to the first factor of *Reves* and that is, what happens if there are different buyer and seller motivations? If the buyer has one motivation and the seller has another, then which motivation is determinative? As the test stands, it is easy to get around this factor by the defendant taking the opposite side from the plaintiff. So if you have differing motivations, how is this treated? Is the motivation of the buyer perhaps more important than the seller's? This issue is not addressed in *Reves*.

The final problem involves the *Reves* presumption. The Court in *Reves* presumed that notes for the most part are securities. Since *Reves*, there are some cases that just dive right into the four-factor test without applying the presumption. This ignores the express statutory language in Section 2(1) of the Act and Section 3(a)(10) of the Exchange Act.

At this time I'd like to mention some significant cases since *Reves*. Unfortunately, I cannot mention them all. One is *Banco Español de*

Credito v. Security Pacific National Bank in the Second Circuit, Southern District of New York, in 1991. In that case, the plaintiffs purchased participations in short-term bank loans, *i.e.*, loan participations. The question was, is this a security? The court said that even though the underlying loans were not securities, perhaps the loan participations themselves would be. The Court then applied *Reves*. Three things are very important in this case and perhaps give some guidelines for future application of the *Reves* test. First of all, this case does open up the possibility that a participation in a non-security may ultimately be a security. That is, that even though a mortgage note is not a security, if there were a mortgage pool, or a loan pool situation where there was a secondary market, then there may be a security.

Another significant issue raised in the case is how to define the investing public. Even though the court didn't attempt to define this, it did acknowledge that there may be a problem if the investing public has differing perceptions. In that particular case, the solicitation was made to sophisticated investors. The court said that if the investing public was the general public, there was no perception since they had no knowledge of the program's existence.

The final significant matter in this case was that the court felt that since bank loans are regulated by the Office of the Comptroller, this is a risk-reducing factor.

The second case is also in the Second Circuit, the Southern District of New York case of *National Bank of Yugoslavia v. Drexel Burnham Lambert*. The question was whether time deposits are securities. The court applied the four-factor *Reves* test. Drexel argued that in this situation, time deposits were analogous to something that was already on the family resemblance list. The court disagreed and applied the four-factor test and found that there was a security. I will discuss the more significant parts of this case. First, the court raised the issue of differing buyer and seller motivations. Drexel took the position that this was not an investment situation but a loan situation. The plaintiff of course stated the opposite. The problem with differing motivations was not resolved but this case brings up the issue that *Reves* provides no guidance as to what to do when this happens. Secondly, the court said that the fact that there was no widespread plan of distribution was not a fatal factor in not finding a security. This seems to diminish the importance of this factor. Thirdly, in addressing the risk-reducing factor part of the *Reves* test, the court stated that the short maturity of the notes was not necessarily a risk-reducing factor. In regard to this factor, Drexel argued that since common law as well as applicable bankruptcy laws existed, satisfactory risk-reducing factors were present. The court said that since both of these laws existed before the securities laws came into existence, they should not be considered risk-reducing factors. Finally, as far as the short-term note issue, the court said that the 1934 Act only exempts short-term notes that are considered to be commercial paper.

In the Fifth Circuit, in *Reader v. Palmer*, in a lower court decision in Louisiana, the question was whether postdated checks were securities. In this case, a travel agency issued postdated checks for travel junkets. The court did not find the checks were securities. The court found no need to examine the third prong of the *Reves* case since the public could not have had any expectations about something it never saw. This was an unusual definition of public expectations, indicating that somehow the public had to be polled or had to have at least seen the transaction to satisfy this factor.

The Sixth Circuit, in *Mercer v. Jaffe, Snider, Raitt and Heuer, P.C.*, a lower court Michigan case, addressed the question of whether notes secured by home mortgages are securities. The court recognized that the notes in this type of transaction were on the family resemblance list and, therefore, not a security; however, it stated that since these notes were sold in a secondary market, this changed the nature of the transaction. *Reves* was therefore applied. When applying the fourth factor, the court stated that a risk-reducing factor could be adequate collateralization.

In the Ninth Circuit, there are two cases. The first case is not as important as the second. The first case is *First Citizens Federal Savings & Loan Assoc. v. Worthen Bank & Trust Co.* The question was whether a loan participation agreement, represented by a note, was a security. The court ruled it was not. It stated merely that this type of transaction was already on the family resemblance list of non-securities, therefore, applying *Reves* was unnecessary. The second Ninth Circuit case, *SEC v. R.G. Reynolds Enterprises*, was decided in December 1991. In this case, a defendant had what is called a managed account. The defendant would get people to lend him money, stating he would invest it for them. Notes represented these loans. Unfortunately, the defendant invested this money in his fiancée, in buying cars for himself, etc. As one can imagine, the investors were irate when they found out about these "investments." They argued the notes were securities. The court applied the *Reves* four factors. First, the court said that the motivation of buyer and seller in this case was definitely investment-oriented. In fact, the notes, as well as the entire transaction, were marketed as an "investment." The second factor, the plan of distribution, involved a wide distribution, not a one-on-one situation. Numerous people held the notes. The third factor, the expectations of the investing public, was met since the transaction was sold on television as an "investment." Finally, regarding the fourth factor, the court merely said, in just one passing sentence, there was no risk-reducing factor. One thing is particularly important about the case, and that is the court felt that notes nine months or less, for the purposes of the 1934 Act, should be exempted only if they are commercial paper. Additionally, they added that notes that did not fall into that category of commercial paper should carry the presumption that they are securities even if they are nine months or less in maturity. The Ninth Circuit attempted to resolve this issue, which was left open in *Reves*.

Despite some instruction from cases following *Reves*, several issues still need explanation or further resolution. First, the motivation of buyers and sellers is a factor that is too easy to get around. The defendant simply takes the opposite side from the plaintiff and the defendant then wins out on this factor because no instruction exists to guide the courts in this situation. I think what is more important is the motivation of the buyer in most instances. Secondly, with regard to the plan of distribution factor, even though one-on-one transactions will not satisfy that factor, one-on-one transactions which evolve into a secondary market should become a security. The actual underlying instrument is not itself a security but if one has a loan which thereafter becomes a part of a mortgage pool, then certainly, secondary trading should make it a security. As I mentioned, some cases agreed with this; one did not. This should be resolved. Maybe this is what the Court in *Reves* was trying to say when they used secondary market language. Thirdly, risk-reducing factors can be many; however, I think only those that address the particular wrong should be considered. For example, if one is going to point to a relevant federal regulatory system as being a risk-reducing factor in a certain case, then it should be a law or system which addresses *that* type of wrong in *that* particular case. It should not be something that just addresses wrongs in a general or peripheral way. Additionally, common law causes of action should not be risk-reducing factors. Many times these causes of action are fraught with defenses that should not be available in securities cases. Finally, I do think that short-term notes (*i.e.*, ones which are not exempted) should be considered to be risk-reducing factors.