NEWS

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THE SHELF RULE: AN INTERIM APPRAISAL

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INTRODUCTION

It is a great pleasure for me to be here today among such distinguished friends and colleagues. I am particularly pleased to have this opportunity to address an area of major importance to us all -- an evaluation of the impact of Rule 415, the SEC's shelf registration procedure, on our capital market system. As you know, Rule 415 governs the registration of securities that are to be offered and sold on a delayed or continuous basis. The Rule was first adopted in March of 1982, on an experimental basis for a period of nine months. On September 1, 1982, six months after Rule 415's temporary adoption, the SEC voted to extend the Rule in its broad form for an additional experimental period that will terminate on December 31, 1983. The majority of the Commission reasoned, in part, "that additional experience beyond December 10, 1982 is necessary in order to assess fully the issues raised by the registration of securities for delayed or continuous offerings." I dissented from the decision to extend the Rule on a broad basis that would include both debt and equity, because I was convinced that the Rule, without modification, encourages adverse changes in our capital market system.

We have now had more than one year of experience with the Rule. The year was hardly a representative one, however. The financial markets were in the doldrums until July 1982, and then from August until the present time they have been enjoying one of the biggest rallies in history. Unfortunately, the aberrational nature of the highs and lows of this market year has, to a large extent, blurred the impact of Rule 415 on our capital markets. Nevertheless, certain conclusions can be drawn, and it is likely that these conclusions will be confirmed by further experience.

It is no surprise to any of us that the Rule has received an enthusiastic reception from corporate issuers and, therefore, numerous offerings have been made under the Rule during the experimental period. During the twelve month period following the Rule's adoption, from March 1982 through February 1983, approximately 339 shelf registrations were filed by some 284 companies for the purpose of making primary offerings of debt and equity securities. 1/

On the debt side, Rule 415 has become a very common way of doing business. Some 270 shelf registrations were filed for debt securities having an aggregate value of $65.2 billion; of those, approximately 262 debt issues actually came to market involving $19.9 billion of straight and convertible debt. Of the entire $49.9 billion in debt offered during the twelve month period, approximately 40% was issued under Rule 415.

On the equity side, the Rule is not being used as often. During the twelve month period, only 69 shelf registrations were filed for equities; and approximately 64 equity issues were offered involving $3.2 billion of preferred and common stock. This represents about 12% of a total of about $26.8 billion of equity offered during the period.

1/ Statistics supplied by Securities Data Company, Inc.

As I will discuss in at least some detail in a moment, the 415 experience and the extensive comments on this experience that I have gathered from the securities community -- from many of you here today -- has left me unreconstructed. Rule 415 in its present form should not continue beyond its expiration date of December 31, 1983.

So what should we do? Although I hesitate to turn back the clock completely, I believe that the Rule must at least be modified to minimize unnecessary risks. I would, therefore, limit the Rule's principal application to debt offerings, and not permit its general use for equity offerings.

I believe that use of the Rule for equity offerings has the greatest potential to produce the disclosure problems and injury to the capital-raising process that I will discuss today. At the same time, equity offerings have less need for the instantaneous offering procedure. Because, in general, investment in equity securities involves greater risk than debt and because, unlike debt, equity is still widely purchased by retail investors, there is a greater need in these offerings for thorough due diligence and for the distribution on a timely basis of high quality information about issuers. If we were to exclude general equity offerings from Rule 415, underwriters would have more time to conduct due diligence and investors would be more likely to receive useful information about an offering on a timely basis. Furthermore, statistics reveal that equity securities are more frequently sold through broad-based underwriting syndicates to large retail investment networks than are debt securities. Thus, the present breadth and depth of our capital markets are likely to be disproportionately affected if there was widespread use of the shelf procedure for general equity offerings.

In my dissent I endorsed the Rule's laudable and timely objective of facilitating access of large issuers to an increasingly volatile debt market. I opposed, however, the chosen route to accomplishing that goal, because in my judgement it unnecessarily threatens to change dramatically, and perhaps damage irreparably, our capital market system -- one that has worked effectively, efficiently and honestly for many years.

To see whether or not these concerns are exaggerated, I have made an effort over the past several months to collect current information on the shelf registration process. The information that I received has tended to confirm my apprehensions, and has demonstrated that significant modifications to the Rule are necessary to aim it more directly at the problems it was designed to solve, and to ensure that the risks we take are commensurate with the rewards we seek. I reach this conclusion for two major reasons, each of which I will explain in detail.

RISKS TO THE DISCLOSURE SYSTEM

The first major problem area with respect to Rule 415 is that it is undermining the market's basic information systems. The overwhelming consensus of market observers is that, in marked contrast to the system of investor protection set forth in the Securities Act, Rule 415, by further accelerating the registration process for issuers, does not allow time for underwriters to discharge adequately their due diligence responsibilities. In this respect, Rule 415 exacerbates an already serious deterioration in due diligence procedures which resulted from the otherwise applaudable integrated disclosure system and the proliferation of short-form registration statements. Ever since the Amendments in 1978 to Form S-16 that permitted large issuers to sell their securities on an accelerated schedule, and to incorporate by reference reports previously filed under the Exchange Act for most required substantive disclosure, the underwriter's role and that of their counsel with respect to their due diligence obligation has been diluted. Even in the accelerated environment of an S-16 prospectus, however, adequate due diligence was undertaken by the underwriters and their counsel prior to the initial filing, and anything that remained to be checked was accomplished between the filing and the effective date. This is vastly different from what is occurring under Rule 415.

According to the investment bankers with whom I have spoken, meaningful due diligence in the context of shelf offerings is simply not being performed. 2/ There are a number of factors contributing to the decline in due diligence under Rule 415. In contrast to the practice under Form S-16, under the Rule due

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2/ A representative of one of the major firms active in the 415 marketplace concedes that his firm has "experienced increasing difficulty in executing [its] due diligence responsibilities under the securities laws." Another investment banker has observed that "Rule 415 tends to emphasize the trading aspect of the business at the expense of due diligence, research, and related investor safeguard activities."

diligence is not practical prior to filing, because the ultimate underwriters have not then been selected. Similarly, the speed with which shelf offerings occur makes meaningful due diligence equally impractical prior to bidding for a shelf offering. In a competitive environment that can only be described as frantic, underwriters frequently may have no more than a few hours to decide whether to bid for a shelf deal. According to one investment banker, in this short time frame a prospective underwriter "is forced to accept at face value documents prepared and filed by the issuer many months ago without the underwriter's participation." The difficulty in performing due diligence is exacerbated by the inability of underwriters to anticipate when issuers will decide to sell securities off the shelf. One investment banker observed that his firm started one week anticipating six offerings, but the firm ultimately handled thirty-two deals that week, twenty-six of them on Thursday and Friday. Of course, this kind of hectic and unpredictable financing calendar makes thorough and timely due diligence impossible.

Finally, the dramatic shift in the balance of power between the issuer and the underwriter, that has been caused, at least in part, by Rule 415, further contributes to the decline in due diligence. The Rule puts the issuer in the driver's seat by enabling it to play off one underwriter against another and thus defeat reasonable requests for investigation or disclosure. This lowest common denominator approach to due diligence and disclosure is not what the securities laws are all about.

Of course, underwriters are taking what steps they can under the circumstances. But the fact remains that they cannot make even a cursory appraisal of the accuracy and completeness of an issuer's disclosure documents in the context of an instantaneous offering. The practice of many major investment banking firms is apparently to assign a recent business school graduate to perform a modicum of due diligence -- as little as a half a day -- upon the filing of a shelf registration statement in which the firm is named as a potential underwriter, and even less if they are not named but only hope to participate. One firm that regularly underwrites low grade debt, which, in fact, is more like equity than debt, conceded that they are now working "right on the fringe." A number of investment bankers have also observed that the decline in due diligence has been accompanied by a deterioration of the quality of underwriting agreements, particularly in the areas of comfort letters and opinions of counsel. 3/

Even apart from its effect on due diligence, the speed with which shelf offerings are made is having an adverse impact on the dissemination of information to investors. Under the Rule, potential investors (or, for that matter, potential members of the selling group) are not receiving adequate, if indeed they are

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3/ It has been suggested that the accelerated timetable of shelf offerings can be accomodated if issuers and underwriters establish an ongoing due diligence program. Some companies report that they have taken steps along these lines. Citicorp, for instance, holds periodic "due diligence" meetings with potential underwriters of its securities. I believe, however, that while such programs may be helpful, they are no substitute for a traditional due diligence investigation performed by an underwriter with its counsel and the issuer's outside counsel.

receiving any, information about an offering prior to being called upon to make an investment decision.

Of course, the speed with which investors must make their investment decision and the lack of available information on which to base that decision are not solely the result of Rule 415. Rather, these problems, like the due diligence problem, had their origins in the integrated disclosure system and the creation of short form registration statements.

The impact of Rule 415, however, has been to aggravate the difficulties for the investor in making an investment decision. In instantaneous shelf offerings, one leading firm reports that it is not uncommon, at least in debt offerings, "for neither the basic prospectus nor the prospectus supplement to be circulated to investors prior to their being called upon to make a commitment to purchase the offered securities." Some institutional investors have reported receiving telephone calls from investment bankers asking them for an investment decision on the spot; others have reported receiving calls from salesmen who have had so little opportunity to educate themselves about an offering that they are unable to answer such fundamental questions as what type of business is engaged in by the company. Obviously, this time-pressured atmosphere favors snap investment-decision making, and leaves little room for the thoughtful investor to conduct a sound investment analysis prior to making an investment decision.

Having taken one giant step away from the basic disclosure system by failing to allow adequate time for the preparation and review of meaningful disclosure documents, we take a second such step by failing to allow any time to disseminate and read the documents that are provided. We risk, therefore, repealing by administrative fiat, rather than legislative action, Section 5 of the 1933 Act, the basic registration and prospectus delivery requirement. Section 5 has been a cornerstone of our excellent market system for the past 50 years and it is to me a great shame to see it put at substantial risk on the basis of inadequate analysis all for an obscure principle of regulatory reform.

RISKS TO THE CAPITAL MARKETS

The second major problem with the Rule is that it is accellerating trends which most observers fear will have a detrimental effect on the basic elements of our capital market system. In particular, the rule is accelerating both concentration in the securities industry and institutionalization of our investor class. At a time when America needs greater breadth and depth in its capital markets, the Rule is having the opposite tendency.

1. Increased Concentration of Underwriting Business.

As predicted, the compressed offering period under the Rule has resulted in increased concentration of underwriting business and has made it difficult for investment bankers to form traditional broad-based selling syndicates. Experience thus far has been that traditional syndicates are being formed much less frequently in Rule 415 offerings, and only a fraction of those broker-dealers who formerly participated in these deals are currently included in the more recent smaller syndicates.

The extent to which the Rule is accelerating concentration of underwriting business in the hands of a few firms was very much in evidence last year, when approximately 77% of the shelf financings were managed by the five largest firms. Even in an industry that has witnessed increasing concentration over the years, this figure reflects a dramatic shift in power to the top five firms.

In addition, substantially fewer offerings under Rule 415 were syndicated when compared to offerings not made under the Rule. During the twelve month period following the Rule's adoption, 48% of the 415 offerings were syndicated as compared to 65% for all offerings. Even more remarkable is the fact that in the year preceding the Rule's adoption, fully 82% of all offerings were syndicated.

Furthermore, the average number of firms participating in market syndicates has dropped 50%. Numerous regional firms have reported that they have been excluded from both debt and equity offerings under Rule 415, although in prior similar offerings they played a significant role in the distribution to the public. One large regional, for example, reports that in 1982 its underwriting participation declined 60%, despite the fact that a record number of offerings was marketed, and another regional reports a similar decline of 50%. Many small and regional broker-dealers have difficulty documenting the extent to which they have lost business as a result of Rule 415, but they overwhelmingly conclude that the Rule has hurt them dramatically.

Even though the present bull market may be keeping the regionals alive, we must ask ourselves why we are threatening their viability. Can we afford to waste important players in our market structure? Who else will perform as they do for the small investor and the small issuer? Should the desire of a few large issuers to have instant access to increasingly illusive market windows be allowed to undercut services to the start-up and growing companies? It would seem that in the name of increasing competition we are much more likely to decrease it.

2. Impact on Major Underwriters

Ironically, another major problem of Rule 415 is the greatly increased risks it places on the major investment banking firms. Historically, underwriting syndicates have existed to permit a sharing of the risks of underwriting as well as facilitating a wide distribution of securities. Instead of spreading risk among a large number of broker-dealers, Rule 415 has reduced the number of broker-dealers participating in a given transaction and has sharply increased the financial risk to those who do.

Investment bankers wanting to participate in shelf deals must be willing to put unparalleled amounts of capital on the line to purchase securities and to bear that capital risk until they are able to sell the securities. If an underwriter making such a substantial purchase has trouble selling the securities, or gets caught in a plunging market, the results could be disastrous, not only for the investment banker, but for investors, our capital markets and our economy. Fortunately, luck and the bull market have, so far, carried investment bankers over the roughest spots. But there have been some difficult moments.

3. Institutionalization of Investors

Another problem with the Rule is that it is accelerating the current trend towards institutionalization of our securities investor group. Institutions are becoming the dominant purchasers of new issues and small investors are being denied equal access to these offerings. As the time constraints fostered by the Rule have eroded the syndication process, underwriters have found it necessary to place large blocks of securities quickly in order to reduce their own market risks. This has resulted in the individual investor being bypassed. For instance, of the approximately $19.0 billion of debt sold off the shelf in the year ended February 28, 1983, about 35% was sold in "bought deals", that is, issues sold directly to a small number of institutional investors without the formation of an underwriting syndicate.

Institutional purchases of the equity shelf offerings have not been quite so pronounced but are still substantial. Approximately 16% of the $3.2 billion of shelf equity offerings made during the period was sold to institutions in bought deals.

The composition of demand for recent equity offerings by AT&T, the most widely held stock, may be instructive. In June 1981, AT&T engaged in a negotiated offering of approximately 18 million shares involving 255 underwriters. Fully 40% of the securities were sold retail with the balance sold to institutions.

In sharp contrast, in May 1982, AT&T sold 2 million shares off the shelf through a single underwriter -- and only 5% of the stock was purchased by individuals.

We must be circumspect in developing a regulatory system that discourages the participation of individual investors in our capital markets, because the strength and liquidity of those capital markets historically has been a function of the confidence and continued presence of the individual investor.

CONCLUSION

Rule 415 does one thing well. It allows a few major issuers quick access to the debt markets so as to take advantage of market windows. Of course, whether those windows will continue to appear in the face of a $37 billion market overhang in debt already on the shelf is questionable at best. But, even assuming that advantage does exist, what price do we pay for it. We make a mockery of the due diligence done by underwriters and their counsel -- all that is done, that can be done, is the minimum amount necessary to claim the statutory defense. The defense of the public is at best secondary. Basic disclosure documents are held in the SEC's files, and only obscure cross references to them appear in circulated documents. The documents that do circulate come so late in the truncated process as to be worthless. Furthermore, in an attempt to increase competition among underwriters, we do the opposite. Only the largest and richest can play in this high stakes game. The regionals which provide services to emerging companies -- whose establishment and growth will help revitalize our economy -- and our small investors -- who should be attracted back to the market, not pushed away -- have been dealt a heavy blow.

The price is too high, the risks are too great. The 415
king has no clothes -- or if he has, they are full of holes.