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Assessment of Shelf Registration: How Much Diligence is Due Investors?

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Investment Banking and Diligence: What Price Deregulation?, by Joseph Auerbach* and Samuel Hayes, III.** Boston, Massachusetts: Harvard Business School Press, 1986. 274 pages. $24.95.

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It has been over four years since the Securities and Exchange Commission (SEC) adopted its controversial Rule 415,[1] commonly known as the Shelf Registration Rule. Under the Shelf Registration Rule, eligible public issuers[2] may file a single registration statement for a class of debt or equity securities and then sell the securities on a non-fixed price basis at any time during a maximum two-year period. While many commentators have attempted to assess the Shelf Registration Rule's impact,[3] the full ramifications of the Rule for investor protection have yet to be determined. The Shelf Registration Rule is but one component of the SEC's integrated disclosure system, a deregulatory initiative begun during the Carter

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1. 17 C.F.R. § 230.415 (1985). The Shelf Registration Rule was adopted on a temporary basis in 1982 by SEC Securities Act Release No. 6383, *reprinted in* [1937-1982 Accounting Series Releases Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 72,328 (March 3, 1982). Following a trial period during which public comments were received, the Shelf Registration rule was formally adopted by SEC Securities Act Release No. 6499, *reprinted in* [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,449, at 86,335 (Nov. 17, 1983).

2. In general, companies eligible for shelf registration include U.S. corporations which have had a class of equity securities registered pursuant to the 1934 Act for three years or more and have made all required annual and periodic filings under the 1934 Act in a timely manner, have not defaulted on preferred stock dividends, debt or other long term obligations, and meet certain dollar standards for the aggregate market value of voting stock. *See* 17 C.F.R. §§ 230.415, 239.13 (defining securities eligible to be registered on Form S-3) (1985).

3. *See, e.g.*, Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135 (1984) (rule benefits both issuers and investors); Feeney, *The Saga of Rule 415: Registration for the Shelf*, 9 CORP. L. REV. 41 (1986) (rule is beneficial and its availability should be extended); Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005 (1984) (shelf registration is harmful to investors and the economy); Note, *The Impact of the SEC's Shelf Registration Rule on Underwriters' Due Diligence Investigations*, 51 GEO. L. REV. 767 (1983) (shelf registration is inconsistent with securities laws' disclosure policies); Note, *The Impact of the SEC's Rule 415 on Individual Investors*, 46 OHIO ST. L.J. 223 (1985) (while rule benefits issuers, investors may be unable to obtain adequate information).

Administration[4] and put into final form under the leadership of SEC Chairman John S.R. Shad during the Reagan Administration.[5] The integrated disclosure system is designed to avoid unnecessary corporate disclosure by permitting issuers to incorporate periodic reports made under the Securities Exchange Act of 1934[6] ("1934 Act") into Securities Act of 1933[7] ("1933 Act") registration statements.[8]

The Shelf Registration Rule was adopted in the face of serious opposition from the investment banking establishment.[9] In addition, Commissioner Barbara Thomas dissented in part from the Rule's adoption, expressing the belief that shelf registration of equity offerings would reduce the quality and timeliness of disclosure and further the trend toward institutionalization of securities holders, to the detriment of individual investors.[10] Although the Shelf Registration Rule is now widely used in both equity and debt underwritings, doubts about the Rule's possibly adverse side effects have continued.

Investment Banking and Diligence: What Price Deregulation?[11] is an attempt to explain the economic and political developments that led to the adoption of the Shelf Registration Rule and to assess the impact of the Rule on investor protection. Joseph Auerbach and Samuel L. Hayes, III share the reservations expressed by Commissioner Thomas in her dissent to the adoption of the Shelf Registration Rule and conclude that the Rule is harmful to both investors and investment bankers. Their own recommendations for reform, however, would not be likely to halt the

4. *See* R. KARMEL, REGULATION BY PROSECUTION 259-64 (1982).

5. The SEC's proposals for an integrated disclosure system are contained in SEC Securities Act Release Nos. 6331-38, *reprinted in* SEC. REG. & L. REP. (BNA) No. 616, spc'l supp. (Aug. 12, 1981). Integrated disclosure was adopted in SEC Securities Act Release No. 6383, *reprinted in* [1937-1982 Accounting Series Releases Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 72,328, at 62,990 (Mar. 3, 1982). Chairman Shad initially recused himself from participating in deliberations on the Shelf Registration Rule, but concurred in its adoption as a final rule, writing a special concurring opinion. SEC Securities Act Release No. 6499, *reprinted in* [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,449, at 86,346 (Nov. 17, 1983) (Shad, Chairman, concurring).

6. 15 U.S.C. §§ 78a-78kk (1982).

7. 15 U.S.C. §§ 77a-77bbbb (1982).

8. *See* R. KARMEL, *supra* note 4; Nicholas, *The Integrated Disclosure System and Its Impact on Underwriters' Due Diligence: Will Investors Be Protected?*, 11 SEC. REG. L.J. 3, 3-6 (1983).

9. *See, e.g.*, Osborn, *The Furor Over Shelf Registration*, INSTITUTIONAL INVESTOR, June 1982, at 61.

10. SEC Securities Act Release No. 6499, *reprinted in* [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,449, at 86,346 (Nov. 17, 1983) (Thomas, Comm'r, concurring in part and dissenting in part). *See also* SEC Securities Act Release No. 6423, *reprinted in* [1982 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,250, at 85,279 (Sept. 2, 1982) (extension of temporary Rule 415) (Thomas, Comm'r, dissenting).

11. J. AUERBACH & S. HAYES, III, INVESTMENT BANKING AND DILIGENCE: WHAT PRICE DEREGULATION? (1986) [hereinafter cited by page number only].

institutionalization[12] of the securities markets, to which shelf registration seems more a response than a cause.

I. Development of an Integrated Disclosure System

The authors of *Investment Banking and Diligence: What Price Deregulation?* do an excellent job of explaining the background to the adoption of the Shelf Registration Rule. In general, the book is clear, concise, and easy to read. The Appendices include a helpful glossary of terms and a sample of underwriting documents.[13] Hayes and Auerbach trace the developments in the securities markets leading up to the passage of the 1933 Act and the 1934 Act.[14] They conclude that the Securities Acts were based on a policy of "regulation by information" designed to ensure investor confidence, even if at the expense of lost efficiency.[15] The authors' concern with full and accurate disclosure underlies the book's detailed treatment of the due diligence procedures that were adopted by investment banks in response to the passage of the 1933 Act.[16] The authors also address the evolution of the securities markets since the passage of the 1933 Act,[17] properly focusing upon the institutionalization of the securities markets and the power which this has given customers to dictate the terms of underwriting transactions to investment bankers. This development led both to the formation of multi-service financial firms which are supplanting the traditional investment banking houses and to a pressure for lower underwriting fees.

The second half of the book is devoted in part to a discussion of the movement toward integration of 1933 Act and 1934 Act disclosure requirements,[18] which culminated in 1982 with the introduction of shelf registration. Both the Shelf Registration Rule and related SEC rules permitting the integration of disclosure requirements under the 1933 Act and 1934 Act were in part a response to marketplace pressures for speedier, more flexible underwriting arrangements. These SEC regulations enable issuers to shelf register offerings and take advantage of windows in the capital markets to effectuate financings on a day's notice. Auerbach and Hayes recognize that part of the impetus for these developments was

12. Institutional investors accounted for only 25% of the public volume on the New York Stock Exchange in 1953; by 1980 this figure had grown to 65%. In 1980, 50% of institutional-owned NYSE listed equity assets were held by noninsured corporate pension funds, 15% by insurance companies, 10% each by investment companies and nonprofit institutions, and 13% by foreign institutions. P. 97.

13. Pp. 205-66.

14. Pp. 8-61.

15. Pp. 57-58.

16. Pp. 62-84.

17. Pp. 85-107.

18. Pp. 108-122.

activity in the Eurosecurities markets and the need for U.S. underwriters to tap the U.S. markets as quickly and efficiently as the markets in Europe were being tapped.[19]

The adoption of an integrated disclosure system by the SEC in turn accelerated ongoing developments in the marketplace. No doubt it was in part the recognition of these trends and the adverse impact this could have on some firms that led to opposition by investment banks to the Shelf Registration Rule. For example, Morgan Stanley & Co., Inc. was one of the most vocal opponents of the Shelf Registration Rule.[20] In the years following the adoption of the Rule, Morgan Stanley was the most prominent loser among lead underwriting firms, falling from a fifteen percent market share in 1979 to a seven percent share in 1984.[21]

After discussing the developments surrounding adoption of the Shelf Registration Rule,[22] the authors undertake an analysis of the types of issuers that currently qualify to issue securities under the Rule.[23] The purpose of their analysis is to determine the extent to which issuers under the Shelf Registration Rule fit the ideal profile of a large, stable public company about which a large volume of information is publicly disseminated. Finally, Hayes and Auerbach analyze the impact of the Shelf Registration Rule and propose modifications to current shelf registration procedures.[24] They are less successful in assessing the impact of the Shelf Registration Rule, however, than they are in describing the trends in the securities markets that led to its adoption.

II. The Impact of the Shelf Registration Rule On Underwriter Due Diligence

Auerbach and Hayes devote much of their book to an analysis of the impact of the Shelf Registration Rule on the underwriting process. Their primary conclusion is that inadequate due diligence investigations undertaken by investment banks as a result of the Shelf Registration Rule—the result of the very short time between the decision to issue securities and their sale—are likely to have a deleterious effect on investor protection. There is very little analysis in the book, however, of the actual impact of the Shelf Registration Rule on the quality of information contained in

19. P. 124.
20. P. 172, n.8, citing 15 SEC. REG. & L. REP. (BNA) No. 45, 2104 (Nov. 18, 1983).
21. P. 135. It is interesting to note that Morgan Stanley has now gone public, demonstrating a need to diversify and raise capital which deregulation generally seems to spawn. *See* Monroe, *Morgan Stanley Initial Offering Is a Hit as Firm's Stock Soars in Early Trading*, Wall St. J., Mar. 24, 1986, at 5, col. 1.
22. Pp. 123-44.
23. Pp. 145-174.
24. Pp. 174-199.

registration statements. The empirical evidence in support of their conclusion is inadequate; the best they can come up with is an analysis of companies eligible for shelf registration which indicates that such issuers vary widely with respect to size, operating performance, capital structure, and stock market performance, and that not all of them are necessarily followed by financial analysts.[25]

Based on their assumption that the markets for the securities of some of the issuers eligible for shelf registration are not efficient,[26] Auerbach and Hayes conclude that normal due diligence procedures—not the abbreviated procedures prevalent under the Shelf Registration Rule—are necessary to ensure adequate investor protection.[27] The authors' skepticism of the efficient market theory may well be justified: The notion that the securities markets are efficient remains controversial. Indeed, a primary justification for the federal securities laws is the inefficiency of the markets and the need to mandate disclosure because investors would otherwise be unable to obtain information necessary for them to have confidence in the securities markets.[28] Yet, although the SEC paid lip service to the efficient market theory in promulgating the Shelf Registration Rule, this change in the nature of SEC processing of underwriting documents rests on a firmer foundation than a belief in efficient markets: It rests on a pragmatic recognition that the changed character of the securities markets requires flexible underwriting arrangements and integrated disclosure.

Auerbach and Hayes place too much emphasis on the Shelf Registration Rule itself. They fail to appreciate that the developments they deplore—the abbreviation and erosion of the due diligence process—are the result of a variety of legal and economic factors other than the Shelf Registration Rule. Under the SEC's integrated disclosure system, most public companies which have been in the SEC reporting system for three or more years can incorporate by reference into registration statements filed in connection with public offerings under the 1933 Act accounting and other information contained in annual and periodic reports filed with the SEC under the 1934 Act.[29] This ability to incorporate information created by the issuer and its accountants in documents which underwriters must use in offerings has led to the dilemma of today's investment bankers. That is, although the underwriters are still subject to liability

25. Pp. 163-173.

26. Pp. 165-72, 187. For discussions of the concept of market efficiency, see Fama, *Efficient Capital Markets: A Review of the Theory and Empirical Work*, 25 J. FIN. 383 (1970); Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554-65 (1984).

27. Pp. 165-72.

28. *See* 6 SENATE COMM. ON GOVERNMENTAL AFFAIRS, 95TH CONG., 2D SESS., STUDY ON FEDERAL REGULATION: FRAMEWORK FOR REGULATION 18-21 (Comm. Print 1978).

29. *See* 17 C.F.R. §§ 239.12 (Form S-2), 239.13 (Form S-3) (1985).

under the 1933 Act—for which they have a due diligence defense available[30]—they are in many cases unable to persuade issuers to revise or change information previously filed with the SEC.

Furthermore, 1934 Act filings are not reviewed and commented upon by the SEC in the same manner that 1933 Act registration statements traditionally have been, because such filings do not have to be declared effective by the Commission. The SEC staff therefore has much less practical ability to change the form or content of corporate disclosure in annual and periodic reports. To be amended, such disclosure would have to be so clearly wrong as to justifiy an SEC enforcement action. The informal give and take between the SEC's staff and corporate counsel over disclosure that used to be a part of the processing routine for public offerings no longer exists as to issuers which can incorporate 1934 Act filings by reference in their public offerings. Moreover, the huge increase in the total number of SEC filings both under the 1934 Act and 1933 Act, in a period where there has been no increase in the number of SEC staffers, makes the continuation of such processing techniques infeasible in any event.

Shelf registration has undoubtedly exacerbated the problems of underwriter due diligence. Business conditions, however, are probably more pertinent to these problems than changing legal requirements. Even if an underwriter had a month instead of a few days, could an adequate due diligence investigation of General Motors or IBM really be conducted? Modern enterprise has become far too complex and large to be amenable to old-fashioned due diligence. The SEC and the investing public have no real alternative to relying on public corporations to have the integrity to report adequately and accurately on their financial and business affairs.

III. Policy Implications

There is no question that underwriter due diligence procedures have changed over the past decade. Despite the SEC's safe harbor Rule 176,[31] however, which specifies due diligence standards, the SEC's shelf registration and integrated disclosure rules have not altered the liability provisions of Section 11 of the 1933 Act that pertain to underwriters.[32] Yet, as Auerbach and Hayes conclude, the specter of such liability may not be "sufficient to influence underwriters' behavior decisively" because of the "competitive forces at work in the securities industry."[33] Moreover, they

30. 17 C.F.R. § 230.176 (1985).
31. *Id.*
32. 15 U.S.C. § 77k (1982).
33. P. 179.

also conclude that various substitutes for old-fashioned due diligence that have been suggested by the SEC, particularly market efficiency, are insufficient.[34]

Auerbach and Hayes make some policy proposals in response to the problems they perceive with underwriter due diligence procedures under the Shelf Registration Rule. First, they suggest that not all S-3 issuers[35] should remain eligible for shelf registrations, but only "quality" issuers. The SEC would measure quality rather like a rating agency does, with a "formula embodying a number of investment quality earnings and assets indices."[36] For the universe of lesser-quality issuers which the SEC believes should be permitted to use an abbreviated registration process, Auerbach and Hayes propose the authorization of "professional diligence agencies" which would take the place of the investment bankers and counsel who have traditionally performed due diligence. These "professional investigators" would be personally liable for failure of due diligence, and the underwriter would be no longer so liable.[37]

These policy proposals are not discussed in much depth or detail by the authors, and deserve a fuller analysis. The idea of permitting the SEC to operate like a rating agency and to give some issuers better access to the marketplace than others flies in the face of basic policy decisions made fifty years ago to substitute full disclosure for merit regulation in the federal securities laws.[38] The increasing institutionalization of the market which has led the SEC to the current shelf registration and integrated disclosure rules should be an impetus to less rather than more investor protection legislation. Institutional buyers are better able to fend for themselves than are unsophisticated investors. Moreover, not only would the current political climate—which favors marketplace discipline over government regulation—be inhospitable to the authors' proposals, but there is no reason to assume that the professional diligence agencies suggested by the authors would do a more competent job than investment bankers, independent accountants, and counsel have done for fifty years.

The real problem with the current regulatory framework, which the authors hint at but do not frankly state, is that a serious bear market could spawn securities litigation which would bankrupt current purveyors of due diligence. If the kind of strict liability concepts which the courts have applied to general tort claims were to be applied to cases for misrepresentation in securities offerings, it is doubtful that current diligence

34. P. 172.
35. *See supra* note 2.
36. P. 192.
37. P. 194.
38. *See In re* Universal Camera Corp., 19 S.E.C. 648 (1945).

practices would be an adequate defense to damages that would be imposed on accountants, investment bankers, and counsel for many underwritings. As SEC Chairman Shad stated in his special concurring opinion adopting the Shelf Registration Rule:

> The bulk of shelf offerings to date have occurred during the broadest and strongest stock, bond and new issue markets in history. Investors do not seek rescission or other redress, unless the security declines in price. The test of the shelf rule will come during the next bear market.[39]

Auerbach and Hayes suggest that greater investor protection be purchased by issuers through insurance or letters of credit.[40] This technique has been used to satisfy nervous purchasers of municipal bonds. Whether such an added burden should be placed on the already seriously strained insurance and banking industries, however, is a difficult question. Because these very types of institutions are the predominant investors in the securities markets today, perhaps they should bring their skills as assessors of risk to bear upon their own investment decisions. In other words, perhaps the appropriate policy response to the situation described by *Investment Banking and Diligence: What Price Deregulation?* is not investor protection re-regulation, but a relaxation of due diligence liability to complement the shelf registration and integration rules. It is not obvious that the financial intermediaries who bring issuers and purchasers of new issues together are in a better position to guarantee the accuracy and adequacy of financial disclosure than institutional investors.

The problem with a greater degree of investor due diligence or a return to *caveat emptor* in securities regulation, of course, is where this leaves the individual small investor in a market increasingly dominated by institutional investors. This is the real dilemma confronting policy makers, who have never been able to decide whether the objective of federal financial institution regulation is to strengthen the national economy by making the capital markets a more efficient mechanism for allocating capital or to protect consumers.

39. SEC Securities Act Release No. 6499, *reprinted in* [1983-1984 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 83,449, at 86,346 (Nov. 17, 1983) (Shad, Chairman, concurring).
40. P. 195.