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PRIVATE PLACEMENTS SHOULD BE REGISTERED

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[*In "Should Direct Placements Be Registered?", published in the previous issue of the* REVIEW,*** Professor Cohan took issue with Professor Steffen's views*† *on the question and answered negatively. Professor Steffen's affirmative reply follows.* THE EDITORS.]

There is much to agree with in Professor Cohan's study of the private placement[1] problem. But, unfortunately, there are also some things which cannot be accepted. Not least, of course, his conclusion, which is diametrically opposed to what I conceive to be in the public interest.

Perhaps a word should be said at the outset about viewpoints. If I have read Professor Cohan rightly, he is of the school which would go to some length to keep government out of business. Indeed, he accuses the SEC of "typical bureaucratic timidity"[2] for not drawing up a list of persons—insurance companies, banks, pension funds, and plain people—who are "able to fend for themselves."[3] Although there is no statutory warrant for so doing, he says the Commission should entirely excuse registration as to these persons; in fact, he says registration should be excused as to just anyone "who wished to be included"[4] on such a list. After all, he asks, "who is the SEC to say him nay?"[5]

Of course, much water has gone over the dam since it was

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** 43 N.C.L. REV 298 (1965).

† See Steffen, *The Private Placement Exemption: What To Do About A Fortuitous Combination in Restraint of Trade*, 30 U. CHI. L. REV. 211 (1963) [hereinafter cited as Steffen].

[1] The term "private placement" is used here in the same sense as "direct placement." Both involve a direct sale. But the significant thing is whether registration will be excused under section 4(1) of the Securities Act of 1933, 48 Stat. 77, 15 U.S.C. § 77d(1) (1958). Many direct sales are not excused. The older term, "private placement," is used as best distinguishing the transaction from a "public offering."

[2] Cohan, *Should Direct Placements Be Registered?*, 43 N.C.L. REV. 298, 313 (1965) [hereinafter cited as Cohan].

[3] *Id.* at 314.

[4] *Ibid.*

[5] *Ibid.*

the fashion to say: "That government governs best which governs least." My suggestions, in any case, were made to bring about fuller and more consistent application of two basic national policies: one, that of the Sherman Act,[6] with its insistence on unfettered access—even for securities—to a free competitive market; and the other, that of the Securities Act of 1933,[7] with its emphasis upon "full and fair disclosure." The exemption from registration provided by section 4(1),[8] it seems to me, "has operated, more or less fortuitously, in a way contrary to the spirit of those acts."[9]

I. Background

On one point there can be no disagreement; the growth of private placements, as Professor Cohan says, "has been one of the most striking developments" in corporation finance "since the mid-thirties."[10] Indeed, as his tables[11] show, the dollar value of industrial issues placed privately and without registration has exceeded that of the issues registered and sold publicly in every year since 1942. And, for 1962, he reports some 3,678,000,000 dollars escaped registration in this way, topping those issues registered and sold to the public in a ratio of three to one.

The statistics for rail and utility issues present a different picture. But, only so because government intervened in 1941[12] and 1944[13] to require competitive bidding. I suspect Professor Cohan regards this as unfortunate, for he points out that the "cost of flotation of utility and rail issues would surely have declined *more* if competitive bidding had not been made compulsory."[14] And, of course, he is correct in a sense; the private placement does enjoy a small apparent reduction in incidental costs. But the SEC and the ICC had become convinced that if really significant sums were to be saved, it could only be done by bringing about actual competition for rail and utility issues. Hence for many years now, only the

[6] 26 Stat. 209 (1890), 15 U.S.C. §§ 1-7 (1958).
[7] 48 Stat. 74, 15 U.S.C. §§ 77a-77aa (1958).
[8] 48 Stat. 77 (1933), 15 U.S.C. § 77d(1) (1958).
[9] Steffen 215.
[10] Cohan 300.
[11] *Id.* at 301-06.
[12] SEC Holding Company Act Release No. 2676 (April 8, 1941).
[13] In the Matter of Competitive Bidding in the Sale of Securities Issued under Section 20a of the Interstate Commerce Act, 257 I.C.C. 129 (1944).
[14] Cohan 302-03 n.9.

unusual issue has been permitted to go the noncompetitive, private placement route.

Omitted from Professor Cohan's background material is any reference to the legislative background for section 4(1). It seems to be true, though, that no one who had anything to do either with the drafting or the enactment of the Securities Act had any idea that private placements would ever bulk so large. The pattern of the act was to bring about "full and fair disclosure"[15] for all securities, by means of registering successive issues as they came to market. In this context, section 4(1) was of minor consequence; it was thought to cover relatively few, strictly private transactions, where both buyer and seller were fully informed. But, in light of the statistics, it may now also be said that "one of the most striking developments"[16] has been the extent to which congressional purpose has been defeated.

II. Consequences of Growth

Most of what Professor Cohan writes under this heading is irrelevant and somewhat misleading. Suppose it were true, as he says, that private placements have "increased the degree of competition in the market for long term corporate funds"[17] and have contributed in some degree to the reduction of flotation costs.[18] In both cases, the lion's share of the credit must go to competitive bidding, which not only has reduced bankers' spreads but has given issuers an optimum price for their securities as well. It has been competitive bidding—strenuously opposed, and for obvious reasons, by both bankers and institutional investors—which has set the competitive pace, not the private placement.

Actually the private placement operates in a sheltered area. In the first place, since registration is not required, negotiations can be had with no whisper of competing terms or prices. In the second, only a small number of "sophisticated"[19] investors (no doubt with similar price views) may be approached, else the issuer will run the risk of having made a public offering. And thirdly, since underwriting costs are not involved, the investor has a nice leeway in

[15] Steffen 221.
[16] Compare text accompanying note 10 *supra*.
[17] Cohan 301-02.
[18] *Id.* at 302.
[19] *Id.* at 299.

which to set his price. Perhaps this is "competition"—Professor Cohan hails it as such—but it is surely a rarified sort. Plainly it is not the bare knuckles kind afforded by competitive bidding, where the issuer offers his securities in the light of day and has two or more sharp-pencil prices from which to choose.

But, however this all may be, it is quite irrelevant to the present discussion. The same, unfortunately, must be said for Professor Cohan's further points: that the private placement has meant "the development of quite new types of loans";[20] and that many borrowers, unable to make a public offering, "have been able to obtain long term debt financing at moderate cost."[21] Surely it is clear the question is not whether private placements should be *abolished* nor even whether they have *advantages* over the public offering; the question, simply, is whether the direct placement should be *registered.* For all that Professor Cohan writes on the point, registration might well enhance, rather than destroy, the usefulness of the direct offering.

III. Register All Issues

Under this topic Professor Cohan first essays to refute the two propositions referred to above: the one, that Congress never intended section 4(1) of the Securities Act to be a loophole through which securities aggregating 3 billion dollars a year might escape registration; and the second, that the effect has been to give the larger institutional investors a monopoly position which, if reached by agreement, would violate the Sherman Act. Then, secondly, he seeks to deny that any good consequences would follow, even if private placements were to be registered. The result is confusing: whether congressional policy applies is one thing; whether it is good policy is another.

A

Actually, Professor Cohan does little to refute the point that the scheme of the Securities Act—when viewed as a whole—is to bring about "full and fair disclosure"[22] for *all* securities. He presents nothing by way of legislative background to support his view. He is therefore in the position of seeking to justify an exception,

[20] *Id.* at 303.
[21] *Id.* at 305.
[22] Compare Steffen 220-23.

and so he denies—something not stated—that Congress intended disclosure *just "for its own sake."*[23] Such a thing could not be true, he says, for he "(and perhaps a few others) had always supposed" that disclosure was "to 'protect' the small, unsophisticated *individual* investor who, in the nature of things, cannot tell the difference between a balance sheet and a turnip tree."[24] This, of course, is known as begging the question.

The point, though, is an important one. There is not a word in the Securities Act to say that it is just "to 'protect' the small, unsophisticated individual investor . . . ." But, to indulge Professor Cohan, suppose it had so provided: was protection to cease forthwith, once an investment had been made? Certainly not. This legislation is full of provisions—limitations on insider trading, requirements for accurate reports, and so on—all designed to protect the investor, small or large, *after* he has become an investor. Not least of these, I suggest, is the requirement that subsequent issues, too, are to be registered; this to acquaint investors with the price and terms of the issue, matters of as much concern to *existing* investors as to *prospective* ones.

Thus, if Professor Cohan is to carve out an exception to excuse registration in favor of large insurance companies, he must defend an untenable proposition. That is, he must say that it is of no concern to the "small, unsophisticated *individual* investor" whether subsequent issues, often with terms and conditions vitally affecting his interests, are brought out without registration, just so long as the subsequent buyers are "able (perhaps only too able) to 'fend for themselves.' "[25] This, of course, he fails to do. But, perhaps sensing the weakness of his case, he lamely suggests that I might "perhaps be surprised"[26] at how much information concerning private placements really does come out, sooner or later. The point, though, is that investors need *timely* information.

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The attack on the monopoly point comes off no better. When Professor Cohan's objections to the supposed consequences of

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[23] Cohan 308.

[24] *Ibid.* Professor Cohan, also without foundation, purports to quote the writer as saying "everyone has a 'right' to know 'what goes on.' " *Id.* at 309.

[25] Steffen 221-22 n.66.

[26] Cohan 311.

registration are put to one side, he says little to refute the point that the large institutional investors now do enjoy a monopoly. He merely says: "Monopoly is a nasty, emotional word, virtually devoid of content and, therefore, it should not be used loosely."[27] I would suggest that the word monopoly is by no means "devoid of content," nor has the term been used "loosely." Since at least so long ago as the famous "playing card" case[28] of 1602, when the Queen's Bench struck down a monopoly granted by Queen Elizabeth, it has been fairly clear that the power to exclude others from a given commerce and to fix noncompetitive prices constitutes monopoly.[29] The large institutional investors have that power: they limit the number of a buying group, to avoid having a public offering; they are sheltered from competition when setting prices and terms, by being excused from registration.

However, Professor Cohan continues: "The simple fact of the matter is that the degree of competition in the market for long-term corporate funds has increased substantially since the mid-thirties, thanks largely to the growth of direct placements."[30] This statement confuses the growth or size of the private placement market with competition. Let us apply Professor Cohan's favorite illustration about butter and margarine.[31] When in the 1930's government required public issues to be registered, since that raised costs —though only "by so much as a penny"[32]—it meant that some issuers would turn to the private market, as they did. But, even if this shift could be described as an increase in "the degree of competition,"[33] which I question, it still is no denial that monopoly now exists. In antitrust law proof of *some* competition is not a defense; nothing short of "free and unfettered"[34] competition will do.

In any case, Professor Cohan virtually concedes the point in his conclusion. He differs only on the *method* by which full competition can best be brought about. His solution, as noted above, is to open the doors wide and excuse registration entirely as to anyone—bank,

[27] *Id.* at 312.
[28] Case of Monopolies, 11 Coke 84, 77 Eng. Rep. 1260 (Q.B. 1602).
[29] See American Tobacco Co. v. United States, 328 U.S. 781 (1946); United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945).
[30] Cohan 312.
[31] See *Id.* at 311 & n.22, 312, 313.
[32] *Id.* at 311.
[33] *Id.* at 312.
[34] Northern Pac. Ry. v. United States, 356 U.S. 1, 4 (1958) (Black, J.).

insurance company, or individual—who signifies that he would like to trade in the private placement area. In other words, Professor Cohan would in truth make a full retreat "in the direction of the *status quo circa* 1935."[35] But, he says, we would then have "a vigorously competitive market indeed."[36] In fact, he asserts that such a market "might well prove to be the single most competitive market in the country."[37]

One does not have to go so far to restore competition. The truth is, a fully registered direct placement market would be equally, in fact more, competitive. In the first place, the public market would no longer be under its present handicap; each market would have similar registration costs. Professor Cohan recognizes the point, for he says registration "would make it more difficult for the financial institutions to compete with the public market . . . ."[38] That is not an argument against registration; nor does it deny that the large institutional investors presently do have an artificial competitive advantage. It is simply a bare assertion that Professor Cohan thinks, for reasons not stated, that the big investors *should* be allowed to keep their advantage indefinitely, even though it means less real competition.

Nor is there any reason to suppose that competition *within* the private placement sector would be greater under a plan of non-registration than if there were general registration. For one thing, the private placement, as noted above, is done quietly, without notice to anyone. Thus, there is usually *no opportunity* for competitors with a better price, or, more important, with different terms or conditions,[39] to present their case. The private placee does not even have to meet the latent sort of competition which comes from knowing that the details of a transaction are to be spread on the public record, before the deal is closed. Of course, the issuer would gain the opportunity to approach others, if he thought best. But his op-

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[35] Cohan 312.
[36] *Id.* at 314.
[37] *Ibid.*
[38] *Id.* at 312.
[39] Price competition is one thing, competition as to terms is another. As things now stand, the large institutional investors are in position to tie up an issuer by many restrictive clauses—concerning dividends, business expansion, and so on—with none of the restraint that comes from publicity, to say nothing of the effect competition might have. These are important considerations. See Steffen 231.

portunity to do this would surely be no less, if the issue had been registered.

Only a word is necessary to dispose of Professor Cohan's last and most hopeful point, that, since issuers do not presently register their private issues, it must be they "do not believe that registration would be worthwhile . . . ."[40] Of course, the question is not whether *issuers* regard registration as worthwhile, as well they may; it is whether registration affords a useful protection, especially to "the small, unsophisticated *individual* investor." That aside, the argument is not very realistic. When the borrower goes to Wall Street with cap in hand, why should he affront the lender by saying, "of course, I am going to the trouble of having the issue registered to make sure I get a fair, competitive deal"? No, the conclusion to be drawn from non-registration today is simply that a *voluntary* system will not work[41] anymore here than in the public sector. And, although registration there is required, no one—issuer, broker, or investor—has in recent years seriously advocated a return to pre-SEC days.

IV. Conclusions

Perhaps because of Professor Cohan's zeal to excuse registration for those lenders "able to fend for themselves," he did not discuss the after market. The present situation is that billions of dollars of securities have piled up in the hands of large investors, without registration, and yet the conditions under which all or part of these may be resold in case of need are by no means clear. There would seem to be two imperatives: one, that resale of such securities should be permitted in future to anyone, without new registration; and, two, since all buyers on resale may not be assumed to be "sophisticated," there should be initial registration, as discussed above.

Finally, it should be stated again that there has been no purpose "to favor one or another of the actors in this drama."[42] The object, on the contrary, has been "to broaden the private placement market—to let in enough competition to square with antitrust policy—

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40 Cohan 313.

41 Aside from the small additional expense entailed, there are other reasons. For example, the issuer would subject himself to the civil liabilities stated in section 11 of the Securities Act of 1933, 48 Stat. 82, 15 U.S.C. § 77k (1958), if the issue were registered.

42 Steffen 215.

and also to provide for full and fair disclosure—to conform with the purposes of the Securities Act."[43] Then, "in the spirit of free enterprise," let the actors "fight it out, and the devil take the hindmost."[44] That way our economy has prospered and grown strong.

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[43] *Id.* at 238.
[44] *Id.* at 215.