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The Capital Markets in Transition:  
A Response to New SEC Rule 144A†

KELLYE Y. TESTY*

Whenever the fingers are burned, a cure is always lustily called for by those who have been burned the most severely . [T]hey call for a government officer, who shall from time to time regulate how they shall hold their hands to the fire without being burned. Whether this special interference shall be crowned with success by keeping down the heat of the fire, or by increasing the distance at which the venturesome hand shall be allowed to approach it, is a perplexing difficulty which has not yet been solved. . [I]f the heat of the fire should be kept so low, or the distance from it so great, as that no hands can be burned, why then there will be no fun in the thing, and the government officer will enjoy a sinecure.†

INTRODUCTION

The Securities and Exchange Commission ("SEC" or "Commission"), since rising from the ashes of the stock market crash of 1929-1932, has

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2. The SEC was created at the conclusion of the Senate Banking and Currency Committee's 1932-1934 investigation of stock exchange practices, usually known as the Pecora Hearings in recognition of the role played by the Committee's counsel, Ferdinand Pecora. The purpose of the Pecora Hearings was to determine why the devastating decreases in security values had occurred during 1929-1932 and to propose legislation to prevent another stock market crash. Stock Exchange Practices: Hearings Before the Senate Banking Comm., 72d and 73d Congs. (1932-1934). The 1929-1932 crash caused the value of all stocks listed on the New York Stock Exchange to shrink from a total of nearly $90 billion to just under $16 billion—a loss of 83%—between September 1, 1929 and July 1, 1932. Senate Banking Comm., Stock Exchange Practices Report, S. Rep. No. 1455, 73d Cong., 2d Sess. 7 (1934).


Although the scope of this Note permits only brief consideration of regulatory parameters outside of the Securities Act and the Exchange Act, four other statutes also fall within the
undertaken the task of keeping "hands from being burned" in connection with the workings of the United States capital markets.\(^3\) Several scholars have documented the SEC's ability to respond to the needs of the financial marketplace,\(^4\) with arguably the most comprehensive documentary concluding that the SEC has been a regulatory success story during its first half-century.\(^6\) The wisdom of recent SEC policies is, however, very much open to debate. Indeed, the SEC's ability to succeed as Wall Street's watchdog in its second half-century now demands attention.

Rule 144A\(^7\) is one recent SEC effort to respond to a changing financial marketplace, and as such it represents an opportunity to assess the quality of that response. Rule 144A removes restrictions on the ability of

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3. In commemorating the SEC's 25th anniversary in 1959, Milton Freeman, of Arnold, Fortas and Porter, Washington, D.C., wrote that the SEC has helped to restore the once shattered public confidence in the financial community and at the same time to foster a process of elevating the moral tone of that community. The changed conditions in the securities market are in a not insubstantial measure the result of the acts which the Commission administers and the way in which they have been administered.


5. See J. Seligman, supra note 4. Seligman provides a comprehensive history of the SEC and its relationship to corporate finance, covering the years 1929-1977. *Id.* at ix.

6. J. Seligman, supra note 4, at 568 (calling the SEC an outstanding example of the independent commission at its best).


Citations to Rule 144A throughout this Note will be to the Code of Federal Regulations (C.F.R.), although the applicable C.F.R. volume's update was pending at publication time. The amendments and additions to the C.F.R. brought about upon the adoption of Rule 144A and related amendments to Rules 144 and 145 are contained in Release No. 6862, *supra*, and may also be found at 55 Fed. Reg. 17,933 (Apr. 30, 1990).
institutional investors\(^8\) to trade securities that are not subject to the registration provisions of the Securities Act of 1933.\(^9\) Under Rule 144A, which has been called "the most important step the SEC has taken in 50 years,"\(^10\) securities acquired in a private placement,\(^11\) or otherwise restricted,\(^12\) are per se exempted from a holding period requirement if resold to a "qualified institutional buyer."\(^13\) The absence of a holding period requirement is expected to improve liquidity in the private placement secondary market.\(^14\) In promulgating Rule 144A, the Commission recognized two persistent trends\(^15\) that are revolutionizing the nation's capital markets. One

\(\footnotesize{8. \textit{See infra} notes 21-28 and accompanying text (institutional investor defined).}
\(\footnotesize{9. \textit{The registration requirement of the Securities Act is contained in § 5. 15 U.S.C. § 77e. See \textit{infra} notes 57-92 and accompanying text for a discussion of the statutory context in which Rule 144A operates.}}\)
\(\footnotesize{11. A \textit{private placement contrasts with a public offering, which must be registered with the SEC under § 5 of the Securities Act. See 15 U.S.C. § 77e. From its inception, the Securities Act of 1933 has focused on distinguishing between public and private offerings. One of the Act's drafters, James M. Landis (who served as Chairman of the SEC from 1935-1937 and as Dean of the Harvard Law School from 1937-1946), emphasized this distinction in describing his participation in the Act's drafting sessions: "It was these discussions that first evolved the exact scope that we wanted the Securities Act to cover. 'Public offering' as distinguished from 'private offerings' proved to be the answer." Landis, }The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev 29, 37 (1960). For further discussion of the normative rationale underlying the Act, see \textit{infra} text at notes 55-70. The definition of what constitutes a private placement continues to draw considerable debate. For a discussion of this issue, see \textit{infra} text accompanying notes 37-40.}\)
\(\footnotesize{12. \textit{See infra} note 80.}\)
\(\footnotesize{13. \textit{Release No. 6839, supra} note 7, at 207. \textit{See infra} notes 93-123 and accompanying text for a detailed discussion of Rule 144A's operation.}\)
\(\footnotesize{15. \textit{This Note singles out the two trends of increased institutional holdings and increased private placement activity. However, this choice is not meant to suggest that there are not other dynamic changes occurring in the marketplace. Indeed, two other key trends that are receiving an increasing amount of attention are internationalization (or globalization) and debt-for-equity replacement. See, e.g., }Securities and Exchange Comm'n., Internationalization of the Securities Markets: Report to the Senate Comm. on Banking, Housing and Urban Affairs and the House Comm. on Energy and Commerce, 99th Cong., 1st Sess. (1987); }Leveraged Buyouts and Corporate Debt: Hearing Before the Senate Comm. on Finance, 101st Cong., 1st Sess. (1989) (three part series). An in-depth discussion of these changes and others, while also important in assessing the transformation of the capital markets, is beyond the scope of this Note.}\)

Internationalization, especially, is closely related to many of the topics that this Note discusses. Indeed, Regulation S, which eases the ability of United States issuers to market securities outside of the United States without being subject to the registration and disclosure provisions of the United States securities laws, was promulgated by the SEC in tandem with Rule 144A. Regulation S was proposed in Securities Act Release No. 6779, 41 SEC Docket 126 (CCH) (June 10, 1988), reproposed in Securities Act Release No. 6838, 43 SEC Docket
trend is the increasing role that institutional investors are playing in the public and private debt and equity markets. Institutions currently own over 43% of all public common stocks, and their share is expected to continue to increase.16 Secondly, the private placement market, the premier institutional investor playground, is challenging the public market's share of total corporate financings. The dollar volume of private placements exploded from $70 billion in 1985 to $202 billion in 1988, accounting for 43% of total corporate financings in 1988.17 If current trends persist, "[t]he last share of publicly traded common stock owned by an individual will be sold in the year 2003."18

In the wake of this explosive growth in the institutional and private placement markets, the SEC has fanned the flame with Rule 144A. This Note offers a critical assessment of whether the SEC's Rule 144A is an appropriate response to the current marketplace by analyzing whether the Rule will accomplish its intended regulatory objectives and by exploring the costs and benefits to the efficiency of the capital markets that may result. Part I examines the growth of the institutional and private markets, emphasizing both quantitative data and the substantive effects of those...
growth trends. Part II presents the SEC's new Rule 144A, outlines its operation, and examines its regulatory and normative basis. Part III then critiques Rule 144A on two levels—as both a regulatory tool and a policy instrument.

Finally, this Note posits in conclusion that Rule 144A is an appropriate addition to the Securities Acts, but that it does not reach far enough in addressing the needs of a changing financial marketplace. The SEC should amend Rule 144A to align it more closely with the normative purposes of the Securities Act of 1933 and with the demands of current business practice. However, this Note also recognizes that the issues surrounding Rule 144A need attention through other avenues, and suggests additional methods of responding to increasing institutionalization and privatization that will enhance the efficiency of corporate governance and the capital markets.

I. TRANSFORMATION TRENDS

A. Growing Dominance of the Institutional Investor

The impact of institutional investors on the capital markets and corporate decision-making processes has attracted widespread attention from practitioners, regulators, and academics. While few would disagree that institutions are playing an increasingly important role in the capital markets, no one has been able to quantify this impact precisely. This absence of fundamental analysis stems from two problems. First, the definition of an institutional investor is elusive in a dynamic capital market structure, not only within the United States, but even more so in a global context. Second, no single public source of data on institutional investors currently exists. An overall assessment of the institutional investor's role in the economy began just recently at Columbia University.

19. See, e.g., Forum, supra note 16 and sources cited therein; Papers Presented at the Salomon Brothers Center and Rutgers Centers Conference on The Fiduciary Responsibilities of Institutional Investors (June 14-15, 1990) [copies on file with the Indiana Law Journal].
20. See, e.g., L. LOWENSTEIN, WHAT'S WRONG WITH WALL STREET 58 (1988) (noting that at the end of 1986, institutions owned "about 45 percent of the almost $3 trillion of public company stocks" although "[t]he precise amount of institutional ownership is difficult to calculate, in part because of the lack of recent data and in part because of a definition that sometimes, for example, includes bank trust accounts and investment advisory accounts, and sometimes not.").
21. See Brancato & Gaughan, The Growth of Institutional Investors in U.S. Capital Markets, Institutional Investor Project, Columbia Center for Law and Economic Studies, Columbia University at iii (Nov. 1988) [hereinafter Project I]. One need only consider the creative development of a myriad of financial investment instruments within the last few years to appreciate how the players in capital markets change. Mutual funds, now one of the more
School of Law. The individuals conducting Columbia's Institutional Investor Study Project (the "Project") note that their data "must be painstakingly constructed from a wide variety of sources, few of which provide consistent comparison." The Project is currently working on developing a concise data base that can be used for an on-going analysis of the institutional investor's role in capital markets.

For purposes of analyzing the markets' increasing institutionalization, this Note adopts the definition of institutional investor used by the Project, which includes private pension funds, closed end investment trusts, life insurance companies, property and casualty insurance companies, non-pension fund money managed by banks and foundation and endowment funds, mutual funds, and state and local retirement funds.

In basic terms, the distinction between an institutional investor and an individual investor revolves around the fact that money is being professionally—or institutionally—rather than individually managed. This

basic arrangements, were new items in the early 1970s. Now, mortgage pools, other collateralized obligations and complex hybrid securities are popular. Junk bonds, see infra note 31, which were first introduced by Drexel Burnham Lambert in the mid-1970s and enjoyed a heyday in the 1980s, may have come full circle. See infra note 31. Pension funds, Employee Stock Option Plans (ESOPs), and retirement funds (propelled by ERISA) have also entered into the spotlight in recent years.

22. The Center for Law and Economic Studies at Columbia University School of Law (the "Center"), in collaboration with the New York Stock Exchange (the "NYSE"), established the Institutional Investor Study Project (the "Project") in 1988. The Project, which is independently funded, is directed by Professor Louis Lowenstein of Columbia. Mr. Ira M. Millstein, senior partner at Weil, Gotshal & Manges, is chairman of the board of advisors of the Project. Lowenstein and Millstein describe the Project as "a major, long-term effort to explore the large, growing, and increasingly contentious role of the institutional investor in large, publicly-owned corporations." Forum, supra note 16, at 739. In the first work published by the Project, Drs. Brancato and Gaughan discussed the Project's initial groundwork for studying the institutional market, noting that there is "no one central data source available to provide data on institutional investors in an organized and condensed form which would be amenable to fruitful analysis." Project I, supra note 21, at 51. Many data bases compile data on parts of the institutional market. There is little consistency among these sources. This shortcoming is no doubt related to the initial problem of simply defining "institutional investor." Project I, supra note 21, at iii.

23. Project I, supra note 21, at iii.

24. Telephone interview with Carol Koz, secretary to Professor Lowenstein of Columbia University School of Law (Oct. 25, 1989); see Project I, supra note 21, at 51.

25. Project I, supra note 21, at 3.

26. Project I, supra note 21, at 3. This definition could understate the amount of money that is invested institutionally. For example, the problem of defining "institutional investor" becomes further complicated when new financial instruments and pools of investment funds are formed, such as those amassed by certain investment banking houses for leveraged buyouts. These funds represent monies that individuals delegate to an "institution" to manage so that the individual does not make the investment decisions. In dynamic capital markets, however, such pools are difficult to identify, much less quantify, and any definition of "institutional investor" could be understated by any amounts from individuals which come under such professional management and are not already classified under other categories such as pension funds. Further, real estate holdings, a category of increasing interest to institutional investors,
distinction is relevant because one of the key factors the SEC uses in assessing whether an investor requires the disclosure protection of the federal securities laws is that investor's level of sophistication.27

Establishing a working definition of an institutional investor is but a threshold issue. The more urgent issue is the nature and degree of the institutional investor’s impact on capital markets. Four principle quantitative measurements reflect this impact: (1) the amount of assets under management by institutional investors, (2) the market value of institutional holdings, (3) the trading volume of institutional investments, and (4) the corporate ownership represented by institutional investor holdings.28 Some of the more revealing statistics about the institutional market’s growth include the Project’s finding that total assets under the management of institutional investors have more than doubled in value from $2.1 trillion in 1981 to $4.6 trillion in 1987.29 Institutional holdings in individual corporations have increased as well, with 47 of the top 50 United States corporations (ranked by 1987 stock market value) having institutional ownership in excess of 33%, and 27 out of 50 having institutional ownership in excess of 50%.30 Although institutions generally have been characterized as players in the debt market,31 the Project estimates that

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27. See infra text at notes 74-92.
28. These four measurements are used by the Project and also have been employed in other attempts at quantifying the institutional market. See generally Lowenstein, supra note 20.
29. Project I, supra note 21, at 1.
30. Project I, supra note 21, at ii.
31. See C. Bruck, The Predators’ Ball 129-30 (1988) (detailing institutions’ participation in the bond market, especially the junk bond market). The bond market has been the traditional bastion of institutional investors. In 1989, the amount of investment grade debt issued domestically was $109.4 billion, up from $94.6 billion in 1988. Non-investment grade debt (junk bonds) issued in 1989 amounted to $25.2 billion, down from $27.8 billion in 1988. Drexel Burnham Lambert was the lead underwriter of junk bonds in 1989 with a 38.7% market share, Schultz, Risk Enters the Picture in 1989, Investment Dealers’ Dig., Jan. 8, 1990, at 26, 27.

As Bruck chronicles in The Predators’ Ball, supra, the junk bond market, masterminded by Michael Milken and the firm of Drexel Burnham Lambert has been a favorite investment vehicle for institutions, especially in generating leveraged buyout funds. Private placements of junk bonds with institutions were “perfect for Milken’s system of repayment of favors, and rewards.” C. Bruck, supra, at 130. Currently, Drexel is in the midst of bankruptcy proceedings and Milken has pleaded guilty to federal securities law violations. See, e.g., Belton, Ex-employees Toast Drexel at ‘Creditors’ Ball,’ USA Today, Aug. 17, 1990, at 2B, col. 2.

See S. Cottele, R. Murray & F. Block, Graham and Dodd’s Security Analysis 467 (5th ed. 1988), noting that junk bonds may be more properly characterized as equity, rather than debt, interests in a firm, “a contingent claim not unlike a warrant or other means of
as of 1986, institutions controlled almost 43% of the total market value of equity holdings in the United States.\textsuperscript{32} Trading patterns also reveal the increasingly dominant role of institutional investors. Increased size of trades and turnover indicate the level of institutional activity. On the New York Stock Exchange, total share volume increased from 1.6 billion shares in 1965 to 47.8 billion shares in 1987, the average trade size increased from 224 shares to 2,112 shares, and turnover rose from 16% to 73% during the same period.\textsuperscript{33}

As the above data demonstrate, institutional investors are a formidable clientele in the marketplace. If numbers alone were the sole judge of power over corporate management, then CEOs would be consulting their institutional investors about whether to use black or blue ink to sign paychecks. Indeed, the concentrated power of institutions is well-suited for resolving some of the problems of separation of ownership and control in corporations identified by Berle and Means.\textsuperscript{34} However, institutional investors' increasing power is under-utilized. Professor Lowenstein notes participating in the future of an enterprise." \textit{Id.}, see also STAFF OF THE JT. COMM. ON TAX'N, 101ST CONG., 1ST SESS., FEDERAL INCOME TAX ASPECTS OF CORPORATE FINANCIAL STRUCTURES 35-37 (Comm. Print 1989) [hereinafter CORPORATE FINANCIAL STRUCTURES] (factors used to distinguish debt from equity); Note, \textit{Using Risk Analysis to Classify Junk Bonds as Equity for Federal Income Tax Purposes}, 66 IND. L.J. 273 (1990). The Graham and Dodd approach to security analysis emphasizes fundamental or intrinsic values of securities which can be uncovered through diligent analysis of firms. It argues that the "market's pricing mechanism remains based to such a degree upon faulty and frequently irrational analytical processes that the price of a security only occasionally coincides with the intrinsic value around which it tends to fluctuate." S. COTTLE, R. MURRAY & F. BLOCK, \textit{supra} at xi.

32. Project I, \textit{supra} note 21, at 13-14. This 43% translates to a $1,327.2 billion market value in equity holdings for institutional investors as of 1986. \textit{Id.} at 14.

33. Project I, \textit{supra} note 21, at 14-17 (figures derived by the Project from the New York Stock Exchange (NYSE) Fact Book, 1988). Large block trading on the NYSE, defined as trades of 10,000 shares or more, has also increased from 3.1% of reported volume in 1965 to 51.2% in 1987 which doubled 1985's figures. "[A]n average of 3,639 block trades crossed the tape each day—roughly nine per minute." \textit{Id.} at 17.

However, the proportion of NYSE publicly traded stock activity by institutions declined from 61.1% in 1985 to 49.6% in the first half of 1988. \textit{Id.} at 16. This decrease arguably reflects institutions' increasing movement into the private placement market or to other investments such as real estate. For data on institutions' share of the private placement market, see \textit{infra} notes 43-47 and accompanying text.

It is also significant that institutions account for a lesser percentage of activity on the American Stock Exchange and the over-the-counter ("OTC") market than on the Big Board (NYSE). Project I, \textit{supra} note 21, at 14-17 This phenomenon is perhaps explained by institutions' demands for liquidity and their perceptions that the NYSE offers greater liquidity than do other exchanges or trading systems. See \textit{infra} note 73.

that institutions, despite hopes to the contrary, have not been a factor in corporate governance. Part III of this Note argues that institutions are positioned to take an active role in corporate governance and suggests an agenda for modifying existing law to encourage more active management oversight by institutional investors.

B. The Growing Private Placement Market

Definitional problems similar to those encountered in assessing the impact of the institutional investor arise when analyzing the private placement market. As new types of securities and methods of marketing those instruments emerge, defining and measuring the private placement market becomes increasingly difficult. One Wall Street source commented that “[t]he advent of swaps, options, the bank loan syndication market, and the junk bond market have all caused any serious player to look upon [the private placement market] and redefine it in different ways.”

The only publicly available source for data on private placements defines a private placement as “a non-registered security placed by an agent with non-bank, third party investors... having a maturity of at least one year.” This definition is under-inclusive but nevertheless is useful for


For the past thirty years, the ownership of American public corporations has become increasingly concentrated, thus encouraging hopes that the insurance companies, pension funds, investment companies, and other institutional investors would, by taking an active role, protect not only their own interests but those of shareholders generally. All the ingredients seemed to be there. They own large blocks of stock, some of them as much as $100 million in a single company. They have the staffs and the sophistication. As it turned out, however, the money managers have contributed almost nothing to the direction or oversight of the companies whose stocks they so briefly hold.

Id. But see infra note 186 (developments indicating that institutional investors are becoming more aggressive in corporate governance matters).

36. See infra text at notes 157-95.


38. Maher, Boom!, supra note 14, at 20 (comments of Rob Lawrence, vice-president and director of private placements at Citicorp).

39. Maher, Is the Party Over?, INVESTMENT DEALERS’ DIG., Sept. 4, 1989, at 13, 19. The data reported in Investment Dealers’ Digest is compiled by IDD Information Services, Inc. The SEC does not compile this information itself (or at least not publicly). Id. at 20. In the proposing release for Rule 144A, the SEC relied on the data compiled by IDD and published in Investment Dealers’ Digest. Release No. 6806, supra note 7, at 78 n.12.
estimating minimum levels of private placement activity. Recent growth in the private placement market is more startling considering that reported figures arguably represent the low end of the scale.

The United States private placement market, while not a new market, has increased substantially in importance in the 1980s. The total amount of securities privately placed in the United States increased from $18 billion in 1981 to $139 billion in 1987, and to $202 billion in 1988. Additionally, the private placement market has broadened in the last decade. Ten years ago, the largest fifteen institutional investors dominated the market, but an informal survey of the fifteen largest players in the private placement market in 1989 showed their total investment to account for just one-fifth of the market. This broadening of the market has

The definition is under-inclusive for several reasons: (1) it does not include securities privately placed directly by the issuer, (2) bank loans, interest rates, and currency swaps are excluded, (3) securities that a dealer buys for its own account are not included in the data, (4) school issues, tax-exempt securities, sales of outstanding securities, privately placed securities purchased by foreign investors, and bridge loans are excluded, and (5) most privately placed commercial paper is excluded. Release No. 6806, supra note 7, at 78 n.12.

The definition could be slightly over-inclusive as well. Drexel Burnham Lambert used a technique of attaching registration rights to about 90% of the private placements it engineered. These deals were structured so that they became registered, public securities in about one year. At present, these deals are currently included in private placement totals generated by IDD Information Services, Inc. Maher, Boom!, supra note 14, at 20.


Bensman, Shifting Boundaries: Moving the Line Between the Public and Private Markets, INVESTMENT DEALERS' DIG., Mar. 21, 1988, at 15, 19; Maher, Boom!, supra note 14, at 15; see also Release No. 6806, supra note 7, at 77-83 (Rule 144A proposing release detailing private placement market characteristics).

Schwimmer, Biggest Buyers Upped Volume Slightly in '89, INVESTMENT DEALERS' DIG., Oct. 16, 1989, at 11. The following table reveals at a glance who the top players are in the private placement market.

<table>
<thead>
<tr>
<th>Investor</th>
<th>1989 (Estimated)</th>
<th>1988</th>
<th>% Purchased Directly</th>
<th>Total Portfolio Size</th>
</tr>
</thead>
<tbody>
<tr>
<td>Prudential</td>
<td>11,000</td>
<td>10,000</td>
<td>50.0%</td>
<td>35,000</td>
</tr>
<tr>
<td>Metropolitan</td>
<td>3,000</td>
<td>3,500</td>
<td>50.0%</td>
<td>24,000</td>
</tr>
<tr>
<td>Equitable</td>
<td>3,200</td>
<td>4,500</td>
<td>5.0%</td>
<td>13,000</td>
</tr>
<tr>
<td>Cigna</td>
<td>2,800-2,900</td>
<td>2,400</td>
<td>7.0%</td>
<td>10,000</td>
</tr>
<tr>
<td>John Hancock</td>
<td>2,500</td>
<td>2,000</td>
<td>7.3%</td>
<td>9,000</td>
</tr>
<tr>
<td>Aetna</td>
<td>2,000-2,500</td>
<td>1,700</td>
<td>20.0%</td>
<td>12,000-13,000</td>
</tr>
<tr>
<td>Travelers</td>
<td>2,200</td>
<td>1,700</td>
<td>10.0%</td>
<td>6,500</td>
</tr>
<tr>
<td>Teachers</td>
<td>2,200</td>
<td>1,850</td>
<td>15.0%</td>
<td>10,300</td>
</tr>
</tbody>
</table>
resulted from, inter alia, such factors as the entry of pension fund managers with substantial cash holdings into privately placed leveraged buyout (LBO) debt that offers a significant premium above other available investments.\(^4\) Additionally, foreign and domestic commercial banks are increasingly competing for leveraged-lease\(^5\) deals and project financings.\(^6\)

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<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Mass Mutual</td>
<td>1,750</td>
<td>1,300</td>
<td>10.0%</td>
<td>4,500</td>
</tr>
<tr>
<td>Principal Mutual</td>
<td>1,650</td>
<td>1,800</td>
<td>10.0%</td>
<td>5,700</td>
</tr>
<tr>
<td>MONY</td>
<td>1,280-1,380</td>
<td>965</td>
<td>15.0%</td>
<td>4,500</td>
</tr>
<tr>
<td>Northwestern</td>
<td>1,200</td>
<td>1,000</td>
<td>20.0%</td>
<td>4,600</td>
</tr>
<tr>
<td>New York Life</td>
<td>1,000-1,250</td>
<td>1,800</td>
<td>20.0%</td>
<td>7000-8,000</td>
</tr>
<tr>
<td>State of Wisconsin</td>
<td>600</td>
<td>650</td>
<td>22.6%</td>
<td>3,500</td>
</tr>
<tr>
<td>New England Mutual</td>
<td>500</td>
<td>500</td>
<td>5.0%</td>
<td>2,000</td>
</tr>
</tbody>
</table>

\(^4\) For a discussion of the composition of this field, including the entrance of pension funds such as the Teachers Insurance and Annuity Association ("Teachers"), see infra text at notes 147-57.

\(^44\) Premiums on LBOs average 40% over the existing stock price. See S. Kaplan, Management Buyouts: Efficiency Gains or Value Transfers (Center for Research in Security Prices, Graduate School of Business, University of Chicago, Working Paper No. 244, 1988). The source of this increase in value is the subject of much debate and inquiry as economists and legislators assess the social desirability of these corporate restructurings. See, e.g., Corporate Financial Structures, supra note 31, at 58-63. The debate centers on whether LBO premiums represent efficiency gains or are simply wealth transfers from one corporate stakeholder to another. Id. Concerns over improper transfers target the following likely beneficiaries: stockholders (at the sake of bondholders and/or employees) and management (at the sake of "outside" shareholders). Id., see also LBOs: Greed, Good Business—or Both?, Fortune, Jan. 2, 1989, at 66, 67 (Metropolitan Life and other bondholders of RJR Nabisco sued management for damages based on the company's $5 billion of outstanding bonds losing around 20% of value during their buyout battle involving the Kohlberg Kravis and Roberts LBO firm).

\(^45\) A leveraged lease involves a lender in addition to the lessor and lessee. The lender, usually a bank or insurance company, puts up a percentage—usually more than half—of the cash required to purchase the asset. The balance is contributed by the lessor, who is both the equity participant and the borrower. With this cash, the lessor acquires the asset, giving the lender both a mortgage on the asset and an assignment of the lease and the lease payments. The lessee then makes periodic payments to the lessor, who in turn pays the lender. As owner of the asset, the lessor is entitled to tax deductions for depreciation on the asset and for interest on the loan.

\(^46\) Schwimmer, supra note 43, at 11. Rule 144A, with its emphasis on institutional investors, will fuel the debate over whether banking activities should be separate from securities activities. Banks have become a large part of the private placement market, with three banks among the top fifteen investors in private placements in 1989. Id. Since Rule 144A was adopted, Citibank and others have become more active in the private placement market. Citi, Other Banks Make Private Placement Push By Underwriting Deals, The Institutional Investor Corp. Fin. Week, July 9, 1990 (LEXIS, Nexis library, Current file); Citibank Broadens Its Hold on the Rule 144A ADR Market, PR Newswire, Aug. 30, 1990 (LEXIS, Nexis library, Current file). Additionally, the recent credit crunch in the banking industry, combined with the passage of Rule 144A, has caused a market shift from commercial bank financing to private placements, fueling the tension between the banking and securities industries. Goodwin, Private
The composition of the private placement market, in addition to its sheer size, is leading to a transformation of the capital markets. Private placements


Although banking and securities law overlap in many respects, historical differences in underlying philosophy create many ambiguities for regulators and the regulated:

Securities law is designed to protect investors. It is based on the premise of full disclosure of both the activities of issuers of securities and enforcement actions by the SEC. The purpose of full disclosure is to use the marketplace to assist in regulation.

The history of banking regulation is far different. It has been premised on protecting the financial system, not the shareholders. Consequently, the examination and enforcement actions of the bank regulators have been nonpublic. With the increase in bank holding companies, their nonbanking activities, and the broader activities of banks themselves, there has been increased conflict between the different regulatory philosophies: the disclosure approach of the SEC and the safety and soundness approach of the bank regulators.


The resolution of this debate will affect the impact of Rule 144A on the current financial marketplace. At the present time, banks are actively participating in the private placement market, but to do so they must jump through several hoops. For instance, the Federal Reserve Board ("FRB") allows certain bank subsidiaries—called § 20 non-bank banks after the statutory provision of Glass-Steagall that has created this loophole—to participate in securities activities. *Maher, Private Market Changes May Not Be So Helpful to Commercial Banks, Investment Dealers' Dig., Aug. 21, 1989, at 9,* [hereinafter Maher, *Private Market Changes*]; *see also Securities Indus. Ass'n v. Board of Governors of Fed. Reserve Sys., 900 F.2d 360 (D.C. Cir. 1990) (upholding a FRB decision to permit § 20 subsidiaries to underwrite corporate equity securities). Large commercial banks are now grappling with the issue of where to place their private placement business: in the traditional commercial bank structure with their loan business or in their § 20 subsidiaries. *Maher, Private Market Changes, supra.* Since § 20 includes an underwriting limit of five percent of the subsidiary's revenue, many large banks will have an incentive to move their private placement business (agented, fee-based businesses) into § 20
once occupied only a debt market; however, the percentage of equity now privately placed has grown to twelve percent of corporate financings in 1987.47 This growth of privately placed equity, coupled with a trend toward decreased initial public offerings48 and increased “going-private” transactions,49 is significantly eroding the public’s share of corporate ownership.

subsidiaries. Id. The FRB’s interpretation of Glass-Steagall demands a wall of separation between the commercial bank and the subsidiary (an “arms-length relationship”), a demand that is not in line with the reality of separating the private placement business from the very similar loan business. Id. Recent developments are chipping away at the Glass-Steagall wall. See Quint, Regulatory Shift Allows U.S. Banks to Trade Stocks, N.Y. Times, Sept. 21, 1990, § A, at 1, col. 6 (FRB effectively reversing major parts of Glass-Steagall by approving an application by J.P Morgan and Co. to trade and sell corporate stocks).

Although the resolution of the Glass-Steagall issue will affect many of the issues discussed herein, an in-depth analysis of the debate over whether bank securities activities should be restricted, and to what extent, is beyond the scope of this Note. For the SEC’s response to this issue, see SEC Reauthorization: Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 101st Cong., 1st Sess. 252-54 (1989) (response of David C. Ruder, Chairman of the SEC, to a post-hearing question on Rule 144A and Glass-Steagall by Congressman Leland) [hereinafter SEC Reauthorization]. The author agrees with the SEC’s interpretation that it would be preferable to restructure the existing regulations to regulate securities and banking activities by function, not by whether they are state or federal entities or whether they are technically labeled a bank activity or a securities activity. See also Cane, Non-Broker Brokers and Other Anomalies in the Regulation of Financial Services, 11 HARv. J.L. & PUB. POL’Y 111, 175 (1988) (noting how absurd it is that our regulatory system has generated non-bank banks and non-broker brokers and calling for regulation “by function and not institution[] type”).

The SEC is the obvious choice to oversee the function of securities activities. The overall protection of investors, and of the financial marketplace in general, is much more likely to be accomplished through this approach than through further segmentation when market forces are moving in just the opposite direction—consolidation of financial services to improve competition in global markets. The SEC has proven itself to be a capable regulator of the securities industry, regardless of where those securities activities are actually conducted. Recent events in the banking industry call for a revised approach to regulation. Clothed in the name of opportunity for innovation, deference to state powers resulted in a savings and loan fiasco that ultimately fell on the federal government to resolve. See Financial Institutions Reform, Recovery, and Enforcement Act of 1989—(H.R. 1278): Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 101st Cong., 1st Sess. (1989) (two-part series exploring Public Law No. 101-73, known by its acronym “FIRREA” and signed into law by President Bush on August 9, 1989). Because of this law’s length, complexity, and recentness, not much literature analyzing the law’s effect on financial institutions has yet emerged. However, in an outline prepared for a recent conference attended by the author, one expert said that the law “will forever change the complexion and configuration of the U.S. financial institutions industry, probably resulting in massive consolidations.” Knepper, The Changing Shape of Financial Services: New Directions for Financial Institutions After FIRREA, reprinted in PLI 21st Annual Securities Institute Course Materials 105, 109 (1989).

One leading economist, Michael Jensen, has termed this phenomenon the "eclipse of the public corporation."\(^5\) Jensen, labelled by Lowenstein as the "apostle of each 'new era' in finance,"\(^5\) applauds these changes as a necessary evolution in corporate financial structure and characterizes the resulting firms as more efficient than the public corporation.\(^5\) Other commentators are less optimistic about the change and worry about the erosion of the public corporation—the hallmark of the United States capitalist system.\(^1\) With the demise of the public corporation, Jensen's critics see a loss of public confidence in the economy, a loss of informational access, a loss of monitoring safeguards, and a corresponding loss of efficiency.\(^4\) Part III of this Note analyzes the merits of this debate—a debate that reflects fundamental tensions driving corporate governance theory—and predicts the role that Rule 144A and the increased institutionalization and privatization of the markets will play in its resolution.

II. RULE 144A

A. Regulatory Framework and Normative Underpinnings

Rule 144A is almost certain to propel the trends of increasing institutionalization and use of private financing that are already underway in the market.\(^5\) However, before assessing the Rule's impact and its macroeconomic consequences,\(^4\) it is necessary to understand the statutory context in which Rule 144A operates and to explore the policy behind that legal structure.\(^5\) Several interconnected themes run through the federal securities and Organizational Structure: A Study of Reverse LBOs (unpublished working paper, Southern Methodist University, 1989) (copy on file with the Indiana Law Journal) (examining the large wealth gains shareholders acquire when companies that have been taken private go public again, usually within three years).

54. See infra notes 174-96 and accompanying text for a further discussion of this issue.
55. See infra text at notes 141-57.
56. See infra text at notes 158-97
57. Arguing, or measuring, the efficiency or acceptability of alternatives without reference to normative justifications is a shallow enterprise. For an interesting article that explores the deficiencies of argument without normative discourse, see Leff, Economic Analysis of Law: Some Realism About Nominalism, 60 Va. L. Rev. 451 (1974) (a commentary on Richard Posner's book, ECONOMIC ANALYSIS OF LAW (1973)). Although Leff's article offers many substantial insights, one theme is the need for discourse on the normative aspirations of the law. Leff criticizes Posner for denying that his descriptive statements about the law have
laws' regulatory framework: privileging disclosure over merit as a standard of review, limiting the scope of regulation to public distributions rather than private sales, and distinguishing between regulation of primary distributions (focus of the 1933 Act) and trading of securities in the secondary market (focus of the 1934 Exchange Act).

1. The Disclosure Philosophy

Rule 144A is an addition to the Securities Act of 1933. President Roosevelt, in his message to Congress on March 29, 1933, outlined what would become the underlying philosophy of the Act:

Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.


Leff's comments apply with equal force to the law of corporate governance and finance. Not all laws can be measured by their effect on the market. Whether LBOs are efficient may be an entirely different question to academics or Wall Street's investment bankers than to the employees losing their jobs or the community losing the business entity that has become entrenched in the local culture. This Note adopts the premise that the most effective use of corporate law is to mediate between the various corporate constituencies (i.e., shareholders, management, employees, creditors, suppliers, etc.) rather than to design rigid rules that per se elevate one interest over another. See infra text at notes 181-97. This Note saves for future inquiry whether the modern public corporation is the proper entity to withstand and to promote such mediation.

59. See supra note 2 (discussing the Securities Act).
Simply stated, the Securities Act adopts a disclosure, as opposed to a merit, standard of review. Section 5 of the Act implements the Act's focus on disclosure in public offerings by requiring anyone who offers or sells a security to comply with the SEC's registration provisions unless a valid exemption from registration is available. The exemptions relevant for the purposes of analyzing Rule 144A are the section 4(1) trading exemption and the section 4(2) private placement exemption. The procedure contemplated by section 5 requires that a registration statement (including a disclosure document called a "prospectus") be filed with the SEC. The SEC staff then reviews the filing materials for deficiencies while often corresponding with the registrant by letter to point out shortcomings in the disclosure documents. The registration statement may become effective by

61. Some blue sky (state) securities statutes do provide for merit review by the state securities commissions. See, e.g., Braisted, Merit Regulation in Blue Sky Laws 1989 (PLI Course Handbook Series, No. 654).

The SEC is in the process of implementing an electronic filing system it calls "EDGAR" (acronym for Electronic Data Gathering, Analysis and Retrieval) to improve the processing and dissemination of the over seven million pages of documents filed with the Commission each year. Id. at 586. The securities bar seems frustrated that EDGAR has not yet been fully implemented. During the 21st Annual Institute on Securities Regulation held November 2-4, 1989 in New York City, which this author attended, representatives of the SEC were questioned on the status of EDGAR during a panel discussion. The question drew loud applause from the audience but little response from the SEC.
68. See 17 C.F.R. § 202.3(a) (1990) (detailing the Commission's procedure for processing filings, including registration statements). In pertinent part, § 202.3(a) states:

If the filing appears to afford inadequate disclosure, as for example through omission of material information or through violation of accepted accounting principles and practices, the usual practice is to bring the deficiency to the attention of the person who filed the document by letter and to afford a reasonable opportunity to discuss the matter and make the necessary corrections.

Id. Section 202.3(a) also discusses the circumstances under which the Commission may dispense with the informal comment procedure in favor of administrative remedies: "This informal procedure is not generally employed when the deficiencies appear to stem from careless disregard of the statutes and rules or a deliberate attempt to conceal or mislead or where the Commission deems formal proceedings necessary in the public interest." Id.

SEC declaration or by passage of time.69 An effective registration statement means that the registrant may lawfully offer and sell securities to the public under the document. A copy of the prospectus must be given to each investor prior to the sale, or in some cases, when the security is delivered after the sale.70

2. The Distribution/Trading Distinction

Not all securities and transactions fall within section 5's registration net. Securities law makes a baseline distinction between distributions of securities and trading of securities. This distinction reflects two separate markets: the primary market, in which business entities distribute securities to raise capital, and the secondary market, in which the certificates representing that capital infusion are traded among market participants. The Securities Act prohibits distributions from occurring without the Act's disclosure safeguards (or a valid exemption from registration).71 Trading, provided it is free of fraud, is relatively unconstrained. This freedom allows what William J. Baumol has called "an act of magic" to occur:

[It permits long-term investments to be financed by funds provided by individuals, many of whom wish to make them available for only a very limited period, or who wish to be able to withdraw them at will. Thus it [transforms] "what are short-term credits from the private viewpoint into long-term savings from the social viewpoint to the fullest extent."72]

The stock market provides investors with liquidity,73 but at the same time, it provides corporations with a steady pool of capital. The market performs

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In fiscal years 1986-87 and 1987-88, the Commission met its goal of reviewing all initial public offerings, going private transactions, third party tender offers, proxy contests, and new securities and novel financing techniques. SEC Reauthorization, supra note 46, at 78 (written response of Chairman David S. Ruder to questions posed by Representative Edward J. Markey).

69. Section 8 of the Act, 15 U.S.C. § 77h (1988), details the procedure by which a registration statement may become effective, including provisions for amendments thereto.

70. The prospectus-delivery requirements are derived from the interplay between § 5 and § 4(3) of the Act. 15 U.S.C. § 77e, 77d(3) (1988). In considering the interaction of the 1933 Act and the 1934 Act, see infra text accompanying note 197, it is important to note Rule 174, 17 C.F.R. § 230.174 (1990), which waives the statutory waiting periods of § 4(3) if the issuer is a reporting company.


73. Liquidity is the subject of much inquiry in legal and economic literature. Even a precise definition of liquidity is debated. See J. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 240 (1953) ("The conception of what contributes to 'liquidity' is a partly vague one, changing from time to time and depending on social practices and institutions."); Lippman & McCall, An Operational Measure of Liquidity, 76 AM. ECON. REV 43, 48 (1986).
this magic free from the enormous transaction costs that would be involved if the corporation dealt with the millions of investors on an individual basis.

3. Rule 144A Transactions

At one end of the regulatory spectrum is the individual selling a few shares of registered stock through a local broker. This transaction is exempt under the section 4(1)(a) general trading exemption. At the other extreme is a multinational corporation, assisted by Wall Street's investment bankers and a network of broker-dealers, distributing five million shares of common stock in an initial public offering. This transaction is always subject to section 5's registration requirements, because it is the goal of the Act to ensure that a public distribution is accompanied by enough information about the issuer to enable the investor to make an informed investment decision. Between those extremes is the private placement that is exempt from section 5 by section 4(2). This would entail, for instance, an offering of subordinated debentures to an insurance company or other institution.

Two scholars capture this definitional problem as follows:

Keynes once observed that while most of us could surely agree that Queen Victoria was a happier woman, but a less successful monarch than Queen Elizabeth I, we would be hard put to restate that notion in precise mathematical terms. Keynes' observation could apply with equal force to the notion of market liquidity. The T bond Futures pit at the Chicago Board of Trade is surely more liquid than the local market for residential housing. But how much more? What is the decisive difference between them? Is the colorful open-outcry format of the T-bond Futures market the source of its great liquidity? Or does the causation run the other way?


Liquidity is important to institutions for several reasons. For example, a high level of liquidity allows the trading of large blocks of stock without adversely affecting the market. Also, many institutions have liquidity requirements statutorily or contractually imposed to ensure that sufficient cash (or quasi-cash) reserves are available to cover demands. Further, an instrument with high liquidity will carry a lower rate of return than will a less liquid instrument.


75. The stock issued might also be a more complex instrument than common stock such as a hybrid security (containing features of both debt and equity). Issues of securities are becoming increasingly complex. For information on what types of securities and attributes (such as conversion features, warrants, and exchange rights) mean to investors, see V. Brudney & M. Chirelstein, Corporate Finance (1987), and R. Wilson, Corporate Senior Securities (1987).

76. 15 U.S.C. § 77e.

77. 15 U.S.C. § 77d(2).

78. A subordinated debenture is a debt instrument "that has a claim on the issuing firm's assets that is junior to other forms of debt." Black's Law Dictionary 1426 (6th ed. 1990).
As one drafter of the Act said: "The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government."79

Still, such privately-placed securities are labeled restricted securities80 and are not freely tradeable as are securities acquired in a public offering. Determining whether the resale of restricted securities is more like ordinary trading, or like a distribution that needs the Act's protection, is the question to which Rule 144A is addressed.

The existing regulatory framework does not provide an answer. Section 4(2) offers an exemption for "transactions by an issuer not involving any public offering."81 However, an institutional investor, or anyone seeking to resell securities, is not the issuer of the stock. Also, while section 4(1)'s trading exemption—"transactions by any person other than an issuer, underwriter, or dealer"82—seems like a possibility on its face, the term underwriter83 is defined so broadly that it tangles institutions selling blocks of stock in its web. The resale of restricted stock in a private placement does not fit squarely into either the section 4(1) trading exemption or the section 4(2) private sale exemption, although it contains characteristics of both. This transaction, however, has been judicially84 and administratively85

79. Landis, supra note 11, at 37.
80. Restricted securities are securities acquired in a private placement or securities held by an affiliate of the issuer. Conversely, securities acquired in a valid public offering are not restricted and may be freely resold, as long as the investor is not an affiliate of the issuer. See 17 C.F.R. § 230.144 (1990). This concept demonstrates the transactional nature of the Securities Act. See Hicks, The Concept of Transaction as a Restraint on Resale Limitations, 49 Ohio St. L.J. 417 (1988). Other than a few limited provisions that actually exempt a security from the requirements of registration, an exemption is only good for the particular transaction. Id. at 423 n.38. An issuer's exemption does not carry over to the purchaser. The purchaser must find a separate exemption from the registration requirements of the Act. Id. at 428-31.
82. 15 U.S.C. § 77d(1).
83. Section 2(11) states:
The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.
found to be within the overall purpose of the Act and thus has been exempted from registration requirements in many contexts. Indeed, this exemption has become known as the section 4(1-1/2) exemption, although it has never been officially sanctioned by the SEC. In order to protect themselves from liability for violating the Act, issuers, counsel, and buyers have to carefully construct each transaction under this phantom exemption. This is a time consuming, costly process, but the alternative is either potential liability or resorting to the existing safe harbor of Rule 144 that mandates a two-year holding period before resales can be effected free from potential liability.

Rule 144’s holding period is the SEC’s method of determining that the securities were held for “investment” rather than for “distribution.” However, the holding period substantially reduces the liquidity of the securities, causing investors to demand a liquidity-premium for purchasing

the existence of § 4(1-1/2) exemption. Although the Commission’s staff does issue no-action letters touching on § 4(1-1/2) exemption issues, it has formally declared that it will not express views on this general area. Procedures Utilized by the Division of Corporate Finance for Rendering Informal Advice, Securities Act Release No. 6253, 45 Fed. Reg. 72,644 (Nov. 3, 1980).


87 The SEC has commented on the need to address the uncertainty surrounding the § 4(1-1/2) exemption on several occasions. For example, Linda C. Quinn, Director of the Division of Corporate Finance, delivered an address to an ABA committee entitled: “Redefining ‘Public Offering or Distribution’ for Today,” in which she called the § 4(1-1/2) exemption a “phantom” exemption. Schneider, supra note 86, at 505 n.25.

88. Failure to comply with federal restraints on the resale of securities may result in administrative sanctions and/or a private action for damages by the purchaser of the securities under § 12(1) of the Act. 15 U.S.C. § 77l(1) (1988). Section 12(1) is a strict liability provision, as a plaintiff does not have to prove scienter on the part of the defendant. See J.W HICKS, CIVIL LIABILITIES: ENFORCEMENT AND LITIGATION UNDER THE SECURITIES ACT OF 1933 (1989) (two additional volumes forthcoming).


90. Underlying this holding period requirement is the assumption that the purchaser of the securities ought to be “at risk” for a reasonable period of time before selling the securities without registration, thereby implying a bona fide ownership interest. Release No. 5223, supra note 89, at 81,056.

91. For a discussion of liquidity, see supra note 73. When considering liquidity premiums, it is important that if an investor receives a discount for lack of liquidity, then she has been compensated for any restraint on resale to avoid double counting.
them instead of non-restricted securities, which then raises the cost of capital to the issuer. This is an unreasonable price to pay when the nature of the transaction indicates that it was never intended to be within the Act's scope. So began the pleas to the SEC to loosen the reigns on resale restrictions which culminated in Rule 144A, allowing sophisticated investors to fend for themselves in the market.92

B. Technical Operation of Rule 144A

Rule 144A addresses the confusion surrounding the section 4(1-1/2) exemption93 by explicitly exempting certain resales of restricted securities from the registration provisions of the Securities Act.94 The section 4(1-1/2) exemption was most clearly authorized when the resale of restricted securities was made to a party able to "fend for itself" in the marketplace and was done in a private transaction not involving the dangers attendant upon a public offering.95 It is precisely this situation that Rule 144A addresses. The SEC creates in essence a block exemption96 by providing a nonexclusive safe harbor97 from the registration requirements of the Act98

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92. See supra note 7 for the history of the Rule 144A proposal.
93. See supra notes 84-87 and accompanying text.
95. For an insightful analysis of judicial development of doctrine to address the resale of restricted securities, see Hicks, supra note 80.
96. I use "block exemption" to refer to an exemption based on a recurring fact pattern which has become so frequently requested and consistently granted, that it is administratively more convenient to carve it out of the regulatory net than to deal with each set of facts separately. The European Economic Community (EEC) uses this technique in its antitrust law. Article 85(3) of the Treaty of Rome allows the Commission, with the authorization of the Council, to issue "block exemptions" that specify general classes of agreements for which an individual application for exemption from antitrust law is not required. See B. HAWK, UNITED STATES, COMMON MARKET AND INTERNATIONAL ANTITRUST: A COMPARATIVE GUIDE (2d ed. 1985).
97. The phrase "nonexclusive safe harbor" is used in securities law parlance to mean that the failure to fully comply with the particular safe harbor rule does not preclude reliance on another exemption that may be applicable. The following example can serve as an illustration of this principle in the context of Rule 144A. Consider the resale by a very large insurance company such as Prudential of $2 million of a class of unlisted IBM preferred stock to another insurance company of medium size. Consider further that Prudential wants to sell this stock in reliance on Rule 144A. Prudential makes the sale, but its counsel neglects to verify that the buyer is a "qualified institutional buyer" as defined in Rule 144A. Rule 144A requires a "qualified institutional buyer" to have a minimum of $100 million invested in securities. The facts reveal that the buyer had $75 million invested in securities at the close of its most recent fiscal year and therefore did not qualify under Rule 144A's $100 million limit. Although the "safe harbor" of Rule 144A is not met for Prudential, it can still rely on another resale exemption from the Act, such as the § 4(1-1/2) theory or the options available in Rule 144 if applicable. Provided another exemption is available to Prudential, there will be no risk of liability for the failure to comply with Rule 144A since it is nonexclusive.
98. 17 C.F.R. § 230.144A, preliminary notes 1, 2.
for resales of restricted securities to "qualified institutional buyers" as defined in the Rule.\textsuperscript{99} The operation of Rule 144A turns on three factors: eligible purchasers, eligible securities, and information requirements.

1. Eligible Purchasers

Although the original proposal\textsuperscript{100} contained three tiers\textsuperscript{101} of transactions that would have been eligible for the safe harbor, the final Rule adopted only a modified version of the first tier—"qualified institutional buyers."\textsuperscript{102} Rule 144A creates a presumption, based on the dollar amount the institution has invested in securities, that an institution falling within its definition of "qualified institutional buyer" is sophisticated—a presumption that the investor has enough experience in the private resale market for restricted securities to be able to fend for itself.\textsuperscript{103} To qualify as an eligible purchaser, institutions generally must own and invest, on a discretionary basis, at least $100 million in securities of issuers not affiliated with the entity.\textsuperscript{104} This

\textsuperscript{99} 17 C.F.R. § 230.144A(a)(1) defines the term qualified institutional buyer. See infra notes 101-08 and accompanying text.

\textsuperscript{100} Release No. 6806, supra note 7, at 93-99.

\textsuperscript{101} The three tiers of the original proposal were: (1) the qualified institutional buyer tier, (2) the non-fungible securities tier, and (3) the fungible securities tier. The first tier permitted unlimited resales of any security of any issuer as long as the buyer met the definition of a qualified institution. The second tier allowed unlimited resales of securities to a wider class of specified institutions as long as the securities were not fungible with a class listed on a national securities exchange or quoted in an inter-dealer quotation system (NASDAQ) and were non-convertible debt securities, non-convertible preferred stock, or securities issued by a company subject to a continuous reporting obligation under the Exchange Act. The third tier covered resales of non-convertible debt securities, non-convertible preferred stock, and securities of reporting companies that are traded in a public market in the United States to the same class of institutions that are specified in the second tier. Release No. 6806, supra note 7, at 76-77, 93-99.

\textsuperscript{102} It is interesting that the SEC elected to use the term "buyer" rather than "investor." For criticism of buying and selling versus investing, see L. Lowenstein, supra note 20.

\textsuperscript{103} In the proposing release, the SEC stated:

In defining a "qualified institutional buyer," the Commission has attempted to establish a level at which it can be confident that participating investors have extensive experience in the private resale market for restricted securities. In addition, the Commission is seeking to identify a class of investors that can be conclusively assumed to be sophisticated and in little need of the protection afforded by the Securities Act's registration provisions.

Release No. 6806, supra note 7, at 94.

\textsuperscript{104} 17 C.F.R. § 230.144A(a)(1)(i). A dealer registered under § 15 of the Exchange Act must own and invest, on a discretionary basis, $10 million in securities, rather than $100 million. 17 C.F.R. § 230.144A(a)(1)(ii). A broker acting as a riskless principal on behalf of a qualified institutional buyer is also deemed a qualified institutional buyer. 17 C.F.R. § 230.144A(a)(1)(iii). The lowering of the broker-dealer threshold is a significant change from the Rule as originally proposed, but arguably is justified because the development of the Rule 144A market will largely hinge on the existence of dealers willing and qualified to make a market in Rule 144A securities.
"investments in securities" standard is in contrast to the $100 million total asset limit contained in the original proposal of Rule 144A.\(^{105}\) It is likely that the SEC made this change in order to limit the number of eligible purchasers, especially the number of troubled banks and thrifts eligible to participate.\(^{106}\) Although much debate centered on how to determine whether an institution was per se sophisticated,\(^{107}\) the "investment in securities" test is likely to be more successful in assessing investor sophistication than an asset standard.\(^{108}\)

2. Eligible Securities

Rule 144A is not available for securities that, when issued, were of the same class as securities listed on a national securities exchange or quoted in the National Association of Securities Dealers Automated Quotation (NASDAQ) system.\(^{109}\) The functional reality of this limitation is to exclude common stock from the Rule's protection and to relegate Rule 144A's use to non-convertible debt and non-convertible preferred stock.\(^{110}\) As originally proposed, Rule 144A did not contain this limitation; it was added in response to critics' assertions that side-by-side public and private markets would develop for the same class of an issuer's securities.\(^{111}\) However, this concern seems unlikely to mature and may have been driven by critics' pocket book reactions to the new Rule.\(^{112}\)

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105. Release No. 6806, supra note 7, at 94.
106. The SEC confirmed this argument upon final adoption of Rule 144A by adding a second check on banks' qualification under the Rule. In addition to the $100 million "investments in securities" test, a bank or savings and loan must also have an audited net worth of at least $25 million as demonstrated in its latest annual financial statements. 17 C.F.R. § 230.144A(a)(1)(vi). The number of institutions that would have been eligible under the asset standard was considerably higher than the number of institutions eligible under the invested securities standard. See Release No. 6839, supra note 7, at 2032.
108. Release No. 6806, supra note 7, at 95-96. SEC data indicates that this presumption is reasonable, in part, because entities of this size (and smaller) employ investment analysts to handle their securities portfolios. Id.
109. 17 C.F.R. § 230.144A(d)(3)(i). This qualification does not encompass the over-the-counter market (OTC), also known as the "pink sheets." Both convertible or exchangeable securities, with a conversion premium of less than 10% and warrants that may be exercised within three years from the date of issuance or that have an exercise premium of less than 10%, are treated as securities of the class into which they are convertible, exchangeable or exercisable. Id.
110. H. Bloomenthal, supra note 14, at 8-23 to 8-24.
111. See Release No. 6839, supra note 7, at 2035; Comment Letters, supra note 107.
112. Criticism and support of Rule 144A emerged in factions clustered around Rule 144A's perceived effect on the commentators' current business. See, e.g., Levin, NYSE Still Has Misgivings About SEC Plan for Private Placements, Investment Dealers' Digest, Oct. 2, 1989,
3. Information Requirements

Rule 144A uses the reporting requirements of the Exchange Act\textsuperscript{113} to determine when a seller in a Rule 144A transaction must provide information to the buyer about the issuer of the securities, and when there is sufficient publicly available information that this is not necessary. Where the issuer is a reporting company under the Exchange Act, the holder wishing to resell securities under Rule 144A has no duty to provide the buyer with any information about the issuer of the securities.\textsuperscript{114} Also, if the issuer is a foreign private issuer exempt from the reporting requirements of the Exchange Act through Rule 12g3-2(b),\textsuperscript{115} which mandates that the foreign

\textsuperscript{113} The reporting requirements of the Exchange Act are contained in §§ 12(g), 13(a), and 15(d). 15 U.S.C. §§ 78l(g), 78m(a), 78o(g) (1988). Reporting requirements involve factors such as the number of beneficial owners in companies with securities traded over the counter (12(g)), whether the issuer has filed a registration statement under the 1933 Act (15(d)), and whether the issuer has stock listed on a national securities exchange (13(a)). As of September 30, 1989, there were 18,090 companies required to file annual reports with the SEC.

\textsuperscript{114} 17 C.F.R. § 230.144A(d)(4)(i).

\textsuperscript{115} 17 C.F.R. § 240.12g3-2(b) (1990). Under this rule, the securities of over 1,400 foreign issuers are traded in the United States. These issuers are exempt from the reporting requirement of the Exchange Act if they do not make a public offering in the United States or are listed on a national exchange or quoted in NASDAQ, and they make available to the Commission the information required to be public in their home country. This provision was promulgated to recognize that foreign issuers have difficulty complying with the United States specifications for disclosure, principally because foreign countries do not adhere to GAAP (Generally Accepted Accounting Principles) standards, but instead use their own accounting standards. SEC Reauthorization, \textit{supra} note 46, at 92 (1989). See \textit{generally PRACTISING LAW INSTITUTE, ACCOUNTING FOR LAWYERS} (1989) (includes a chapter (26) on sources of GAAP).

Most of these foreign securities are traded as American Depositary Shares (ADSs). An ADS is evidenced by a certificate called an American Depositary Receipt or ADR. The ADR entitles the holder to receive securities of a specified foreign issuer upon presentation of the ADR to the depository institution. ADSs were developed to resolve problems such as dividends payable in foreign currencies and foreign clearance practices. The investor wishing to trade in foreign securities can deal directly with a local depositary institution in local currency, making the process less burdensome to the investor. SEC Reauthorization, \textit{supra} note 46, at 92; see also M. TOROSIAN, SECURITIES TRANSFER: PRINCIPLES AND PROCEDURES (rev. 4th ed. 1988) (comprehensive and readable text on basic procedure of securities transfer).

The Commission keeps the financial community informed as to what foreign companies are exempt under rule 12g3-2(b) by publishing periodic lists of those companies. In this way, brokers and other intermediaries, as well as investors, can have an accessible reference of foreign companies that have public information on file with the Commission. For a recent listing, see Securities Exchange Act Release No. 27,325, 44 SEC Docket 1195 (CCH) (Sept. 29, 1989).
issuer provide certain information to the SEC in order to maintain the
exemption, then the seller incurs no further disclosure obligation to the
buyer.1\textsuperscript{16} The SEC\textsuperscript{17} and commentators\textsuperscript{18} believed that the publicly available
information on the issuer should be sufficient to protect the buyer.

However, if the securities are issued by a company not subject to the
reporting requirements of the Exchange Act or exempt under Rule
12g3-2(b),\textsuperscript{19} then the seller is required to provide to the buyer, upon request,
basic information concerning the business of the issuer and its financial
statements.\textsuperscript{20} The Commission constructed these information requirements in
response to concerns raised over the availability of information on the issuer
of the securities being resold.\textsuperscript{21} This distinction between reporting and
nonreporting issuers comports with the underlying philosophy of the secu-
rities laws—disclosure—and strikes what is likely to be in practice a reason-
able compromise between buyers and sellers.\textsuperscript{22} The information contained
in the Exchange Act filings is essentially the same information that is
required under the 1933 Act’s registration provisions. The Commission’s
integrated disclosure system,\textsuperscript{123} implemented to allow issuers to simply

118. See Comment Letters, supra note 107.
119. 17 C.F.R. § 240.12g3-2(b).
120. 17 C.F.R. § 230.144A(d)(4)(i). This aspect of Rule 144A drew a strong dissent from
Commissioner Fleischman, see Release No. 6862, supra note 7, as well as concern from the
investment banking community over marketplace intrusion and potential liability for infor-
mation that sellers furnish. See H. Bloomenthal, Emerging Trends in Securities Law 5-17
121. Release No. 6839, supra note 7, at 2036.
122. See supra notes 59-70 and accompanying text. This information requirement is, in
theory, inconsistent with Rule 144A’s buy-side premise that certain investors are sophisticated
enough to fend for themselves in the market. However, in practice the burden created may
be insubstantial: many non-reporting issuers are likely to have their stock traded in the OTC
market (or pink sheet market), triggering Rule 15c2-11 which already requires that brokers
have information on issuers available to buyers. See 17 C.F.R. § 240.15c2-11 (1990).
123. The Commission’s integrated disclosure system has two major features. First, it coor-
dinates required disclosures under the 1933 Act and the 1934 Act, premised on the efficient
market hypothesis (“EMH”) postulate that information effectively disseminated to the public
will be reflected in share prices regardless of the source of the data. This provision is
implemented by allowing 1934 Act reporting companies to file streamlined registration forms
under the 1933 Act (Form S-2 or S-3 rather than the longer Form S-1). Second, it contains
generic disclosure items for both the 1933 Act registration and the 1934 Act registration and
reporting requirements (Regulation S-K for nonfinancial information about the issuer and
Regulation S-X for financial information about the issuer). L. Loss & J. Seligman, supra note
58, at 599-621; see also Cohen, The Integrated Disclosure System—Unfinished Business, 40
Bus. Law. 987 (1985); Gordon & Kornhauser, Efficient Markets, Costly Information and

In arguments based upon the efficient market hypothesis, it is important to note that there
are really three versions of the EMH: (1) the strong form, in which prices reflect not just
public information but all information that can be painstakingly obtained through fundamental
analysis of the company and the economy, (2) the semi-strong form, in which prices reflect
incorporate by reference their 1934 Act filings into a 1933 Act registration statement, underscores this similarity. Providing investors the same information twice increases transaction costs with no corresponding benefit to the marketplace.

III. RULE 144A'S EFFECT ON THE MARKETPLACE

According to the SEC, "Rule 144A is likely to improve substantially the efficiency and liquidity of the United States private placement market, and as a result may well have major implications for financing practices in the United States of both domestic and foreign issuers." After having examined the current state of financing practice in the United States, with emphasis on the increasing institutionalization and privatization of the marketplace, and having looked at the context and operation of Rule not only past prices but all other published information, and (3) the weak form, in which prices reflect all information contained in the record of past prices. See R. Brealey & S. Myers, Principles of Corporate Finance 287-88 (3d ed. 1988).

Research termed "random walk" studies has determined that the market is at least efficient in the weak sense. Random walk theory about the movement of stock and commodity futures prices hypothesizes that past prices are of no use in forecasting future price movements, rather, prices follow a random walk. R. Brealey & S. Myers, supra, at 282-87. This idea was first proposed in 1900. See L. Bachelier, Théorie de la Speculation, Gauthier-Villars, Paris (1900), reprinted in The Random Character of Stock Market Prices 17-18 (A.J. Boness trans., P.H. Cootner ed. 1964). Bachelier's mathematical theory of random processes anticipated Einstein's famous work on the random motion of colliding gas molecules by five years. R. Brealey & S. Myers, supra, at 284.

Most researchers agree that the United States markets are at least semi-strong form efficient. This theory has been tested by determining how quickly the market reacts to specific news items such as dividend announcements, forecasts of earnings, and mergers. The price reaction to news and to sales of large blocks of stock seems to be almost immediate. See, e.g., Dann, Meyers & Raab, Trading Rules, Large Blocks and the Speed of Price Adjustment, 4 J. Fin. Econ. 3 (1977); Patell & Wolfson, The Intraday Speed of Adjustment of Stock Prices to Earnings and Dividend Announcements, 13 J. Fin. Econ. 223 (1984).

Whether the United States capital markets are strong form efficient is still debated. If so, then no investor would be able to make consistently superior forecasts of stock prices. Some research indicates that this is currently the case on Wall Street. E.g., Bogle & Twardowski, Institutional Investment Performance Compared: Banks, Investment Counselors, Insurance Companies, and Mutual Funds, 36 Fin. Analysts J. 33 (1980). Other research points out anomalies such as New York Stock Exchange specialists and company managers making consistently superior profits, indicating that U.S. markets are not strong-form efficient. E.g., Seyhun, Insiders' Profits, Costs of Trading, and Market Efficiency, 16 J. Fin. Econ. 189 (1986).

The financial and economic research being conducted has a decided impact on the disclosure policies of the SEC. Although the SEC did not issue a statement addressing the matter, the SEC began to beef-up its sanctions against insider trading as financial economists began showing the superior performance of company insiders compared to outside investors. In the complex field of financial market regulation, the research of economists, corporate finance scholars, and financial economists greatly informs the SEC's regulatory efforts.

125. See supra notes 19-54 and accompanying text.
144A, this Note takes an ex ante look at the firm-level and macroeconomic consequences of the new Rule. In examining Rule 144A, this section employs two overlapping levels of analysis: statutory suitability and policy implications.

A. Rule 144A as a Statutory Response

Considered simply as a response to a gap in existing regulatory structure, Rule 144A narrows, but does not fill, the existing void. The ambiguity surrounding the section 4(1-1/2) exemption persists for everyone except the institutional investors which fall squarely within Rule 144A. Rule 144A’s definition of “qualified institutional buyer,” which requires a minimum of $100 million invested in securities, is likely to be under-inclusive for determining whether a buyer is sophisticated. The demands for performance, indeed for survival, in the market make unlikely the possibility that an institution meeting Rule 144A’s definitional criteria will not be sophisticated. It is more probable that institutions that are able to fend for themselves in the marketplace will not have the safe harbor of Rule 144A available.

The underlying philosophy for exempting a transaction from the Securities Act is that sophisticated investors do not require the protection the Act offers. The investor’s level of sophistication does not waiver by the stage of a transaction she is participating in, unless there are differences in the nature of the transaction that create disclosure variances. By the same token, her need for the protection of the Act does not change either. The SEC, however, has adopted different criteria for recognizing sophisticated investors for purposes of initial private placements than it uses for resales.

See supra notes 55-124 and accompanying text.

See supra notes 84-92 and accompanying text.

17 C.F.R. § 230.144A(a).

See L. Lowenstein, supra note 20, at 56-87 (chapter entitled “The Performance Game”).

SEC Commissioners Charles Cox and Joseph Grundfest have voiced concerns that the reproposed Rule 144A is “overly cautious.” Levin & Maher, SEC’s Modified Private Placement Rule Aimed at Thrifts, Banks, INVESTMENT DEALERS’ DIG., July 17, 1989, at 5. Grundfest commented that “there are many institutions that won’t make this cut and would be fully capable to fend for themselves and participate.” Id. Cox suggested that the investment test be lowered from $100 million to $25 million. Id. The SEC may change the threshold for the presumption of sophistication, perhaps in an early amendment. Id.

See supra notes 59-70 and accompanying text.

under Rule 144A. The SEC has not addressed this inconsistency in Rule 144A's proposal, reproposal, or adopting release.

If Rule 144A transactions were designed as a substitute for public offerings of securities, then it is arguable that more "due diligence" is performed surrounding the public offering than would be in a Rule 144A transaction. Thus, adjusting the sophistication standards would be justified. However, the relevant comparison is with a private placement: Rule 144A addresses resales of securities acquired in a private placement, not in a public offering—those securities are freely tradeable. There is no justification for requiring dissimilar standards of disclosure at the issuing stage and the resale stage of the private transaction. Indeed, if the balance had to tip in one direction or the other, it would be more appropriate to heighten the level of scrutiny at the issuing stage. It is at this point that there is the least information available in the market about the issuer.134

Thus, the appropriate definition of "qualified institutional buyer" should be further researched with an eye towards amending the definition to more closely align it with the definition of "accredited investor" used under Regulation D and section 4(6) of the Act—the two statutory provisions permitting private placement exemptions. An investor who does not require the Act's protection when purchasing from the issuer does not need the Act's protection when purchasing from another party. The security

133. Due diligence refers to the process that takes place in the preparation of the issuer's registration statement (or private placement memorandum), where underwriters and counsel scrutinize the document and support materials in order to satisfy their duties of care under the civil liability provisions of the securities laws. See L. Loss & J. Seligman, supra note 58, at 365-67 A due diligence meeting is conducted by the underwriter of a new offering at which brokers can ask representatives of the issuer questions about the issuer's background and financial reliability and the intended use of the proceeds. Increased civil actions against underwriters and broker-dealers have caused the due diligence meeting to become more than a perfunctory, hand-shaking affair. Often, several informal due diligence sessions are held, where top management representatives of the issuer are available to answer the questions of analysts and institutional investors.

134. Research illustrating the lack of information available about an issuer when pricing an initial public offering indicates that it is more likely that the market would have less information to absorb during a primary offering than during a later secondary trade. A private placement may have even less available information initially. The Initial Public Offering (IPO) market is a difficult market to understand. Many studies have been done concerning the problem of pricing of new stock issues due to information inefficiencies. See, e.g., Simon, The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues, 79 Am. Econ. Rev 295 (1989) (extensive bibliography of research on the new issue market). One researcher has developed an "implicit insurance hypothesis," which holds that IPOs are underpriced to serve as a cushion against legal liability and reputational damage to investment bankers in case the IPO does not perform well. Timc, Anatomy of Initial Public Offerings of Common Stock, 43 J. Fin. 789 (1988).

135. 17 C.F.R. § 144A(a).
136. See supra note 132.
137 17 C.F.R. § 230.501-703(T).
purchased is identical, regardless of the seller’s identity. The intermediary simply has no relevance in the disclosure inquiry, especially when the issuer is a reporting company under the 1934 Exchange Act and information on the issuer is publicly available.

B. Rule 144A as a Policy Tool

1. Effect on Trends

Rule 144A is certain to increase demand for private placements, and, in turn, since institutions are the dominant players in the private placement market, increase the institutionalization of the capital markets. By lowering transaction costs and liquidity premiums, Rule 144A will lower the cost of private placements. Therefore, assuming a downward-sloping demand curve applies, the number of private placements will increase.

The factional resistance to Rule 144A reflects the declining transaction costs: one person’s cost is another person’s paycheck. Investment bankers, lawyers, and other intermediaries, who have made handsome profits drafting complex documents and opinions to march their clients through the legal grey area of the section 4(1-1/2) exemption, are complaining about Rule 144A when they are not out looking for business. Large insurance companies like Prudential and Metropolitan have already started generating

139. See supra note 113.
140. When the author questioned several securities lawyers about whether Rule 144A should be available for resales of any security of a reporting company, many attorneys replied that their firms “had taken that position with clients for several years.”
141. Maher, SEC, supra note 47, at 18 ("Rule 144A would open the gates wide to new investors helping to fuel an even bigger boom in the private market.").
142. Transaction costs include underwriters’ fees, legal fees, and the costs saved due to the speed at which the transaction can be affected. The ability to resell immediately, rather than wait for a holding period to expire or solicit a no-action letter from the SEC, allows market participants to take advantage of market fluctuations. Maher, SEC, supra note 47, at 18 (statement by SEC staff about requests from Wall Street firms for no-action letters regarding resales).
143. See supra note 73.
144. For a basic text on economic principles, see W Curtis, Microeconomic Concepts for Attorneys (1984).
145. See supra note 112.
146. During a panel discussion at the 21st Annual Institute on Securities Regulation held November 2-4, 1989 in New York City, which the author attended, Francois de Saint Phalle, of the investment banking firm Dillon, Read & Co., commented that Rule 144A looks to him like “one more way around the marketing function of Wall Street firms.” He then went on to say that Rule 144A takes revenue out of the securities industry by “shortening the path between the capital user and the capital provider.” At this point, de Saint Phalle was promptly cut off by Linda Quinn, the SEC’s Director of the Division of Corporate Finance, and staunch supporter of Rule 144A. Panel Discussion, 21st Annual Institute on Securities Regulation (Nov. 2, 1989).
private deals to satisfy their own portfolio appetite, even acting as underwriters by syndicating pieces of their deals to smaller institutions. The challenge for investment bankers is threatening: if they do not add value, but are simply a step in the process that adds only costs, they will be bypassed. Not only will the existing players in the market increase the demand for private placements, but the entrance of a new player—mutual funds—will increase demand as well. Mutual funds are currently constrained by SEC regulations to allocate only ten percent or less of their assets to restricted (illiquid) securities. Unregistered securities are generally considered illiquid due to their resale restraints. However, the mutual fund industry has successfully lobbied the SEC to give them freedom to invest in the Rule 144A market, since the new Rule will increase the liquidity of privately placed securities among institutions. Several mutual funds have already held shareholder votes to restructure internal policies to allow investments in the Rule 144A market. Mutual funds, controlling over $470 billion in funds, could cause a substantial infusion of capital into the private placement market.

Pension funds represent another industry presently constrained from investing in illiquid securities. Pension funds control over $1.9 trillion in assets, so that even a small percentage increase in pension fund investments in the private placement market will have an impact. The largest pension funds, such as the Teachers Insurance and Annuity Association, are already active participants, and others are poised to follow suit once the Rule 144A market develops.

2. Macroeconomic Effects

In examining Rule 144A, the difficult issue is not deciding whether it will increase the trends of privatization and institutionalization, but whether

147 Schwimmer, License to Deal, INVESTMENT DEALERS' DIG., Dec. 18, 1989, at 18, 22; Michels, Bypassing Wall Street, INVESTMENT DEALERS' DIG., May 22, 1989, at 14-17.
148. Jessica Palmer, managing director-capital markets at Salomon Brothers stated that "[i]there are a lot of things at stake here. The test over time is whether the services the Street provides are worth it or are they not." Michels, supra note 147, at 15.
151. For a discussion of Rule 144A's effect on current mutual fund regulation, see Maher, SEC, supra note 47, at 19.
152. Schwimmer, supra note 149.
153. Schwimmer, supra note 149.
155. Id.
156. Id.
157. Id.
those increased trends can affect firms, the marketplace, and the economy in positive ways. Looking at Rule 144A as a policy instrument, this section will focus on two questions central to that inquiry: First, will Rule 144A atrophy public disclosure? And second, will Rule 144A improve corporate governance?

a. Public Disclosure

Because Rule 144A governs resales, not offerings, of securities, any impact the Rule has on disclosure standards will be derivative. Although frequently misunderstood since its proposal, Rule 144A's impact on capital formation is indirect.\textsuperscript{8} The disclosure requirements for public offerings under the 1933 Act,\textsuperscript{159} and continuous reporting requirements under the 1934 Act\textsuperscript{6} are unchanged. Indeed, Rule 415,\textsuperscript{161} which provides for shelf registrations, should raise more concerns as it is directed at the primary market. However, after six years of existence, Rule 415 has not created substantial regulatory problems but has increased the efficiency of capital formation processes.\textsuperscript{162}

Rule 144A's effect on public disclosure will be measured by the extent to which its benefits lure deals to the private placement market that otherwise would have been done as public offerings. Capital formation gravitates to the most efficient method.\textsuperscript{163} Decreasing the cost of capital to business frees funds for other uses such as research and development. Rather than fight

\textsuperscript{158} See \textit{SEC Reauthorization}, supra note 46, at 91. David Ruder, Chairman of the SEC (at the time), had to explain the distinction between resales and primary offerings to Congress, when asked how he could justify a rule that exempted securities from the Act's disclosure requirements. \textit{Id.} However, issuers do receive direct benefit from Rule 144A in that an issuer's exemption under § 4(2) or Regulation D of the Act will not be compromised by a purchaser who buys securities from the issuer with a view to reselling such securities in a Rule 144A transaction. 17 C.F.R. § 230.144A preliminary note 7.

\textsuperscript{159} See supra notes 61-70 and accompanying text.

\textsuperscript{160} See supra note 113.

\textsuperscript{161} 17 C.F.R. § 230.415 (1990). For a thorough treatment of issues surrounding Rule 415, see L. Loss & J. Seligman, supra note 58, at 353-72. Shelf registration permits delayed or continuous distributions of securities without requiring that a registration statement be filed each time, thereby allowing issuers to keep securities "on the shelf" and ready to distribute. The hazard involved is that the information in the prospectus will become stale. The issue of shelf registrations engendered the Banoff-Fox debate. \textit{Compare Banoff, Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 VA. L. REV 135 (1984)} (supporting Rule 415 on efficiency grounds) with Fox, \textit{Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis, 70 VA. L. REV 1005 (1984)} (a critique of Banoff's article).

\textsuperscript{162} Market participants' use of Rule 415 has settled on those transactions for which it is efficient (usually a debt offering on a Form S-3). In this context, any loss of due diligence benefits is negligible due to reduced investor risk in debt offerings and the integrated disclosure system. L. Loss & J. Seligman, supra note 58, at 368.

\textsuperscript{163} Blackwell & Kidwell, \textit{An Investigation of Cost Differences Between Public Sales and Private Placements of Debt}, 22 J. Fin. ECON. 253, 256 (1988) ("firms minimize the costs of issuing securities by selecting the market providing the lowest expected yield on net proceeds").
market forces, it would be preferable to ensure that public disclosure is not dampened—the traditional philosophical posture of the federal securities laws. One way to accomplish this task is by confining Rule 144A to the securities of issuers that file periodic reports under the Exchange Act, or requiring the seller to give the buyer that type of information. Rule 144A is even more restrictive than that at present, since only some securities of reporting issuers are eligible under the Rule.\textsuperscript{164}

Rule 144A suffers from timidity: the Rule could be further extended to allow resales of any security of a reporting company without any loss of public disclosure standards. Inapplicable to fungible securities,\textsuperscript{165} Rule 144A’s primary application will be to non-convertible debt, preferred stock that is not publicly traded, and foreign securities traded on exchanges outside of the United States.\textsuperscript{166} These restrictions are unnecessary. Privately placed equity and debt securities are traded every day in a secondary market,\textsuperscript{167} even though the identical security is traded in the public securities markets.

The SEC operates under the premise that securities that are traded on NASDAQ or the over-the-counter market have adequate information that is publicly available.\textsuperscript{168} The SEC should be less concerned, therefore, about the adequacy of the disclosure for trading in a secondary market confined to institutional investors. Additionally, the existing exchanges have submitted rule-change proposals\textsuperscript{169} to the SEC in order to establish new marketplaces for secondary trading that would meet the requirements of Rule 144A. This market oversight is designed to provide for record-keeping, controls on settlements, and control of the exit of unregistered securities into the

\textsuperscript{164} 17 C.F.R. § 230.144A(d)(3), (4).
\textsuperscript{165} 17 C.F.R. § 230.144A(d)(3)(i).
\textsuperscript{166} H. Bloomenthal, supra note 14, at 8-33.
\textsuperscript{167} H. Bloomenthal, supra note 14, at 8-33.
\textsuperscript{168} These markets are generally found to be efficient by most analysts, and SEC regulations of those markets support this belief. See supra note 123 (discussion of the efficient market hypothesis).

domestic retail market. The National Association of Securities Dealers (NASD) system—"PORTAL"—the most fully developed at this stage, should quell any concerns over "leakage" into the retail market of unregistered securities.

Concerns voiced to the SEC that institutional investors will move resources from the public to private markets are misdirected. The SEC cannot control this factor in the long run any more than it can control institutions moving resources to other investment alternatives. Part of successful regulation is knowing what cannot be regulated. The SEC can provide disclosure standards and can keep the markets free from fraud, but it cannot ensure their viability single-handedly. SEC policy can boost short-term efficiency in the markets, but, over time, other variables will determine the level and type of investment in the economy. Macroeconomic forces such as monetary policy, inflation, and interest rates play a far greater role than the SEC. However, the SEC can work to indirectly influence efficiency in the markets through policies that help to solve problems such as corporate inefficiencies. Rule 144A is an excellent tool to increase the level of institutional investment in United States corporations even further and to encourage additional Institutional monitoring of management.

b. Corporate Governance

As in many cases, those commenting on LBOs and Rule 144A's effect on the LBO craze seem to have gathered at the extremes, when the reality lies somewhere in the middle. Evidence indicates that while there has been some erosion of public ownership of United States corporations, this trend is not as widespread as Michael Jensen indicates when he welcomes the eclipse of the public corporation. Neither is the evidence indicating some

170. PORTAL I, supra note 169, at 2. For a good overview of the PORTAL system, see H. Bloomenthal, supra note 122, at 6-1 to 6-23.

171. Several commentators on Rule 144A were concerned over the possibility of "leakage" of unregistered securities into the retail market. However, under Rule 144, 17 C.F.R. § 230.144, unregistered securities are allowed to seep into the retail market gradually or completely after the two-year holding period. See Rule 144(e) (limitations on amount of securities sold) and Rule 144(d) (holding period). 17 C.F.R. §§ 230.144(e) & 230.144(d). In studies the SEC performed before proposing Rule 144A, data revealed that leakage would not be a viable concern. Release No. 6806, supra note 7, at 93. Also, Rule 144A does nothing to disable the anti-fraud protection of the Act, thereby subjecting unauthorized resales to the Act's sanctions. Release No. 6806, supra note 7, at 92.

Significant liberalizing amendments to Rule 144's holding period requirement went into effect along with Rule 144A. The required two-year holding period now runs continuously from the date of acquisition of a security from an issuer or an affiliate of the issuer. Release No. 6862, supra note 7, at 49.

172. See Comment Letters, supra note 107.

173. See H. Bloomenthal, supra note 14, at 8-33.

erosion and revamping of the public corporation as draconian as Jensen's critics assert. The advent of institutional investors holding large blocks of shares in corporations can neutralize Jensen's criticisms of the public corporation. Institutions may cause the corporations to become "leaner and meaner" (perhaps even resembling in some ways the LBO associations that Jensen heralds as the wave of the future), but the public corporation has an opportunity to be improved rather than eclipsed as a result of Rule 144A.

The value of the public market, even to investors having access to relatively liquid private markets, has been proven empirically. Entrepreneurs turn to the public market for a source of capital, partly because of its efficiency as a provider, but also because of the perceived status of having a corporation listed on the national exchanges, thereby giving the public market a degree of inelasticity. This inelasticity allows Rule 144A to operate successfully without side-by-side public and private markets developing simultaneously for the same securities, or without the private market totally eclipsing the public one. Rule 144A, then, can work to increase corporations' access to an alternative source of capital in the private

175. See supra notes 53-54 and accompanying text.
176. Jensen, Eclipse, supra note 49, at 69-74. Jensen argues that LBO associations like Kohlberg, Kravis & Roberts (KKR) are more decentralized than publicly held conglomerates, rely more on leverage, and are thus able to operate more efficiently. The basis of his argument is that high leverage forces the business to look to external rather than internal sources of financing. Debt, then, acts as a monitoring device over management, since any poor performance will make it less likely that their external sources will be willing to invest. Id. Jensen cites dramatic gains in profit margins and share returns once the corporation has been taken private by the LBO association. Id. at 70-71. One problem with Jensen's analysis is that he fails to explain why these operating inefficiencies cannot be corrected while the company is still publicly held. When management takes the company private, management gains at the expense of outside shareholders. Jensen implicitly sanctions this premium transfer from the public shareholders to the insiders. Jensen's data on seven LBO partnerships show that thirteen professionals and nineteen nonprofessionals are overseeing twenty-four business units with annual sales of over $11 billion. Id. at 69. His study also shows that these LBO associations concentrate equity holdings among managers. Id. While having a stake in the corporation can obviously encourage management's performance, this concentration of power is anything but "decentralized." It is also unlikely that these few individuals can oversee the businesses sufficiently. Jensen admits that it "is physically impossible for KKR and other LBO partnerships to become intimately involved in the day-to-day decisions of their operating units." Id. Decreasing management involvement is not likely to increase productivity.

178. Id. However, whether the demand for liquid public markets is inelastic, and if so, to what degree, is still open to debate. See Rudnick, supra note 73, at 1180-81 & n.757.
179. The fear of "side-by-side" public and private markets developing that was expressed in many comment letters on Rule 144A, see supra note 107, caused the SEC to retreat from allowing fungible equity securities to be traded in reliance on the Rule. H. Bloomenthal, supra note 14, at 8-32, 8-33. However, the strongest criticism came from the existing exchanges, fearing loss of business.
market, with the resulting competition to the public market stimulating improvements in the public market as a source of funding.180

Discourse on corporate governance issues centers on the tension between various corporate constituents, especially management and shareholders.181 Termed agency costs, moral hazard, shirking, free rider, the common pool problem, or corporate opportunity doctrine,182 the basic dilemma is that everyone is tempted to act in his own self-interest to the detriment of the whole. Managers, shareholders, employees, and creditors are all self-interested corporate actors. Corporate law, therefore, is centered on imposing restraint where self-restraint may be lacking. For years, arguments for shareholders' rights came from the Left. Individuals such as Ralph Nader advocated shareholders' rights over management, because they assumed that shareholders' interests were in line with consumer, employee, and community interests.183 The Left forgot Rule Number One—no one is beyond temptation. In the wave of hostile takeovers and LBOs, which resulted in significant premiums to shareholders, the interests of shareholders collided with other corporate constituencies. However, shareholders were not abandoned. The Right adopted their cause in the name of market efficiency.184 At this juncture, and despite the new parent, shareholders are still not effective monitors of corporate management. Corporate productivity is declining, and the United States status in international competition has fallen as well.185 However, as Rule 144A successfully increases the attractiveness of the private placement market, and firms turn to that market as a source of capital, institutions are positioned to become a more potent force in corporate governance.186 Private placements are individually negotiated

180. See Blackwell & Kidwell, supra note 163.
184. E.g., Jensen, Eclipse, supra note 49.
185. L. Lowenstein, supra note 20, at 98-118.
186. This trend has already begun, witnessed in part by the recent proxy battle between NL Industries and Lockheed Corporation. See J. Martin, The Lessons of NL Versus Lockheed (May 18, 1990) (unpublished manuscript presented at the Salomon Brothers Center and Rutgers Centers Conference on The Fiduciary Responsibilities of Institutional Investors) (copy on file with the Indiana Law Journal).

transactions. With a relatively limited market of buyers qualified to deal in the private placement market, a corporation will be forced to take notice of institutions' demands or risk losing a source of capital. In the web of institutional relationships, one disgruntled source could carry over to several unanswered phone calls when it comes time to raise additional capital.

Improvements in existing proxy rules, such as those recently being advanced to give institutions increased access to the proxy machinery, would bolster an institution's ability to effectively monitor

187 See Nash, Institutional Private Placements: A Legal Overview, in Practising Law Institute, Private Placements 1989, at 133. One of the benefits of a private placement over a public offering is the ability to tailor the terms of the financing for the specific issue. Often, event-risk protection can be negotiated that would not be possible in a public offering to dispersed investors. See Michels, supra note 147, at 14 (Metropolitan able to negotiate for event-risk protection).

188. The President of Prudential Power Funding Associates, a large direct purchaser of utility-related private placements, commented that “[y]ou can really put it to a guy on one deal but you can only do it once. There’s so much Monday morning quarterbacking going on now. There’s more communication” Schwimmer, supra note 147, at 22.

189. Proxy rules are contained in § 14 of the Exchange Act. 15 U.S.C. § 78n (1988). A proxy statement is information that the SEC requires the board of directors to provide to shareholders before they vote by proxy on company matters. The statement contains proposed amendments to articles of incorporation or other items of business that require a shareholder vote. In the takeover context, the proxy is used to persuade shareholders to vote for either incumbent management or the acquirer. See L. Loss & J. Seligman, supra note 58, at 693-95, 738-39, 1258-59.

The SEC's rule-making power in the proxy arena is arguably stronger than the problematic Rule 19c-4 (one share/one vote) area because of the explicit Congressional authorization under § 14(a) of the Exchange Act for the SEC to enter the realm of corporate governance. The Court of Appeals for the District of Columbia Circuit recently invalidated Rule 19c-4 in Business Roundtable v. SEC, 905 F.2d 406 (D.C. Cir. 1990). For discussion regarding the SEC's power in the proxy arena in Business Roundtable, see id. at 416-20.


Elmer W. Johnson, a senior partner in the Chicago law firm Kirkland & Ellis and member of the New York Stock Exchange's Legal Advisory Committee, has proposed an exemption from the proxy rules for private solicitations among sophisticated holders—an exemption that would mirror the definition of "qualified institutional buyer" under Rule 144A. Johnson advocates improvements in the proxy process to encourage long-term investors to exercise their power of voice rather than their power of exit in monitoring management. Johnson, An Insider's Call for Outside Direction, Harv. Bus. Rev., Mar.-Apr. 1990, at 46; see also E. Johnson & R. Osborne, Revitalizing the Board of Directors (May 17, 1990) (unpublished manuscript presented at the Salomon Brothers Center and Rutgers Centers Conference on The Fiduciary Responsibilities of Institutional Investors) (copy on file with the Indiana Law Journal).

The California Public Employees' Retirement System (CalPERS) has recently proposed revisions to the federal proxy rules. See Letter from CalPERS to the SEC, Nov. 3, 1989 (copy on file with the Indiana Law Journal); Letter from the American Bar Association to the SEC, Apr. 27, 1990 (commenting on the CalPERS proposal) (copy on file with the Indiana Law Journal).
managing. Institutions' power will be an effective foil for management and can resolve some of the agency problems that widely dispersed shareholders are not capable of resolving.

Assuming institutions do begin to take a more active role in monitoring management, with whose interests are institutions aligned? This issue is complicated by the varying natures of institutions. Some institutional investors operate foremost as conduits for individuals, whereas others operate principally as a separate entity. To borrow terms from economic literature, "financial institutions range from transparent through translucent to opaque." Considering the individual as the "simplest and most transparent institution," mutual funds would be the most nearly transparent, insurance companies and banks the most opaque, and pension funds in the middle—translucent. The further the institution is from the model of the individual investor, the less likely that retail forces and individual portfolio optimization will be dominant.

This consideration, that an institution may be more than the sum of its parts, could have major implications for modern portfolio theory as applied to an institutional market. Each premise that is based on assumptions about the unconstrained individual would have to be reevaluated for applicability to institutions. Modern portfolio theory essentially drives much of the current regulation of the capital markets. Factoring institutions qua institutions into the analysis represents an area for continuing research, and, perhaps, responsive regulatory changes. Yet, this insight may simply transfer our realm of discourse from the monitoring of one institution—the public

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1. Ross, Institutional Markets, Financial Marketing, and Financial Innovation, 44 J. Fin. 541, 542 (1989) (Because of "agency theoretic relations, institutional behavior in financial markets is not a simple reflection of the preference structures of individuals.").
2. Id.
3. Id. at 542-44.
4. Id. at 542-44.
5. Modern portfolio theory is based on two valuation models. One is the Capital Asset Pricing Model ("CAPM"). This model was created to be used as a benchmark in assessing the distinction between systematic and unsystematic risk, against which the performance of a portfolio can be measured. The major difficulty in testing the CAPM is that the model is stated in terms of investors' expectations, not in terms of realized returns. V. Brudney & M. Chirelstein, supra note 75, at 101. CAPM employs beta as a risk measure. High beta stocks tend to be priced to yield correspondingly high rates of return. Id.
6. As Ross' research has just begun to explore, these models are based on individual investors. Ross, supra note 191, at 541, 555-56.
corporation—to the monitoring of another—the various institutional investors that Rule 144A addresses.

**CONCLUSION**

In promulgating Rule 144A, the SEC admitted that it had "not until now . . . formally addressed the difference between the institutional and public resale markets. The institutional resale market for restricted securities has evolved to a point where its existence should be acknowledged."\footnote{197} It is perhaps this recognition, more than the substance of Rule 144A itself, that has sparked so much controversy. The radical restructuring of the United States capital markets in the last decade did not escape notice—but the SEC's imprimatur made it real. As this Note documents in Part I, the transformation is real. The capital markets have been significantly altered by the emerging dominance of the institutional investor and the private placement financing alternative.

The SEC is to be commended for addressing these changes through Rule 144A. The Rule's premise, that professional institutions are able to make investment decisions without the protection mandated by the registration requirement of the Securities Act, is consistent with the historical philosophy of the federal securities laws. However, the Commission should trust its own instincts. By responding to pressure from various interest groups, the SEC has threatened to undermine the positive consequences the Rule could have if adopted in a form closer to that originally proposed. The federal securities laws function best when the Securities Act and the Exchange Act function harmoniously. Extending Rule 144A to cover resales (to a qualified institutional buyer) of any security issued by a company subject to the reporting requirements of the Exchange Act will help to accomplish this objective. Further, amending Rule 144A's definition of qualified institutional buyer to more closely resemble Regulation D's accredited investor definition is also warranted. These extensions will allow the SEC to properly mediate between unnecessary restraints on alienation in the form of resale restrictions and adequate protection of investors.

The federal securities laws have operated successfully for over fifty years. To continue that track record, the SEC must continue to recognize that securities law must be multidimensional. It must operate at many levels to be efficient, and it must be finely calibrated to reach various market participants at the level in which they operate in the capital

\footnote{197. Release No. 6806, supra note 7, at 85.}
markets. By creating Rule 144A, the SEC recognized that not all investors have equal tolerances to the heat of the market. Institutional investors are able to hold their hands closer to the fire without being burned: Rule 144A has paved the way for their approach.