UNIVERSITY OF SAN DIEGO SCHOOL OF LAW

MEMORANDUM

TO: Commissioner Charles C. Cox
Mr. Paul Gonson, Solicitor
Irving M. Pollack, Esq.
Professor Joel Seligman
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FROM: Professor Homer Kripke

SUBJ: Major Issues Conference, June 28 and 29

DATE: May 30, 1984

Gentlemen:

In addition to some of the points made in my recent article, my letter of May 4, 1984, and the enclosed short outline, I an attempting to set forth herein some matters that have been percolating in the back of mind inconclusively and are just beginning to be crystallized.

I. THE DOMINANCE OF THE "BIG OPERATOR" IN THE MARKET.

Recently market prices of securities, particularly common stocks, have demonstrated sharp discontinuities when a "big operator" entered the market. Among the persons I refer to by that term are: (1) the tender offeror, including the white knight, and the issuer itself making a bid for its securities; (2) the issuer, when it participates in a going private venture with its principal stockholders who aim to take the company private; (3) the principals of the leveraged buyout, who invariably must includes some of the principals of the company, in order to obtain continuity of management for the financial operators who put together the buyout; (4) the risk arbitrageurs, who may make or break an operation by any of the above.

The Commission has sought to make the disclosure system work for this kind of situation by the disclosure rules concerning accumulation of securities under sections 13(d) and (e) of the 1934 Act; the tender offer disclosure rules under sections 14(d), (e) and (f) of the 1934 Act; the "going private" Rules, 13(e)(3) and (4); and the disclosures and procedures on leveraged buyouts called for by such cases as In Re Spartek, Inc. (Rel. 34-15567, CCH @ 81 961 (1979).

But these are all ex post facto disclosures which reflect the fact that some big operator has seen values in the company and therefore in its securities which have not been clearly revealed, by the conventional disclosures under the 1933 and 1934 Acts.

Basically, the point is that these big operators can see things that can be done with the company that the present management is not doing, and can hope to achieve these things, while the "passive investor", even big institutional ones, can do nothing or do nothing to cause changes to happen. The conventional disclosures based on historical cost, and with considerable suspicion still remaining about forecasts, can at best help in projecting existing trends. Imaginative consideration of what can be done with the company takes more intensive and expensive study than the mandatory disclosure makes possible.

Brokers are increasingly tending to advise investment clients to buy stocks which seen likely subjects of tender offers, or of a leveraged buyout or a going private move. The brokers who make this kind of guess do so not from anything revealed by ordinary disclosure, but by indicia such as the fact that the management of the company does not seem to be particularly competent which is something that can be revealed by the traditional financial ratios; or on the other hand, that the company has unused cash or even unused borrowing power by which it could be purchased with its own money with the recapitalizations, refinancings and dispositions of units following a leveraged buyout. The latter type of opportunity is not clearly revealed by conventional financial analysis resting on SEC-type disclosures, but on a much deeper analysis of a company than ordinary financial reports make possible,

Anyone who (like me) has gotten tired of holding a stock which seems to make no progress and has sold it, only to read about a tender offer or proposed buyout at a much higher price a few days later, cannot help but be discomfited by the failure of the disclosure system to give warning of the possibility. On the other hand, it might be argued that this is just an aspect of the timing as to which some sellers are unlucky and some buyers lucky, and that actually the market system is working very well, because those big operators who can make the best use of them are taking over control of companies, and they are thus providing full value for the holders (even though the holders are bought out or pushed out and are not permitted to share in the company's future adventures).

There is food for thought here as to whether the disclosure system is working well and if not, whether anything could be done about it. I express no final opinions.

II. THE MARRET IS AWASH WITH LIQUIDITY.

This point is somehow related to the first point, in so far as this liquidity provides financing for the big operator. I have the feeling that there are other connections, but cannot point them out.

There was a time, not so long ago, when the investor was limited in the manner of his investment by (1) the margin rules, which required him to commit a substantial portion of the value of the securities purchased if he was hoping for movement on the up side; and (2) by the short sale rules, if he was hoping for movement on the down side.

The Commission's decision to allow listed options has gone a long way to change the picture. The ability to buy a listed call is a ready means of circumventing the Federal Reserve's margin rules, and I have been surprised that there has been so little discussion of the point. I know that a colleague of mine at New York University prepared a study of the margin rules a few years ago for the Federal Reserve, and took a dim view of their usefulness and justification; but so far as I am aware, nothing fundamental has been done about them. The ability to buy a listed put, while not as extensive as the ability to buy calls, at present makes hash of the short sale rules to the extent that puts are available. The Commission proposed some extensive changes in these rules some years ago, but the changes adopted seem not to have been fundamental.

Even the ability to invest or disinvest on a highly leveraged diversified basis is present through the availability of options and futures on market indices of various degrees of comprehensiveness.

I know that the use of options and futures sometimes permits legitimate hedging, but certainly all of these tools of the big operator leave the little fellow more at risk. I am not convinced that, over-all, these changes have been in the public interest, and are certainly not for the protection of those small investors who need protection.

Finally, the fact that the banks have shown themselves willing to finance-leveraged buyouts and programs for companies acquiring their own stock by debt financing, and thus increasing their leverage, shows that the country's financial condition is getting increasingly leveraged and more at risk in the event of a serious depression. This is accentuated, of course, by high interest rates, the impact of which is only partially neutralized by what has been called the essential elimination of the corporate income tax through the 1981 tax law (which was only partially reversed by subsequent tax legislation).

Twenty years ago persons in the commercial finance industry were studying the legitimacy of transactions known as "bootstrap deals", in which by various corporate devices the purchase of a company was financed by temporary debt, which was then loaded onto the company through a merger or other device, and secured by the company's assets. The result was that the company was not only purchased with its own money or borrowing power, but that the equity which formerly protected unsecured creditors had disappeared and had been replaced by secured debt, to the disadvantage of unsecured creditors. When a bankruptcy subsequently occurred to the disadvantage of unsecured creditors, a bankruptcy court characterized the transaction as fraudulent, and excoriated the persons responsible for this kind of manipulation. In re Process - Manz Press, 236 F.Supp. 333 (E.D. Ill., 1964), (reversed by the 7th Circuit on jurisdictional grounds, 369 K.2d 513, cert. den. sub nom. Limpers v. A.J. Armstrong Co., 386 U.S. 957) Sidney Krause, then Chairman of the Bankruptcy Committee of the American Bar Association, characterized it as "management fraud". Krause, Business Frauds, 20 Bus. Law 89 (1964).

Now the same kind of deal (in the hundreds of millions or even billions of dollars rather than the mere millions we dealt with 20 years ago) goes by the high sounding name of "leveraged buyout", and the concern now is no longer about for the protection of unsecured creditors, but of fairness to the minority stockholders who are bought out. See in re Spartek, supra. But if we have a depression, or even when individual companies have their own low periods, we will find the concerns of twenty years ago evidencing themselves again, namely, whether the stripping of a company of its net worth cushion in favor of secured debt (no matter by what corporate maneuver accomplished) is a fraud on the unsecured creditors of the company. Process - Manz pointed the charge of fraud not merely at the big operators but at the lenders who financed them. That case had specially distressing features, but it was fundamentally a leveraged buyout.

I would bet that within a few years this point will again come forcefully to our attention in some bankruptcy case.

It is not at all clear to me that this liquidity and leverage in the market is in the public interest in the long run, with persons being able to take big positions by options or futures and with highly leveraged companies, while the passive investor who buys shares for all cash stands helplessly by at the mercy of the big operators.

One question is whether he belongs in the market directly himself at all, or whether the small investor should work through professionals who know what is going on.

It is certainly clear to me that the person whose stake in the market is so small that he cannot reasonably diversify does not belong there as a direct investor, but should obtain diversification through investment intermediaries. But it is not clear that the ordinary mutual fund or pension fund or insurance company as a passive investor is itself a fully competent person in this market to match the wheeler-dealer big operators.

Perhaps the only really sophisticated way for a small investor to operate is to climb aboard one of the few companies which operate in that fashion and have publicly traded securities. Some such companies have in general been highly successful. I could mention some names, but I refrain from doing so against the possibility that the persons putting together the Course Book may choose to print this memorandum as a possible means of expressing my fears for the future.