Securities Exchange Commission Historical Society
Interview with Carl Schneider
Conducted on May 5, 2004
by Bill Morley, Justin Klein, and Mickey Beach

BM: This is Bill Morley, Mickey Beach, and Justin Klein, and we are here to interview Carl Schneider who had a period with the Commission in the early 1960's of a year as an advisor to the Division of Corporation Finance. He has gone on to a long career with the Wolf Block firm in Philadelphia, and has been a long-time advisor, informally, to the staff of the Commission. He has spent many years writing on SEC topics and appearing on panels. And so we're going to turn it over to Carl, and Carl is going to start with his early experiences of how he got to the Commission in the early sixties, and what he did during that period. And we'll go on from there. Carl?

CS: When I first started practicing, I did have one preference, affirmative or negative, about my practice area. I did not want to be a securities lawyer. I had a pretty good reason for that. My last year of law school I visited a friend in a big firm in New York. He was sitting in a tiny room piled with gigantic books, with a very sharp pencil, editing a long, long document. And I noticed that he was basically changing all the names and numbers, and real specific things. I asked him what he was doing. He said he was a securities lawyer, and he was writing a trust indenture. I thought to myself I simply wouldn't want to do this kind of work; I'd rather practice some other kind of law.

Quite by coincidence, when I joined my firm, my very first project was the first IPO that our office had in the late 1950's. It turned out to be a very glamorous, very interesting,

very fascinating project, and I was very excited about it. It was basically my only assignment until the offering was completed. When that offering was completed I had very little to do; I had no backlog of other work. We got another IPO in the office. I knew something about it, none of the other associates did. So I was elected for that job. And that was the sequence of events for the next couple of years, until almost everybody in the corporate department of my firm was working on IPO's through the boom of the late 1950's.

I always had the idea that I would move to another area. I liked corporate work, but I didn't want to be specialized. I viewed myself as a generalist. And then another lucky accident happened in my career. I had read in one of the newsletters that I followed that a friend of mine, a co-clerk with the Supreme Court, where I had been right after graduation. Chuck Rickershauser, whom some of you may remember—was working at the Commission at a special job. I hadn't seen Chuck since we left the court; it had been several years. This was late 1963, I suppose. And I was in the SEC building on some other reason, for other business. I happened to run a little late, and missed the train I hoped to take, so I figured I'll drop in and say hello to Chuck. He was free for lunch; we had lunch together. He described the wonderful job he had. But it was clearly a one-of-a-kind job, and he said he had moved from California to stay at the Commission for somewhere between a year and a year and a half, to work on this special project. I was really fascinated.

As we were leaving lunch, I posed an ill-formed question. I said, "How does a fellow get a job like this?," not meaning how could I get one, because it was clearly a one-of-a-kind job, but how come you got this job? What led you to get this job? What were the circumstances?, which curiously we never touched during lunch. He sort of took my question another way, and he said, "Would you like this job?" And I said, "Well, what do you mean? You've just come here for along period and you've just started?" He said, "Well, the Governor of California has offered me the job of Corporation Commissioner in California, and I've asked the Chairman, Bill Cary, if I could be excused from my commitment. And the Chairman said, "I will excuse you on one condition: you have to find a qualified successor." Chuck had no idea up to that point, up to that meeting, that I had any interest in securities law. We just hadn't had any contact for several years. But I said, "Oh, that would be wonderful."

I came home that night, and I said to my wife, "How would you like to go to Washington?" where we had lived for a year. So she thought maybe I meant for a weekend, or something. She said, "Great, when?" I said, "Oh, in a week or so." She said, "Well, for how long?" I said, "A year or so." That didn't go down very well. We had just moved to a house; we had two little babies. But to make a longer story short, I did meet with the Chairman, and we made an arrangement that I would work as a consultant to the Commission, basically a full-time but short term job, and I would work from Philadelphia and commute to Washington in two round trips a week, Monday-

Tuesday, and then Thursday-Friday, so I was away only two nights. And I would work at home on Wednesday.

My assigned duty was as Special Advisor to the Division of Corporation Finance. This was a division that really didn't want any advice; they were very happy with the way things were running. I think it was Chairman Cary's insight that he really wanted an outside practitioner to come and evaluate the system, make recommendations, maybe shake things up a little bit. That's why he hired Chuck, and that was basically my assignment.

BM: Carl, excuse me. Who was the Director at that point?

CS: Well, Ed Worthy was the Director, and the division was run really by a group of four: Bob Bagley, who was not a lawyer, but very savvy, and had very strong opinions, Charles Shreve, very intelligent, very bright, very knowledgeable in the system that the division had created. And Harold Leese was the fourth person, who was, I think his title was something to do with forms and so forth. But the four of them had evolved a system that they were very happy with. I mean, they didn't see any problems. For example, whether somebody could resell privately places stock depended on whether there was a change of circumstances. They had a pretty clear notion of what kind of unexpected events were a qualifying change of circumstances, and what kind were not a qualifying change of circumstances. The system was internally consistent and, in the view of a lot

of people, had nothing to do with the needs of the public investor for information or the underlying statutory purposes.

But they were rocking along, more or less satisfied, and they were very cordial to me, but they were not really buying into the program of reevaluating the whole structure that they were administering. They were very pleasant, but they hadn't sought advice; I was imposed on them, and Chuck before me, by the Chairman, who felt that there should be some review.

MB: Was Ralph Hocker involved in that at all? Ralph Hocker, was he still there?

CS: He was, but he wasn't part of the inner circle of the division at the time. I mean, other people were very interested in what I was doing. Manny Cohen was very curious about what I was doing. It was like shooting fish in the barrel to find what the problems were. The question was how to solve them. In hindsight it was very easy to tick off what the issues were. Whether privately places securities could be resold under the system that administered had mainly to do with the lapse of time, and maybe there was a one year rule, maybe there was a two year rule, maybe there was a three year rule. It depended on who gave a speech most recently that suggested a time period from among the senior staff members. And it depended principally on whether there was a change of circumstances of the investor.

And there was no focus on the amount of securities that was sold, who was selling them, the way they were being marketed, whether they were being dribbled into the market as routine brokerage transactions or whether they were being sold in a heavily compensated sale. They had basically one registration form, the S-1, so the same form would be used for an IPO, and a small secondary offering of somebody who got a tiny block of shares in a private placement many years ago. The problems were evident. What to do about them was much more difficult, and my mandate was to make suggestions.

MB: Did you focus only on the resale of privately issued securities, or on the question of what was a private offering, or anything like that? Or was it more . . .?

CS: No, it was, I really looked at all aspects of it. The registration process, for example, as I mentioned, the same S-1 form was used for almost every kind of registered offering. I think there was an S-8 at that time that had to do with employee benefit plans, and so forth. But basically all registrations were on the same form.

BM: And was it the Wheat Report that changed that?

CS: Yes.

MB: The Wheat Report, yes, changed that, and the Wheat Report also began focusing on the continuous reporting, the 34 Act reporting, which at that time was almost virtually ignored.

CS: In those days, the Form 10-K was completely perfunctory. It asked for financial statements, which everybody incorporated by reference to their annual report, so there were no financial statements in it other than by reference. There was one question: changes in business during the course of the year, and I don't remember ever seeing anybody that had an affirmative answer to that. I guess if you were manufacturing locomotives, and went into the sweater business, you would answer, "We changed our business." But the normal evolution of a business never triggered a response to that item. So the 10-K was basically a cover page, one page which said nothing of significance, and a signature page.

BM: Was this pre-'64 Amendments?

CS: Yes. Well, I was there—to clarify, I was there basically the calendar year '64. I started in 1964. I started in January, and I left in December. In hindsight, my efforts were laughable in the sense that there were such major reforms that should take place, and I was one outside consultant giving advice to people who weren't particularly interested in my advice. And occasionally after I would have a memo presented, I would have a chance to present it to the Commission. And I would get nice nods, but the

Commissioners' plates were pretty full, and there was no staff effort to do anything major about these things.

What was extremely gratifying was to see, about three or four years later, the Wheat Report, so-called, under Commissioner Frank Wheat. A major, major task force of senior, very smart people were assembled to really look at these things, and come to some comprehensive resolution. And after I guess about a year of intensive work, a report came out which had a fancy title, but everybody called it the Wheat Report. And it did address many of these problems, and came through with a whole series of new rules, new forms, and an administrative reform effort, which lasted, as I tracked it, for about twenty years. There was a sequence of revised rules, amended forms, short forms, upgrading of the '34 Act reports, better integration of the '33 and '34 Act, etcetera, etcetera.

JK: And of course, the change of circumstances doctrine went by the wayside in 1972 with Rule 144, which was the response to that problem.

CS: Right. There was a series of rules, originally the 160s, and then they changed to 144. I'm not sure why the numbering system changed, but there was a major impetus to accomplish all of these things. There was also the effort to codify the federal securities laws. I had a very interesting, for me, role in that activity. The American Law Institute [ALI] decided that they would support, under the reportership of Professor Louis Loss, a

codification of the six statutes that SEC administered. And they would replace them all with one comprehensive Federal Securities Code. Chairman Cary was a little bit lukewarm, I would say, about this. He was not enthusiastic for various reasons. He gave me the proposal, and he asked me what my thoughts about the codification effort, the codification project, would be. I had reservations also, and I wrote him a memo, and I made a couple of observations. I said the SEC has unique power to change this system administratively. If the forms don't fit, you could have a registration form which was reduced to a postcard, and just say, "This small holder of privately placed stock is now going to sell at routine brokerage transactions, or even at an underwritten transaction. We hereby incorporate by reference all of the information that's on file," which should bring everything up to date that a registration would disclose, but through the '34 Act reports. And the registration statement could be one page. Or to put it in hyperbole, as brief as a postcard.

That the power to define terms, to classify registrants, to adopt forms, to adopt rulesCall of these statutory rights gave the Commission major power already to restructure the system. It didn't take legislation to do that, and indeed, it would be better for the Commission to contrive forms than to ask Congress to do that job. The Commission had already been very creative in solving many problems. For example, the statute said the registration's effective in twenty days. That couldn't work, the way underwriting worked. So by simply creating the delaying amendment and the acceleration request, that

obviated completely what seemed to be an insurmountable problem in a twenty day delay after each amendment got filed.

I had a couple of other reasons I wasn't enthusiastic about the codification effort. One was this: I felt that the statutes were so complex that there was a real danger that the intellectuals would come up with a wonderful statute, and then the political process would begin, and every industry would say, "Oh, this is terrific, but it shouldn't apply to my industry." And just like the insurance companies, with their great political clout, got out from under securities regulation, that the political process would start, and no matter how pristinely beautiful the draft code was, it would end up like a Christmas Tree bill, where everybody had their own special interest. And I was afraid that the project would have so much momentum that it would be hard to stop what would end up as a complete patchwork of special interest reservations and carve-outs.

Another concern I had was that the securities laws developed in different areas, and they're very much in flux, and then it kind of shakes out, and comes to a resolution. And some areas might be very appropriate for codifications. But at that very time, there were other areas of practice and procedure that were just emerging. And I thought it wouldn't be great to freeze them into a code prematurelyCthat in the nature of the securities regulatory process some things should evolve, and some things are ready for codification, but at different times. And if it all went to Congress at once, it would not be the best result.

So I remember there was a big kick-off meeting of the code project in Chicago. The American Law Institute had a meeting of all the great securities lawyers in the country, and various Commission staff people with there. And with a lot of enthusiasm they endorsed the need for reform. Cary had invited me to come; I was probably the youngest person in the room by ten years, and I was sitting on the back bench. And Cary got up to speak, and he said, "I like this project, but I have some reservations. I have a young man with me who I asked to be with my staff. I'm going to ask him to say a word or two." I hadn't expected this, but I was called to the platform to kind of repeat the reservations I had expressed with Cary, and endorse the idea that the staff could really address most of the problems everybody was addressing administratively, with the possible exception of liability issues. Those were not quite in the same category. I remember Professor Loss sort of deftly questioned whether . . .

BM: [Laughs] Not a popular view you were expressing there.

CS: . . . whether the Commission would have the institutional power and will to really change its own structure. And of course, he didn't want the distraction of an alternative effort. It did prompt some controversy. I remember Alan Troop, who I think had been a general counsel, I'm not sure, but he was a very senior securities lawyer at the time. He kind of liked my approach. And that meeting was I think in the winter.

The next summer, at the American Bar Association Annual Meeting, there was a panel—it wasn't called a debate, but I was on the panel, and Professor Loss was on the panel. And the question was the relative merits of a codification effort, and an administrative reform effort. I made a wildly optimistic prediction. I said, "If you go to codification it could take five years to make the code. You could have a reform effort in six months." I mean, the Commission already has the power. They could do these things right away. The consensus overwhelmingly, which was very satisfactory to me, was that it wasn't an either/or situation, that both efforts should proceed. The bottom line was the Commission appointed the group that came through with the Wheat Report, and did exploit all the administrative techniques that were available, and started a major, major reform effort, which continued, with fine tuning, as I said before, for maybe another twenty years with a little tinkering. But the primary goals were accomplished very quickly.

The other track, the code, took ten years, not five, to be adopted by the ALI, and never was even introduced as a bill in Congress. It was just too massive, too complicated, to get any political support. And it provided the thinking that affected the administrative effort. I mean, many of the code's proposals became law through another route, and it was enormously helpful intellectually, but the codification never did proceed.

JK: I think I remember going to a seminar, it must have been in 1979 or 1980, that Professor Loss hosted. I think Ralph Ferrara was there, and it was sort of a day-long program to go through the code. And obviously you're right, Carl. I mean, they . . .

CS: Well, they did that. Because I on occasion went to those meetings, where specific sections were talked about. And they were talked about and talked about and talked about. And the Commission, while as you say, there was always a very lukewarm support from various administrations in the Commission, they went along as far as the idea of the code. They never absolutely said, "No, it's just impossible." And I think you're right. I think through administrative means that most of what was there was done, and done more expeditiously.

MB: I remember going to some of those meetings, too, and we weren't allowed to vote. I mean, the Commission, even when they brought up issues, we were just supposed to be there to listen and learn, and maybe occasionally comment, but not too much.

CS: I think in the real world, a driving issue for the code was the explosion of different liability theories. The courts were going very far in imposing civil liability on issuers where there were colossally big numbers. The damage claims were enormous, and people felt compelled to settle, even if they thought cases had no merit, because they were afraid to go to a jury with a complex issue of accounting disclosure, or something like that.

And a lot of the impetus for the code subsided when the courts started to pull back on the liability theory, where they evolved principles, that mere puffing doesn't create liability, and optimism by corporate executives doesn't make a statement false or misleading. So the trend, something of a reversal in the trend in liability, I think, mitigated the pressure for Congress to step in. But that is political . . .

JK: Probably the imposition of . . .

CS: Yes, there were a whole series of cases. I guess the high water mark of how plaintiffs were prevailing was right around the time that, say the early seventies or so, the time that there was a lot of pressure for the code, and a lot of the issues that the codifiers were focusing on, were civil liability issues. Then the courts began to retreat, and the business community was much more happy than they had been before.

BM: Well, okay. Let's move. Now we've got your time at the Commission, and your advice that was given, some of which eventually became law. There are a series of other activities that you had once you got into private practice where you identified specific areas, at least in your mind, that needed treatment of one kind or another. And through your writings and cajoling, changes have been made. And maybe we ought to talk about a few of those.

CS: Well, one of my early concerns was the question of soft information. I used that term, I think I was the first one to use that term in the securities law context, referring to such

things as predictions, appraisals, and forward-looking statements. When I came to the Commission, there were certain truisms. And one of the things that I learned, like my first day in securities practice, when I started to draft registration statements, was you can only deal with facts in registration statements, hard statements of fact, basically historical statements. And that administrative point of view I think was grounded in liability concerns. The SEC was focusing on protecting the buyers, through the process of registered offerings. And they didn't want buyers to be cheated by optimistic predictions that management couldn't prove.

So registration statements were historical, hard information only. The SEC was not particularly concerned with sellers, for example, and holding back good news. This was, you would get a comment, a letter saying, "Take this sentence out; it's an implied prediction." And it was almost like a paranoia where the Commission would find predictions in, you would think, the blandest statements. You couldn't say, "We will pay quarterly dividends," because that implied that you would have earnings. You could say, you know, "We intend to consider paying quarterly dividends," because then you wouldn't be predicting you would have earnings to pay the dividends from. This didn't make a lot of sense, because if you figure, why disclose something in a prospectus about the past? If the investor says, "I really like the past," you can't buy the stock as of a past date you had this great year in the past.

You only look at historical information, disclaimers not withstanding, because the past is prologue. You use the past to predict what's going to happen in the future. It's no assurance, but there would be no other reason to give an investor who's going to buy now any history of what happened before, if it wasn't sort of a basis for a future prediction. And the irony was that when stock was sold, investors would get a big fat prospectus, almost unreadable, full of turgid legalisms. And the way they decide whether to buy or not was what the salesman told them the company was projecting in earnings for the year to come. All of that information was readily available widely circulated, but never in the registration statement.

And it didn't seem to make sense to me that, you know, that filings, registration statements, could only have hard information, and not any kind of forward-looking information at all. This was an era, by the way, where there was a lot of litigation, and the people who happened to be suing were not always buyers, but they were sellers, and they were sellers that were complaining that soft information of a favorable variety wasn't being disclosed. For example, companies were going private, knowing that the future would be terrific, and they didn't give anything about what the future would be, and people would sell out too cheap.

There were merger cases, and other cases, where the people who were suing, and said that material information was either withheld or statements were incomplete, were essentially sellers, not buyers. They didn't involve registration statements. Well, I did a

lot of writing, and a lot of discussing about whether soft information should be permitted. And there was a gradual evolution. At one point the Commission began to permit forward-looking statements. Still later, they actually encouraged forward-looking statements by rules that gave safe harbors for certain kinds of forward predictive information, acknowledging that a prediction has to be reasonable and well-based, but it's not a guarantee that the future's going to come out that way. There's a recognition that many, many, many predictions don't get fulfilled, but they're not false or misleading if they're reasonably based, and stated in good faith. And investors have to understand that that's the limitation of a prediction.

MB: Did you participate in the hearings that they had on soft information in the middle '70s?

CS: I did. I participated. The Commission had some hearings. There were some Congressional hearings. Finally, safe harbors were added to both the '33 Act and '34 Act by Congress, and I participated in those hearings. I wrote some comment letters on the rule proposals. I testified before the Commission on the rule proposals, and we've seen an evolution. At one point, a lot of this was fought out on the turf of MD&A interpretations and so forth.

The Commission had a provision in the MD&A instructions that forward-looking information, basically, I'm paraphrasing, is encouraged, but not required. But the MD&A itself has evolved to the point where it's clear that some predictive information is

now required. And I think that's it's within the last few years that even that instruction, that vestigial instruction of the old regime, was deleted from the instructions. And now I think it's very clear that much soft information, soft meaning not the old, historic fact kind of hard information—much soft information is required, and people are very accustomed to using it now.

BM: Carl, early on, after the passage of the various safe harbors, there still wasn't much forward-looking information included. People didn't seem to want to rely on it. Has that improved? Have people started to put more forward-looking information in, and try to rely more on the safe harbors?

CS: In my non-scientific survey, I think that the invitation to include soft information voluntarily has not been widely accepted. To a large extent, it's required by the MD&A But I think apart from the MD&A, in a registration, people would rather depend on the investment bankers, and their private memos in-house, which sometimes get to customers even though they shouldn't. They'd rather have the real forward-looking information in other sources. I mean, you still don't see earnings predictions volunteered in registration statements. My overall observation is that you don't have much forward information beyond the significant amount that MD&A requires. But aside from that, I think people would still rather depend on brokers' supplemental literature, and oral selling efforts, rather than volunteer the stuff in the prospectus.

JK: I agree, it's becoming harder in sort of the post-Eliot Spitzer era here for the brokers really to be pushing that, because they really, I think, traditionally relied on analysts going to road shows and presenting their models. And now analysts can't go to road shows anymore.

CS: Maybe the separation in the last year or two of the analyst side and the investment banking side will cause another change, but up to the time that I retired from active practice, I didn't find either investment bankers or clients pushing to volunteer forward-looking information of any sort beyond what was mandated by MD&A or any other line item disclosure.

JK: I agree with that, and that's sort of the counsel they received as well.

CS: Another favorite topic of mine was so-called duty to update. If you ask people to list the triggers for disclosure, several things would be common: a line item requirement, duty to correct something that's false and misleading, false or inaccurate when it's stated, which is a duty to correct. If you have inside information there's a duty to either make disclosure or abstain from trading. And in most cases disclosure is not really a viable option, so it means the insider has to abstain.

And the literature talked about duty to update. I was a little perplexed about what that meant. Suppose you had a statement that was absolutely historically true, and it was: as

of a particular time, this is where we stand. If the facts change a month later, do you have to make, volunteer, a new statement, simply because you made the old statement that was correct when it was made? There were a lot of cases that talked about the duty to update. I read all the cases I could find, and I wrote an article. I was interested to find out, I mean, really surprised to find out, that almost every case that talked about a duty to update involved another duty, a line item disclosure that triggered a new requirement, or it was a duty to correct because the original statement wasn't accurate when it was made, or possibly an insider trading case, where the insider had information that the prior disclosures were no longer current and he was trading to his advantage.

And there were one or two cases where there was a special status of a person who had a duty to come forward, like a C.P.A., an auditor, who knew that a prior report was no longer accurate and was still being used. But there were really no cases that supported the pristine principal that simply because the facts changed you had to update something you said before.

I wrote a whole series of articles dealing with this subject, about whether there should be a duty to update, and if so, what kind of statements triggered it? There was a case that I thought was completely wrong. The Polaroid case involved the efforts of Polaroid to make an instant movie camera. Ironic because of the industry they were in. They published the 10-Q that was completely accurate as of the date it was written, and there was nothing predictive about the statements. Everything was the conventional 10-Q.

Shortly after the 10-Q was published, they had some very bad developments regarding the instant movie camera. It wasn't being developed successfully. And the court originally held, the circuit court, that because of this change, they violated the duty to update.

And I wrote another article, the title was "Did Polaroid Invent the Instant Movie After All?" Because my thesis was that the disclosure was a snapshot in time; it wasn't a frame in an ongoing movie, and it wasn't good policy to say that if you volunteered an accurate snapshot as of a given date, you trigger a duty to keep that up to date every minute there's a slight change. Because there's a disincentive there to start the disclosure process in the first place. It puts somebody in an impossible trap of having to have to produce an ongoing movie if you put the first snapshot out there. And I thought the original Polaroid decision was very poor policy.

I wrote the second article, saying, "This isn't the right way for the law to evolve." Fortunately, the Court of Appeal en banc decision, on rehearing, came out the other way, and said you only have a duty to update if the original statement had a "forward intent and connotation." That's an odd phrase, but I think everybody sort of understood what it means, that if a statement is clearly made that's supposed to have ongoing future effects, you may have a duty to update it. But if it's accurate when it's made, and it's just backward-looking and historical, there shouldn't be any duty to change it. For example, if I give you the score of a baseball game after six innings, you know what it is after six

innings. I shouldn't have to volunteer what happens in the top and the bottom of the seventh and the eighth and the ninth inning just because I gave you the sixth inning score.

I could imagine cases where a statement would be so forward-looking that there should be a duty to update it, and I think that's the way the courts have come out. There have been a few cases since which held that statements triggered a duty, and many, many cases, which if the statement was accurate when made, simply a change of facts doesn't make silence anti-fraud violation, that there's no duty to come forward. There are some specific cases that say, and I like these quotes, that we don't have a "continuous" disclosure system. We had a "periodic" disclosure system, and we have certain events that trigger disclosure, but they're time dated.

Curiously, by the way, Sarbanes-Oxley put a new section in the statute that's called "real time disclosure." And in updating my writings, I raised the question whether that statute is really going to change the paradigm, whether we're going to evolve to a continuous disclosure system, or whether we're going to abandon Basic versus Levenson doctrine that silence is not a breach, silence in the face of material information is not a breach unless something else triggers a duty to make the disclosure.

The statute has a section called "real time disclosure," but so far the SEC's only response is to add more items to the 8-K, and to make them a little more timely, and to restructure

the 8-K. But they've kept the basic model, that you only have to report under that line item reporting item form the specific things that that form calls for. And they remain a laundry list of very significant but identifiable events, and if something happens that's important that doesn't trigger an 8-K, there's still in my view no liability for remaining silent in the face of material information.

MB: A lot of the questions about the requirement to update disclosure, centered around a merger situation, where companies would talk about being in a very serious negotiation, and then did they have an obligation to continue to report? The Commission tried to handle that a little bit in its MD&A release, but is that currently a problem, or are there not that many mergers going on? Has the law, or the way the law is being interpreted, sort of settled on that question, or is that still up in the air?

CS: Let us assume that a company is in material discussions to be acquired, and there's an agreement on price and structure, and everybody's doing their due diligence. Nothing could be more material than that, to a company. It's going to go out of existence and, in the probability/magnitude analysis, it's progressing along. The Commission created a monster for itself with the MD&A, because the MD&A has to talk about known trends and uncertainties, and all the other things we know about. And how can you avoid dealing with a pending merger negotiation if an MD&A comes around? The Commission finessed that very simply in one of its MD&A releases by saying, "We

didn't intend the MD&A to cover that if it would jeopardize the negotiations." Now whether they intended it to cover it, the English language is pretty clear.

But I think the bar gave a big sigh of relief, and everybody simply interprets the MD&A that no matter what it says, certain things are excepted from the scope of disclosure. And I think everybody, I mean, practitioners would still say, if you have very material negotiations of acquisitions or anything else that would be very material to investors, but they're ongoing, and there's been no leak, and it's still confidential and private, the language of the MD&A notwithstanding, you can just rely on that Commission interpretation of its own rules. It flies in the face of the text, but it works. People don't disclose those things now.

[End Tape 1, Side A]

[Begin Tape 1, Side B]

CS: To go back to something I discussed before all the things I tried to do as a consultant, I was just a minor irritant scratching the surface of all the things that could be done. I think I lost a little bit of, or, a little bit of the momentum was lost for two reasons. One was that Cary, Chairman Cary resigned, retired, in the middle of my tenure, and my activities were really his project. And there wasn't a lot of continuity after that.

The other thing that was important was in 1964 there was new legislation that added 12(g) Section 12(g) to the '34 Act, which brought in all the over-the-counter companies to the same requirements of the exchange-listed companies. Up to that point, the OTC. companies were subject to periodic reporting under 15(d), but they weren't subject to the proxy rules, the Williams Act, and the other panoply of '34 Act activity. When the legislation was passed, the Commission was on a pretty compressed time-table to adopt rules and forms and everything else to accommodate the 12(g) requirements. That took a lot of priority, because there was time pressure on that, and I, as many of the other staff members were drafted to work on the implementation of the '64 amendments. So by the time I left, even on my agenda, the things I wanted to do were not at the top of the pile. I was working on 12(g) matters.

I might mention another project that I undertook. I guess I'm sort of a compulsive person. If I see something broken, I just have to go fix it, at least in my professional life. I'm not so good around the household with appliances. But I think law and its administration became not only my profession, but my hobby. I've done a lot of writing. Most of it is at the time other people play golf or mow the lawn, or do other things. It wasn't really, I mean, it was in addition to my regular practice activities.

One of the things that really bothered me intellectually was the fact that the exemptions from registration were construed very strictly, and with horrendous consequences if you missed. The consequence would be that the buyer has a put. The buyer, no matter

whether or not has any injury traced to the failure to comply with the requirements of the exemption, if the security just goes badly, can say, "I want my money back." To take an extreme illustration, the intrastate offering required at least in form that all the buyers be within the state of the offering, in addition to whatever other requirements applied. If you had a single out-of-state offeree, not even purchaser, but a single out-of-state offeree, even though the offeror believed in good faith that the offeree resided in the state in question, then at least in theory every single person who participated in the intrastate offering could get their money back by saying it was an unregistered offering and should have been registered; it wasn't exempt, and Section 12-1 applied.

I proposed that if somebody made an innocent and immaterial mistake, there should be an exemption from liability. That just as a matter of common sense, there shouldn't be the windfall remedy of a rescission right for every purchaser. I wrote an article with a colleague of mine, Charles Zall, and we proposed what we called the "I and I Defense," for innocent and immaterial mistakes. It was our thesis that if there was an innocent and immaterial mistake in complying with an exemption, that there shouldn't be civil liability for rescission. We didn't propose an exemption from enforcement activity, on the grounds that prosecutorial discretion could be relied on, that the Commission would not be excessively punitive if there really was an innocent mistake. But on the other hand, we didn't want to tie their hands from proceeding when appropriate. But of course the individual potential plaintiff doesn't concern himself with public policy issues. He just looks at whether the value of the stock went up or down.

We proposed the "I and I Defense" in an article. We had two overwhelming responses. The private bar was overwhelmingly positive, and the Securities and Exchange Commission was overwhelmingly negative. The staff didn't like this at all, and the matter did not—although we proposed a defense, it didn't proceed very far, and it caused a lot of negative staff comment. To my pleasure, this issue was actually considered in the codification project, and Professor Loss bought into the concept. So did the other people who participated in the drafting of the code, and the code did have the equivalent. They didn't use my terms, innocent and immaterial, but they had substantively pretty much the same idea, that there would be no civil liability for a tiny, tiny, an innocent mistake, in trying to comply with an exemption, even though it preserved the general notion that exemptions are construed strictly.

Of course, the code didn't get adopted. There was a major revision of Regulation D many years after the original article was published. Commissioner Ed Fleischman, who was always a fan of this, he was a very practical Commissioner, had a great deal of experience in private practice, and he knew where private practitioners were coming from. And he liked the idea.

I might mention that even if no civil plaintiff sued, an innocent and immaterial defect could create horrendous problems for a company. For example, how could a lawyer give opinions, that there would be no contingent liability? If a lawyer became aware of the

kind of mistake that we were referring to, he couldn't give opinions possibly on due issuance of stock. He would have to report to auditors contingent liability for rescission. I mean, horrible consequences could flow, even if no civil plaintiff was on the horizon, or even knew about the issue.

I think this was the kind of concern that Ed Fleischman shared, and he insisted in one of the proposals that a footnote be added soliciting public comment on whether there should be the equivalent of an "I and I Defense" in his footnote. The footnote referred to the article, and so forth. Again, not surprisingly, the public response, from I guess all segments of the public strongly supported the principle of an "I and I Defense." The Commission finally bought into it in the Reg D context. They didn't adopt the general rule across all exemptive rules. But in Reg D, they proposed a rule which eventually was adopted after some modification, Rule 508, which is part of Reg D, which again, without using exactly my terminology does codify the "I and I" concept of a defense from civil liability if you have slightly imperfect private placement.

The proposal of that triggered an unexpected consequence: NASAA, the state administrators, went ballistic, because they said, "Our state exemptions integrate with Reg D, and you guys, meaning the SEC, have thrown this at us, and it affects our exemptions. You're really changing the law that affects all the states. We never bought into this concept." They didn't have an Ed Fleischman, who was triggering all this public

comment. They had their rules, and they, like the administrators in Washington, weren't crazy about the idea.

Linda Quinn, who was then Director of the Division of Corporation Finance, called me and said, "Carl, you know, we have a problem." She said, "We proposed the rule. We accepted the reality that this is what the Commission wants us to do, but NASAA now is having a problem, and I have to deal with them, and I would like you to participate in that." So I joined Linda and some other senior staff members, SEC staff members, at a NASAA convention—I think it was in Santa Fe, where that was a major issue on the table. And she defended the Commission's position, and I really explained from my point of view why it was sound public policy to have this kind of exemption, that it wasn't, you know, such a horrible thing. It was really in the public interest to make this slight carve-out from the liability issue.

And the bottom line was that when we had a face-to-face meeting, and a lot of frank discussion, the NASAA administrators, or at least the leaders of the NASAA group that were at that meeting agreed that it made sense. And there was some fine tuning of the language that didn't change the substance, and I think Rule 508 was shortly after that adopted, and the NASAA rules, to the extent that they needed conforming rules, were adopted. And to the extent that they didn't need conforming rules, because Reg D carried over into the state law automatically, they were satisfied. So that was a happy ending on that one.

MB: Do you think the "I and I Defense" is in use very much? The Commission has no way of knowing, because it's not the kind of thing that would come up at the Commission. And in my kind of casual interviews with people, "Have you ever used it?" There doesn't seem to be too many people that have experience with it. Do you know, has it ever been used in a court case, or is it all internal?

CS: I don't know of any case where it came up in litigation, but I would guess that there are plenty of lawyersCthat there are occasions where lawyers know that there is a slightly imperfect transaction, and they can use that with comfort to say, "I don't have to report a contingent liability for rescission."

BM: Yeah, I was going to say, it may be more disguised, because it's the ability of counsel to those companies where there might be a problem to deal with the opinion letter problem, would probably be where it comes up more often.

CS: Yes. I mean, it's sort ofCthere's an analog to this in reporting in the back of a registration statement: recent unregistered securities. I mean, you have to say the basis of the exemption, and if you are taking a company public, and you look back and you see that the exemption wasn't perfectly done, you still could say, "I'm relying on Reg D for not registering these securities." And I think it's comfort, I mean, the accountants can also find some comfort when they're dealing with their issues.

MB: I believe it, hasn't it also been adopted for some of the rules? You mentioned Reg D. Isn't it also Regulation A? And I don't think the Intrastate Exemption Rules adopted it, but I thought Reg A had, and also . . .

CS: Yes, you're right. I do recall that now.

BM: Well, having discussed a number of your successes, how about we talk about one of your not-so-successful forays into trying to, at least to this point, to try to convince the Commission to have some forward thinking?

CS: I had one occasionCmaybe there's a message in this. This was the only time I really undertook to influence the law on behalf of a private client in a specific matter. We had a company going public, and we suggested that it would be a very good idea to have an arbitration provision dealing with disputes between the company and the shareholders, an arbitration provision in the governing documents of the company, that all disputes between shareholders and the company, whichever way they went, but presumably usually the shareholder would be the plaintiffCwould be subject to an arbitration provision.

I got to that conclusion that this would be a good idea because at both the federal and the state level, and in both the statutory and judicial interpretations, arbitration is the favored

dispute resolution mechanism, favored to litigation, if the parties agree to arbitrate. And there was plenty of legal doctrine that the governing instruments, like the by-laws, are functionally in agreement, so that if the company, if all of the company shareholders buy into a company knowing that that's the ground rule, then they would have agreed to arbitration.

We drafted an arbitration provision for this client that was as carefully drafted as we could to be fair, be fair in the sense that we provided for the equivalent of class-actions, we provided for the equivalent of discovery, which is sometimes lacking in arbitration proceedings. We made the arbitration, we didn't pick a loaded arbitrator; I think we used the AAA commercial arbitration rules, unlike, say, the arbitration with brokers, where you take their own turf forum, the NASD, or the stock exchanges, that's been very much objected to.

But anyway, we did everything to be a fair and reasonable arbitration provision, and we disclosed it very prominently in the prospectus, starting with the cover page. Before I filed this, I checked with a very senior staff member, who is now chuckling.

BM: Carl tells me it's me [laughs].

CS: And I said, "Look, this seems to be entirely a matter of state law, but I don't want to waste my time if you think it's different. But we plan to file this registration statement."

And I described the clause. And I think it was, I got a preliminary response that this didn't seem to be a federal issue; the securities laws don't cover this. Arbitration is a standard and preferred way of dispute resolution.

So we filed this provision. Well again, certain staff members, I would say, went ballistic. They thought it was horrible, horrible! I got a pre-emptive strike. Without ever having applied for acceleration, I got a notice that if we applied for acceleration, it will be refused, that this registration would never go effective this way. There was absolutely no suggestion that the disclosure was inadequate, because it was plastered all over the documents. We undertook to repeat the disclosure in annual reports, and 10-K's, and proxy statements, that nobody would ever buy into the stock without knowing that there was an arbitration provision. And my basic point was that this is a favored way of resolving disputes, it's an issue of state law. There's nothing in the securities that remotely prohibit this. It wasn't a waiver of a statutory right.

At every level, I thought the Commission's objection was beyond their power, and not well taken. We fought about this for a long time. But the bottom line was I lost. We lost, my client lost, and we took the provision out. I asked for a statement of why they objected, simply to have specifically on the record what the problem was. They refused; the staff members refused to give any written explanation. I did get an oral explanation. I asked if I could tape the explanation, and I did record it. It was about four sentences, I think each one, I don't remember exactly now, although a published article deals with

this, but each one was either a non sequitur, or something that just wasn't responsive to the issue.

But the bottom line is, this issue did go to the Commission itself, the Commissioners, and they made the decision that they would not let this registration become effective. If it had become effective, probably nobody, it wouldn't have caused much attention. It would be just one random filing for a small, public company. I wrote an article because I was so upset. I raised the issue.

BM: Your normal way of getting it out of your system! [Laughs]

CS: I raised the issue publicly, and it did cause a bunch of other comments. A couple of other articles were written by one present and one former staff member. They didn't think it was a good idea. Other people were strongly in favor. As far as I know, a couple of very prominent lawyers have spoken to me about it, and said they were considering including such a clause in documents for their own clients, one of them being a very prominent one-time Commissioner. He wasn't a Commissioner at the time he called me. But the bottom line is that as far as know, although people have thought about it, nobody has included such a provision in any of its documents to date, which is particularly ironic, because the SEC compels arbitration of disputes with brokers, between brokers and clients, or between brokers and employees, often in areas that have nothing to do with securities practice.

For example, I don't know why the Commission has any domain here, but if a broker and an employee have a suit over an employment matter, like a wrongful termination, or discrimination, something that has no relation to the securities laws directly—the Commissions allows SRO rules that compel arbitration of those cases, and compel arbitration in a forum conducted by the industry, which many people think is not a fair forum.

So there seems to be a big irony that in some areas having nothing to do with securities markets as such, the Commission compels arbitration, but wouldn't allow it in my case. I'm very patient. Most of the things that I've tried to see happen take about a generation or two to percolate to the surface, and maybe some day somebody will be convinced that there should be arbitration provisions in corporate governance documents. As of this point, though, it hasn't happened.

JK: We can probably reconvene, but I apparently . . .

BM: Carl, maybe that provides a good example, and something that you can comment on, and maybe with Justin being in private practice, he can comment on it as well. You indicated that you had gone to the staff in this case, me in particular, to get some preliminary guidance on something that was a little unusual. That guidance didn't turn out to be [laughs] the guidance was what you wanted, but the end result wasn't what you wanted,

proving I may not have been a senior enough staff member at the time [laughs] and never was. But it would be interesting to get your thoughts and experiences on dealing with the staff in normal no-action process, in the comment process, and how you find it best to try and deal with those kinds of issues, and deal with the staff.

CS: A couple of guidelines for me. I think first, not in particular order: do your homework. I mean, know what you're talking about. Do your research, and present solid supporting evidence for whatever position you're trying to advocate. I think it's helpful, it's been helpful for me if you're trying to get something done, to publish your ideas, and let other people participate in the discussion. As I've sort of outlined already, many of the things that I've asked to be done got done not because I asked, but because other people had the same idea. If I took the initiative to write, then they could agree, they could join, they could cite something. And I think in almost every case, other people had the same idea, and the law moved forward because a wide variety of opinion could be marshaled.

I think it's also, another point that is clear to me: a lawyer who is presenting a request, a no-action request, or some kind of relief, or some kind of interpretation, is focusing on its own client, his own particular facts. The Commission legitimately comes from a different perspective. They have to say, "If we act the way you want in your case, what kind of a precedent are we creating? What will the next case be? Where on the slippery slope do we stop?" So whenever I've asked for some kind of interpretation or relief, which I think is a little moving the law, or somewhat favorable within a certain area, I try

to make it clear that this doesn't have to be more of a precedent than my case, that there's something unique about this case, this situation, that wouldn't carry over. Help the Commission find a way to give you relief without what they would consider opening a door to the next and the next and the next version that cross a line where an acceptable result becomes unacceptable.

Another principle I've tried to follow is I can be persistent, but you have to use good judgment, and not overstay your welcome. There's a certain time you can simply make a pain of yourself. And there's times you have to accept an answer. It's like the guy who said, "God always answers my prayers. Sometimes the answer is no." You don't always get what you want, and I think you have to take a long view, and recognize that you don't accomplish everything as soon as you want. You have to use a lot of judgment. I mean, the ethic, and the ground rules are: you can appeal over a staff member to the next highest level and the next highest level, but you have to do that judiciously. You can't do it frivolously; you can't undercut people.

You have to use some judgment, and you fight on things that are really important. I know my general response to comment letters is, if it doesn't matter, even if I think the comment is wrong, it's just easier to go along with it than to make an issue. Some fights aren't worth winning. I would advise clients to object only where it really matters, not just because you think the comment is wrong. If you can agree to the comment, and it doesn't deflect what you're doing, or undercut your basic pitch, then you can back off.

And I think another thing that's very important in all kinds of negotiations, but especially dealing with the staff particularly don't just object to something without having an alternative. If you think something should be different, give a specific alternative. Don't say, "What you're doing isn't the best way to do it." Give them a better way to do it, not just the negative. I think all of those things are helpful in dealing with the Commission, either when you're trying to effect some change in the law, or accomplish something for a specific client. Overall, it's been a very exciting area of practice for me. It's remarkably, remarkably different.

When I started to practiceCI started to practice before the Special Study Report in 1964Cthe Commission was almost entirely a disclosure-oriented agency that was focused almost entirely on '33 Act registration statements and protecting buyers. They had virtually no interest in the economics of the market place. There was a single round lot commission for every hundred shares of stock traded on an exchange, so if you traded ten thousand shares, the commission was a hundred times the round lot commission, which led to the most Byzantine kind of give-backs and arrangements, economic arrangements, where these extraordinarily lucrative commissions, a hundred times the round lot for ten thousand shares, would be rebated in every substantive form except directly in cash.

I mean, you could give other benefits, and the industry loved that because the money managers could spend a lot of their clients' money in commissions, and get benefits back

that somehow never got back to the clients. It only got back to the money managers, whether it was research, or free subscriptions to newspapers, or computer services, or whatever, I mean, all these give-up arrangements. The Commission wasn't concernedChad no interest in that. If the New York Stock Exchange asked for an increase in commission rates, there wasn't even a structure to say what the economics would be, whether that's a fair rate or an unfair rate. Everything was automatically approved. The '34 Act reports were insignificant. The lawyers concerned themselves with changes of circumstances, and just a whole different set of issues. And in the course of the years when I've been in this practice, so many things have changed.

The Commission is now deeply into the economics and the arrangements among the various market participants. You have all kinds of new technologies that are affecting things. The '34 Act reports have largely eclipsed the '33 Act registration statements for anything but the IPO. registrant. We're into a different kind of forward-looking information. The Commission is caught up with the world that's evolved, and is constantly dealing with new and different issues. So it's been a very exciting area of specialty, a very exciting area of practice. As I explained before, I got into it accidentally, but it was one of the lucky accidents of my life. I've enjoyed it very much, and I've enjoyed one of the incidental benefits of a lot of speaking, and other things, is a lot of friends I've made through my professional contacts over the years.

BM: Thank you very much, Carl. Justin?

JK: I guess the one thing that I would say in closing, Carl, is that I think that you've been just so enormously successful because of so many of the things that you have talked about here, the persistence, the use of good judgment, sort of approaching the staff, and rallying other people behind you. And I guess just from my point of view, it's been enormously terrific that you're a Philadelphia lawyer. It's been wonderful having you here.

BM: Despite the connotations of that! [Laughs]

CS: Well, thank you for your kind comments.

[End of Interview]