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L. Thomas Elliston

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Comments

SECURITIES REGULATION— THE WHEAT REPORT PROPOSALS

I. INTRODUCTION

The Securities and Exchange Commission formed an internal study group in November, 1967, to examine the operation of the disclosure provisions of the Securities Act of 1933¹ (hereinafter referred to as the '33 Act), the Securities Exchange Act of 1934² (hereinafter referred to as the '34 Act), and SEC rules and regulations thereunder.³ This study group (hereinafter referred to as the Study) was under the direction and supervision of SEC Commissioner Francis M. Wheat. In March, 1969, the Study made its report to the SEC of its findings and proposals. The report is entitled *Disclosure to Investors—A Reappraisal of Administrative Policies under the '33 and '34 Acts*, but is more commonly known as the *Wheat Report*. The scope of this comment will be to examine and evaluate the Study's proposals in regard to: (1) the form and content of '33 Act prospectuses; (2) the dissemination of '33 Act prospectuses; (3) the use of publicity to create interest in the sale of a new security before a registration statement, as required by the '33 Act, is filed for that security (*i.e.*, the problem of "gun jumping"); (4) secondary transactions; and (5) brokers' transactions.

II. BACKGROUND

A. *The '33 and '34 Acts*

The '33 Act deals mainly with the initial distribution of securities which are offered to the public through the mails or channels of interstate commerce.⁴ Disclosure provisions require that a registration statement containing information about the security, the issuer, and the underwriter be filed with the SEC; and that a prospectus, containing much the same information, be given to the buyer of the security. To enforce this disclosure, the '33 Act creates civil and criminal liabilities if material misstatements or omissions are made in the registration statement or prospectus. An exemp-

1. 15 U.S.C. §§ 77a-77aa (1964). Section numbers will be used in the text of this comment corresponding to the section numbers of the '33 and '34 Acts as originally passed by Congress. The section numbers as found in Title 15, United States Code, will be given in footnotes.

2. 15 U.S.C. §§ 78a-78jj (1964).

3. SEC Securities Act Release No. 4885 (Nov. 27, 1967).

4. The '33 Act also contains anti-fraud provisions which apply if the security is offered or sold through the mails or channels of interstate commerce whether the security is part of an initial distribution or is part of normal market trading.

tion from the requirements of a registration statement and prospectus is given to certain types of securities and securities transactions.⁵

The '34 Act deals primarily with the post-distribution trading of securities. Federal regulation of securities exchanges and markets is established by the act. Disclosure sections include provisions to compel corporations to furnish the SEC with adequate information as to securities publicly traded and provisions to control unfair use of information by corporate insiders. Although the Study's recommendations concerning disclosure under the '34 Act are not directly within the scope of this comment, some proposals under the '33 Act are practicable only if proposals affecting disclosure under the '34 Act are adopted. Therefore, some consideration must be given to the recommendations under the '34 Act that interrelate to those under the '33 Act.

B. *Reasons for the Need for Changes in Disclosure Policies*

The primary reasons for the disclosure provisions in the '33 Act were: (1) to provide adequate and accurate information to prospective investors of the character and nature of the security in which they are to invest, and (2) to prevent fraud and misrepresentation in the sale of securities.⁶ While the authority of the SEC to require the disclosure of certain information is readily accepted, there has been considerable critical comment and analysis of the present disclosure policies.⁷ In addition, the Study felt a re-examination of disclosure policy necessary for a number of other reasons. First, the American shareholder population has increased from 6,490,000 in 1952, to 26,400,000 in 1968. Accompanying this growth has been a vast increase in the number of investment decisions which are based, directly or indirectly, on information disclosed by corporations. Second, an increased demand for accurate and adequate disclosure has resulted from an increase in professionalism within the investment business. Third, the 1964 amendments to the '34 Act (which generally added the requirement of disclosure to qualifying securities traded in over-the-counter transactions) have made it more practicable to integrate the disclosure required by the '33 and '34 Acts. Finally, faster, less expensive methods of distributing to interested parties the information disclosed to the SEC are now available, mainly through use of the microfiche system.⁸

5. Section 3, 15 U.S.C. § 77c (1964), and § 4, 15 U.S.C. 77d (1964), of the '33 Act exempt certain securities and transactions.

6. H.R. REP. No. 85, 73d Cong., 1st Sess. 8 (1933).

7. See, e.g., Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966); Heller, "Integration" of the Dissemination of Information Under the Securities Act of 1933 and the Securities Exchange Act of 1934, 29 LAW & CONTEMP. PROB. 749 (1964); Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607 (1963); Flanagan, *The Federal Securities Act and the Locked-In Stockholder*, 63 MICH. L. REV. 1139 (1965); Wood, *The Investment-Intent Dilemma in Secondary Transactions*, 39 N.Y.U.L. REV. 1043 (1964).

8. SEC, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 46-64 (1969) [hereinafter cited as WHEAT REPORT].

III. CHANGES PROPOSED IN THE WHEAT REPORT

A. Form and Content of the '33 Act Prospectuses

There are four types of prospectuses permitted or required to be used by the '33 Act and SEC rules and regulations thereunder.⁹ Section 5 (b) of the '33 Act states:

It shall be unlawful for any person, directly or indirectly . . . (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of [section 10].¹⁰

A prospectus that meets the requirements of section 10 (a) is referred to as a "statutory" prospectus form and is the subject of most of the Study's proposed changes in prospectus and content.¹¹ The purpose of the statutory prospectus is to provide essential information to a potential investor and thus enable the potential investor to make his investment decision more intelligently.

SEC rules also require that the content of a prospectus be "clearly understandable" and expressed in condensed or "summarized form" in "reasonably short paragraphs or sections."¹² Despite these requirements, there has long been a problem of issuers using prospectuses that are so long and complex that the average investor cannot readily understand them. As a means of combating this problem, the Study recommended that the SEC decline to review and refuse to accelerate a registration statement that includes an "unnecessarily long, complex or verbose prospectus."¹³ Although the standards for determining when a prospectus is "unnecessarily long, complex or verbose" are not given by the Study, the Study recommended the following as means of making a prospectus shorter and more readable: (1) negative statements in the prospectus that are in response to required items of disclosure in the registration forms should be eliminated; (2) information should not be repeated in different parts of the prospectus unless it is absolutely essential to fair disclosure; (3) the description of a com-

9. These four types are a "Preliminary Prospectus" allowed by Rule 433, a "Summary Prospectus" allowed by Rule 434, a "Summary Prospectus" allowed certain issuers by Rule 434A, and the "Statutory Prospectus" required by section 5b.

10. 15 U.S.C. § 77e (b) (1964).

11. The contents of a statutory prospectus are expressly prescribed in § 10 (a), 15 U.S.C. § 77j (a) (1964), and Schedule A, 15 U.S.C. § 77aa (1964), of the '33 Act. However, the SEC is given authority by § 10 (d), 15 U.S.C. § 77j (d) (1964), to prescribe additional information, or permit any of the prescribed information to be omitted, as the SEC deems necessary or appropriate in the public interest or for the protection of investors.

12. SEC Securities Act Rule 431 (b), (d), 17 C.F.R. §§ 230.431 (b), (d) (1969).

13. WHEAT REPORT 80. While the study culminating the Wheat Report was being made, the SEC implemented "temporary" procedures to eliminate the backlog of registration statements. In SEC Securities Act Release No. 4934 (Nov. 21, 1969), the SEC stated they would no longer comment or review a registration statement that was "poorly prepared or otherwise presents problems." Thus, it seems that if the SEC adopts this proposal the only change would be from "temporary" to permanent.

pany's business should be appropriately condensed; and (4) further techniques for condensation of the financial statements of large and complex corporations should be developed by the SEC.¹⁴

1. A "Guide" to Long Prospectuses

The Study recognized that to provide fair disclosure some prospectuses are necessarily longer than others. Therefore, if the "text" of a prospectus is over ten pages in length,¹⁵ the Study recommended that a "Guide" to the prospectus be required in lieu of a table of contents.¹⁶ The recommended guide would be limited to one or two pages, would be a highly condensed summary of the prospectus, in narrative form, and would contain references to pages where the information is given in greater detail.

2. Use of Form S-7

In an effort to simplify the process of security registration and to simplify the prospectus required for the distribution for certain issues, the SEC adopted registration Form S-7 in November, 1967.¹⁷ The SEC's theory in adopting Form S-7 was that adequate disclosure in specific areas could be made in reports and proxy statements filed with the SEC over the years pursuant to the '34 Act. To use Form S-7, a registrant among other things must be a reporting company under section 12 of the '34 Act.¹⁸ Thus, Form S-7 was designed to coordinate the disclosure requirements of the '33 and '34 Acts, and made a simpler and faster means of registering a security while maintaining the requirement of adequate disclosure.¹⁹

The Study reviewed the use of Form S-7 from the time of its adoption and recommended that the category of companies eligible to use it be significantly expanded, provided that improvements in disclosure under the

14. WHEAT REPORT 80-81.

15. The pages of the prospectus used for the financial statements (including auditor's notes and opinions), the list of underwriters, and the cover page would not be counted as pages of the text.

16. WHEAT REPORT 87. SEC Securities Act Rule 421c, 17 C.F.R. § 230.421 (c) (1969), requires a table of contents to a prospectus.

17. SEC Securities Act Release No. 4886 (Nov. 29, 1967).

18. Along with just being a reporting company, the registrant must have compiled in timely fashion with the reporting and proxy solicitation requirements of the '34 Act. Other important requirements include the following: (a) the registrant must have been engaged in business the last five fiscal years; (b) a majority of the registrant's board of directors must have been directors for at least three fiscal years; (c) the registrant must not have been in default in payments on its indebtedness, preferred stock, or long-term leases for the last ten years; (d) the registrant's consolidated sales or gross revenues must have totaled 50 million dollars for the last fiscal year; (e) the registrant's consolidated after-tax net income for such year must have been at least 2 million dollars; and (f) the registrant's consolidated after-tax net income for each of the preceding four fiscal years must have been at least one million dollars. SEC Form S-7, 17 C.F.R. § 239.26 (1969).

19. The Study found that registration statements using Form S-7 were reviewed by the SEC within an average of 22 days, measured from the date of filing until the date of effectiveness. In contrast to this, during the same period, the average time from filing to effectiveness for registration statements using Form S-1 was from 6 to 8 weeks. WHEAT REPORT 76.

'34 Act recommended by the Study were adopted by the SEC.²⁰ In order to expand eligibility to use Form S-7, the Study recommended two changes. First, the requirement that "the registrant has been engaged in business of substantially the same general character since the beginning of the last five fiscal years" should be removed. The Study found that this requirement had proven difficult to apply in practice and suggested that Item 5(a) of Form S-7 be revised by adding the following:

Unless the registrant has been engaged since the beginning of the last five fiscal years in business of the same general character, describe the changes in the business during such five year period, including the nature and effect of any materially important acquisition or disposition of property, any materially important changes in the types of products or services rendered by registrant and its subsidiaries, and any materially important changes in the mode of conducting the business.²¹

Second, the requirement of net income of 2.5 million dollars for the last fiscal year and one million dollars for each of the four preceding fiscal years should be reduced to \$500,000.00 for each of the past five fiscal years. The Study further recommended that the requirement of 50 million dollars in sales or gross revenue for the last fiscal year be completely eliminated.

3. A "Short" Prospectus

For certain secondary offerings on exchanges, for stock to be issued by reporting companies on the exercise of publicly held warrants, and for stock to be issued by a corporation on conversion of the publicly held securities of an affiliated corporation, the Study felt that even Form S-7 was unnecessarily long. Thus, the Study recommended that a short form prospectus be developed and used in each of the above three situations.

Rule 153 presently permits the issuer or any underwriter to deliver to a national securities exchange copies of a prospectus which will be furnished to the exchange members on their request.²² For transactions between exchange members, delivery of the prospectus to the exchange is considered to fulfill section 5(b)(2) of the '33 Act's requirement that a sale be "preceded by a prospectus." In secondary distributions the Study was advised that rarely, if ever, was a prospectus requested. As a practical matter, there is no distinction between a company's securities offered in a secondary distribution and that company's other securities of the same class offered simultaneously. Therefore, it was the Study's opinion that in the above circumstances a registration statement (and form of prospectus) for secondary distributions of a reporting company would provide adequate disclosure through incorporating by reference the issuer's pertinent reports and filings required under the '34 Act.²³

When a person exercises a warrant, or exercises a conversion right, the

20. WHEAT REPORT 97.

21. *Id.* at 97-98.

22. SEC Securities Act Rule 153, 17 C.F.R. § 230.153 (1969).

23. WHEAT REPORT 98-101.

person is influenced primarily by the market price of the underlying security. This market price is the result of the collective decision of the public, as to the value of the security based in theory on information previously disclosed by the company. Therefore, there is little need to require the delivery of a full prospectus at this time. The Study felt that a one or two page prospectus document directing the reader to contain reports required by the '34 Act to be on file with the SEC should, in the above circumstances, meet the prospectus requirement.

4. Proposals in Specific Areas

The Study also found that to adequately inform investors, more informative disclosures were needed in four particular areas. First the Study felt that broader disclosure of business experience of directors and executive officers should be required. Thus, it was recommended that information relating to experience cover the last ten years rather than the present period of five years,²⁴ and that the disclosure include any insolvencies or criminal proceedings involving directors or executive officers of the registrant.²⁵

Second, the Study recommended that appropriate standards be developed and included in Regulation S-X for a "source and application of funds statement."²⁶ This statement would be required to be in prospectuses.²⁷

Third, the Study found that investors face great difficulty in accurately comparing the earnings of one life insurance company to another, a problem due largely to the accounting practices followed by the life insurance industry. For example, the cost of writing insurance policies and collecting premiums is charged as an expense when incurred, but premiums are taken into income over the life of the policy. As a result, expenses may not be properly matched with revenues and the reported earnings of a company that is writing an increasing volume of insurance will understate the true earnings of the company. Conversely, if the company is writing a decreasing volume of insurance, earnings will be overstated. The Study found that brokerage and advisory firms are presently using an adjustment formula to determine the "true" earnings of insurance companies. Eight different formulae are used and each produces a different result. However, since a committee of the American Institute of Certified Public Accountants is at present conducting a study of the reporting problems of life insurance companies in depth, the Study recommended that the SEC await the results of this study before acting.²⁸

24. SEC Securities Act Form S-1, Item 16, 17 C.F.R. § 239.11 (1969).

25. WHEAT REPORT 93-95.

26. SEC Reg. S-X, 17 C.F.R. § 210 (1969), are the SEC's accounting regulations.

27. This "source and application of funds statement" should not be confused with a "cash flow statement" used by some companies, especially those engaged in real estate investment. Cash flow statements generally show only funds generated from the operation in question. The "source and application of funds statement" would have two parts or sections. One section would show the source of funds; the other would show fund expenditures.

28. WHEAT REPORT 91-93.

Finally, in 1968, the SEC proposed amendments further simplifying the description of business done presently required to be in registration Forms S-1 and S-7 under the '33 Act.²⁹ At the time of the proposal item 9 of Form S-1 and item 5 of Form S-7 required a brief description of the business done and intended to be done by the registrant and its subsidiaries, along with an indication of the relative importance of each line of business which contributed 15 percent or more to the gross volume of business done during the last fiscal year. The Study recommended that Forms S-1 and S-7 be amended as proposed, and the SEC did so amend the Forms in July, 1969.³⁰

B. *Dissemination of the '33 Act Prospectuses*

A primary purpose of the '33 Act is to adequately inform potential investors, by the means of a prospectus, of the character and nature of the security in which they may invest. The form and content of a prospectus may be such that an average investor has the ability to understand and make use of the information disclosed in arriving at an investment decision. But, if the prospectus is not available to the investor until after he has arrived at his decision to buy or not to buy, the prospectus is not serving the purpose for which it was designed.

Two time periods are involved in the consideration of the dissemination of prospectuses. The first period is from the filing of the registration statement to the time the registration becomes effective. The second period is the time after the registration statement has become effective.

Three types of prospectus are permitted in the first period.³¹ These are a "preliminary prospectus" allowed by Rule 433,³² a "summary pro-

29. SEC Securities Act Form S-1, 17 C.F.R. § 239.11 (1969), and SEC Form S-7, 17 C.F.R. § 239.26 (1969). The SEC proposed the amendments in SEC Securities Act Release No. 4922 (September 4, 1968). Registration Forms S-1 and S-7 both require the issuer to disclose information to the SEC upon registration.

30. SEC Securities Act Release No. 4988; SEC Securities Exchange Act Release No. 8650 (July 14, 1969). Item 9 of Form S-1 and Item 5 of Form S-7 now require a registrant to disclose the various lines of business of the registrant or its subsidiaries which contributed ten percent or more to its sales or earnings for the past five years. Details must be given for the ten most important lines of business. If the registrant has less than \$50 million total sales, only separate lines of business which contributed over fifteen percent to sales or earnings need to be reported.

Form 10 under the '34 Act, which is the form for registering a security under § 12 of the '34 Act, was also so amended.

31. Section 5 (b) (1) allows the use of any prospectus during this period that meets the requirements of § 10. Thus, at first glance it would seem that a § 10 (a) prospectus ("statutory" prospectus) could be used. The '33 Act does not forbid the use of a § 10 (a) prospectus during this period, but, as a practical matter you cannot have a prospectus that meets the requirements of § 10 (a) until the registration becomes effective.

32. SEC Securities Act Rule 433, 17 C.F.R. § 230.433 (1969). This prospectus is required to contain substantially the same information as a § 10 (a) prospectus except pricing information. The prospectus is required to bear the caption "Preliminary Prospectus" and a statement to the effect that a registration statement has been filed but is not yet effective. Both caption and statement must be printed in red ink on the cover page. Thus, the prospectus is often called a "Red Herring" prospectus.

spectus" allowed by Rule 434,³³ and a "summary prospectus" allowed by Rule 434A.³⁴ The only prospectus that the '33 Act requires to be given an investor is set forth in section 5 (b) which makes it unlawful for any person to use the mails or interstate commerce to carry "any security for the purpose of sale or for delivery after sale unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10" (a statutory prospectus).³⁵ Thus, oral offers and acceptances for the sale of securities can be made in the period before registration becomes effective without a prospectus, since the investor does not receive the mandatory statutory prospectus until a written confirmation of the sale is sent or the security itself is delivered. Yet, it is during the post registration pre-effective period that a prospectus is most needed.

The void created by lack of such a prospectus could be filled by the preliminary prospectus, which will contain the first comprehensive disclosures about the issuer. Nevertheless, when the Study investigated the use of the preliminary prospectus during this pre-effective period, it found that under present practices the preliminary prospectus was not finding its way into the hands of a significant number of ultimate investors.³⁶ This is particularly alarming since it includes a large number of investors in first public offerings by issuers about whom very little is ordinarily known.

1. Wider Dissemination of Preliminary Prospectuses

The Study felt that, to the extent practicable, all prospective investors in a first public offering should receive a copy of the preliminary prospectus at a reasonable time in advance of the effective date, and well in advance of the mailing to the investor of a confirmation of sale. The Study realized that this requirement could not be absolute and must be flexible. For example, if a person becomes a prospective investor immediately before the registration is to become effective, and will receive a statutory prospectus when the registration becomes effective, it would not be sensible to hold up the effectiveness of the registration by requiring delivery of the preliminary prospectus.

In order to insure complete dissemination of information, while at the same time maintaining the needed flexibility, the Study recommended cer-

33. SEC Securities Act Rule 434, 17 C.F.R. § 230.434 (1969). This prospectus must be prepared by an independent organization primarily engaged in publishing statistical and financial information. The prospectus must contain the same basic information as a Rule 433 Preliminary Prospectus but is allowed to be in summary form. At one time it was common for these prospectuses to be printed on small blue cards. Thus, a Rule 434 prospectus is often called a "Blue Card" prospectus.

34. SEC Securities Act Rule 434A, 17 C.F.R. § 230.434a (1969). This rule allows registrants that are required to report by the '34 Act who meet other qualifications to publish a summary type prospectus.

35. 15 U.S.C. § 77e(b) (1964).

36. Preliminary prospectuses delivered to underwriters averaged 50 prospectuses per underwriter in the case of first public offerings and 67 prospectuses per underwriter in the case of repeated offerings, with the low being one prospectus per underwriter in both categories. Delivery of the preliminary prospectus to dealers averaged 4 per dealer for first offerings and 1.7 per dealer for repeated offerings. In several instances the Study found that no copies of the preliminary prospectus had been delivered to dealers. WHEAT REPORT 112.

tain additional requirements that would have to be met before there could be acceleration under Rule 460.³⁷ The managing underwriter would be required to furnish the SEC a written statement to the effect that copies of a preliminary prospectus have been, or are being, distributed to all underwriters and dealers expected to participate in the offering. This distribution of prospectuses must be timely enough to enable each underwriter or dealer to mail, within a reasonable time before the requested effective date, a copy of the preliminary prospectus to all persons to whom the underwriter or dealer expects to mail a confirmation of sale after the effective date. A "reasonable time" should ordinarily not be less than 48 hours. The managing underwriter's written statement would also affirm that it had been advised by each underwriter or dealer that the necessary distribution had been, or would be, made immediately after copies of the preliminary prospectus had been received by the underwriter or dealer. The Study recommended, however, that until there could be a review of the effectiveness of this new requirement as a condition to acceleration, the requirement should apply only to first public offerings.

2. A Rule under Section 15c(2) of the '34 Act

Section 15c(2)³⁸ of the '34 Act allows the SEC to "prescribe means reasonably designed to prevent such acts and practices as are fraudulent, deceptive, or manipulative. In order to further insure dissemination of prospectuses, the Study proposed that the SEC promulgate a rule under section 15c(2) which would make it a "deceptive act or practice" for a broker or dealer not to take "reasonable steps" to furnish a prospectus (preliminary), amended preliminary, or final) to any person upon written request. Brokers and dealers would also have to take reasonable steps to furnish at least one copy of the preliminary prospectus to associated persons (salesmen) who are expected to solicit orders for the security prior to the effective date, and before the solicitation of such orders. At least one copy of the final prospectus would have to be delivered to salesmen expected to solicit orders after the effective date, before the salesman solicits orders. The managing underwriter would be under an obligation to take reasonable steps to furnish all other underwriters and dealers with sufficient copies of the prospectus to enable the underwriters and dealers to comply with delivery requirements.

3. Post-effective Prospectus Delivery Requirements for Non-reporting Issuers

As previously stated, section 5 of the '33 Act requires that delivery of a statutory prospectus accompany or precede the confirmation of the sale

37. SEC Securities Act Rule 460, 17 C.F.R. § 230.460 (1969). The SEC's policy concerning acceleration of the effective date of registration statements is presently found in Rule 460, Rule 461, and SEC Securities Act Release No. 4936 (Dec. 9, 1968), containing "Guides for the Preparation and Filing of Registration Statements." If Rule 460 is amended as recommended by the Study, Rule 461 and Release No. 4936 could be rescinded.

38. 15 U.S.C. § 78j(b) (1964).

of a security or the delivery of the security. Section 4(3) of the '33 Act exempts a transaction by a dealer from the above requirements of section 5. However, section 4(3) does not apply to any transaction in the security that takes place within 40 days (90 days in the case of a first public offering) of either the effective date of the registration statement, or the date of the first bona fide offer to the public whichever is earlier.³⁹ Although this requirement of delivery of a statutory prospectus after the effective date applies to both first public offerings and offerings of reporting companies, the Study found that circumstances should require a differentiation between first public offerings and offerings of reporting companies in regard to post-effective prospectus delivery requirements.

In the case of a first public offering there is no repository of information about the issuer as there is with a reporting company. In fact, the prospectus will be the only source of information available to the investor for a substantial period of time in the case of a first public offering.⁴⁰ Therefore, it was the Study's opinion that, in the case of non-reporting issuers, the post-effective requirement of prospectus delivery serves as an important disclosure method and should not be changed.

As to reporting company issuers, the Study recommended that the post-effective requirement for prospectus delivery be removed if those improvements in reporting under the '34 Act recommended by the Study are adopted by the SEC. The Study felt that section 4(3)(B) of the '33 Act gave the SEC the authority to remove the requirement.⁴¹

C. The "Gun Jumping" Problem

Assuming that the form, content, and dissemination of prospectuses are adequate in all respects, the purpose of the '33 Act, to provide disclosure of information to potential investors through the means of a prospectus before the investor has reached his investment decision, will be frustrated if the market is allowed to be "conditioned" or "aroused." The statutory design of the '33 Act is that any written offering of a security, that is not exempt from registration, shall be made by means of a prospectus. A prospectus is defined very broadly in section 2(10) as any written material, or statement on radio or television, which offers a security for sale.⁴² Section 5c of the '33 Act prohibits any offering before the registration statement is filed.⁴³ Section 5b(1) provides that after the registration statement has been filed, a prospectus may be used if it meets the requirements of section 10 of the '33 Act.⁴⁴ The SEC has interpreted these sections to mean:

39. 15 U.S.C. § 77d(3) (1964).

40. This is because, assuming the '34 Act requires the issuer to report, the first annual report (Form 10-K) would not be due until after the first full fiscal year following the last full fiscal year for which certified financial statements were provided in the prospectus. The semi-annual report (Form 9-K) and the quarterly report (Form 7-K, if required) would not be filed with the SEC until after the requirement of delivery of a prospectus for 90 days had expired.

41. Section 4(3)(B) establishes the post-effective requirement of 40 days "or such shorter period as the Commission may specify." 15 U.S.C. § 77d(3)(B) (1964).

42. 15 U.S.C. § 77b(10) (1964).

43. 15 U.S.C. § 77e(c) (1964).

44. 15 U.S.C. § 77j (1964).

The statute [‘33 Act] prohibits issuers, underwriters and dealers from initiating a public sales campaign prior to the filing of a registration statement by means of publicity efforts which, even though not couched in terms of an express offer, conditioned the public mind or aroused public interest in a particular security.⁴⁵

This interpretation has become known as the “gun jumping” doctrine. Any publicity of a forthcoming offering designed to procure orders for the security is “jumping the gun” whether the publicity is by interviews with newspaper or magazine reporters, speeches, reports to shareholders, market letters, or otherwise.

As a practical matter, the “gun jumping” doctrine has been extremely difficult to apply so as to restrain publicity about an issuer in the registration process. In recent years there has been a significant increase in the interest and participation of the public in the security markets. This has brought about the practice of large corporations publishing more and more information about their affairs and an increase in the publication by the brokerage community of market letters, recommended lists, industry surveys, and similar publications.

The flow of information to investors and prospective investors is partly in response to their demands. If controlled, it constitutes a means for the dissemination of information about issuers and the issuer’s securities to the investing public. If the restrictions of the “gun jumping” doctrine are carried too far, it can prevent or inhibit publicity which is beneficial to the interest of investors.

The Study thus felt there is a need for clearer standards “to differentiate between helpful and informative publicity and publicity primarily designed to ‘condition’ the market in such a way that the disclosure in the prospectus would be rendered ineffective.”⁴⁶ In determining these standards, a balance must be struck between the interests of investors to whom securities are sold in registered public offerings and investors that purchase and sell securities in the trading markets.

1. Publicity Generated by the Issuer of Securities “In Registration”

The SEC has set forth the following standard to determine whether the restrictions of the “gun jumping” doctrine should apply:

In the normal conduct of its business a corporation may continue to advertise its products and services without interruption, it may send out its customary quarterly, annual and other periodic reports to security holders, and it may publish its proxy statements, send out its dividend notices and make routine announcements to the press. This flow of normal corporate news, unrelated to a selling effort for an issue of securities, is natural, desirable and entirely consistent with the objective of disclosure to the public which underlies the federal securities laws.⁴⁷

45. Carl M. Leob, Rhoads & Co., 38 S.E.C. 843, 848 (1959).

46. WHEAT REPORT 127.

47. Carl M. Leob, Rhoads & Co., 38 S.E.C. 843, 853 (1959).

The Study found that this standard has worked reasonably well and makes a sensible accommodation between the needs of the trading market for a continuing flow of investment information and the underlying policies of the '33 Act. Obviously there will at times be close and difficult questions as to whether certain publicity is within this "normal and customary" standard. The Study recommended that this "normal and customary" standard be maintained. If the issuer has any doubt as to whether specific publicity is within this standard, the Study recommended informal consultation with the SEC to avoid any potential controversy (*i.e.*, request a "no-action" letter from the SEC).

A possible conflict may arise for an issuer between the restrictions on publicity of the "gun jumping" doctrine on one hand, and the principles regarding "insider trading" and the duty developed in *SEC v. Texas Gulf Sulphur Co.*⁴⁸ and related cases to make timely disclosure of information which might materially affect the market for its securities on the other. The Study felt that if the issuer in good faith determines he is required by *Texas Gulf Sulphur* to make a disclosure, the restrictions of the "gun jumping" doctrine should not be applied if the disclosure is purely factual and does not include predictions, conclusions, or opinions.

Inconsistent positions have been taken at various times by the SEC on the question of whether an issuer is "jumping the gun" by announcing the fact that it is contemplating the making of a public offering in securities required to be registered. For clarification of this point, the Study recommended that Rule 135⁴⁹ be amended to allow the issuer to give public notice that it proposes to make a public offering.⁵⁰ The information in the notice would be restricted to identity of the security, the number of shares (or other units) that the issuer expects to register, and the approximate dollar amount of the proposed offering.

2. Publicity by Brokers and Investment Advisors

The Study found that no clear standards existed for applying the restrictions of the "gun jumping" doctrine to publicity generated by brokers and investment advisors. As a result, a wide diversity of views exists among brokers and investment advisors as to when and to whom the restrictions should apply. For example, one brokerage firm would refrain from publishing a recommendation of a security in registration only if the firm was to be included in the underwriting group. Another brokerage firm would not publish a recommendation for any security of an issuer in registration. Moreover, while one financial publisher felt it could not publish opinions or recommendations in its regular subscription service concerning a company in registration, another financial publisher recognized no such restriction.⁵¹

The Study noted there should be a difference in the restrictions applied to a participant and those applied to a non-participant in a public

48. 401 F.2d 833 (2d Cir. 1968).

49. SEC Securities Act Rule 135, 17 C.F.R. § 230.135 (1969).

50. WHEAT REPORT Appendix VII-2.

51. *Id.* at 137-38.

offering regarding their publication activities. A non-participant distributing publications to the trading market is very likely to be making independent judgments and recommendations, derived from research done by independent financial publishers and independent research organizations, concerning a company's securities. These publications serve the need of informing the trading public.

a. Participants in a Public Offering

Many brokerage firms regularly publish a broad, general list of securities which they recommend. The Study felt that to require a firm to delete all references to an issuer or its securities because the issuer is in the registration process for another security and because the firm expects to participate in the distribution was extending the restrictions of the "gun jumping" doctrine too far. Therefore, the Study recommended that the SEC adopt a rule permitting publication by brokerage firms of recommendations, opinions, or information about securities registered or to be registered, regardless of whether the firm expects to participate in the distribution, providing certain conditions are met. These conditions include: (1) the issuer has a class of securities registered under section 12 of the '34 Act; (2) the publication has been distributed with regularity, at least annually, for the past two years; (3) the publication is one containing a broad, general, and comprehensive list of securities that are currently recommended by the brokerage firm; (4) the recommendation, opinion, or information is given no greater space or prominence in the publication than any other security; (5) the publication does not contain projections of sales or earnings beyond the issuer's current fiscal year; and (6) a previous publication by the brokerage firm, that was distributed before the firm reached an agreement to participate in the distribution of the security presently in registration, contained an opinion or recommendation of the security that was no less extensive.⁵²

In addition to the use of "recommended lists," as discussed above, the Study felt that the restrictions of the "gun jumping" doctrine should not be applied in any event to the use of information by brokerage firms about the common stock of an issuer that was in the process of registering a non-convertible senior security. The investment conditions and reasons for investing in common stocks, as opposed to non-convertible senior securities, are significantly different. Moreover, the purchasers of non-convertible senior securities are to a large extent institutions rather than persons. Thus, the Study recommended a rule which would permit brokerage firms to recommend common stock where the issuer is in the process of registering non-convertible senior securities (or vice versa) provided that the issuer meets the qualifications recommended by the Study for using Form S-7.⁵³

Finally, a problem occasionally arises where a brokerage firm has prepared and published a market letter or industry survey relating to an issuer or security before the brokerage firm reaches any understanding that the firm is to participate in an underwriting of an issuer's security. If the number of copies published is no greater and the distribution no

52. *Id.* at 143-45, Appendix V-3.

53. *Id.* at 142-43, Appendix V-2. See text at III, A, 3 *supra*.

more extensive than for similar publications issued by the firm in the recent past, the Study felt that the "gun jumping" doctrine should not be applied. Obviously there will be close questions and practical problems in applying the above standard. If so, the Study recommended that informal advice, *i.e.*, a "no-action" letter, be sought from the SEC before participating in the underwriting.

If the brokerage firm has recommended a security before agreeing to participate in an underwriting of the security, and during the pre-filing period events involving or affecting the issuer occur, the Study recommended that the firm be allowed to issue brief factual reports of such events. The reports could not contain any projections of sales or earnings, or a recommendation to buy.

b. Non-Participants in a Public Offering

The restrictions of the "gun jumping" doctrine are applied to prevent the potential investor from being misled by the market being "conditioned" or "aroused" to forthcoming distribution of a security. On the other hand, non-participants in a public offering should be able to demonstrate that their publications are designed and distributed for the purpose of stimulating trading interest in particular existing securities and brokerage services, and not for the purpose of "conditioning" the market or "arousing" interest in a security that is "in registration." Moreover, if the brokerage firm is not participating in the underwriting, the publications would usually not be prepared and distributed in a context where extra compensation could operate to affect the independent judgment of the brokerage firm publisher about the security.

The Study felt that application of the "gun jumping" doctrine to publications by non-participants could deprive potential purchasers of an important source of independent opinion regarding the security being distributed. Thus, the Study recommended that the restrictions of "gun jumping" should not be applied to the publications of a non-participant.

This recommendation, however, raised a problem of defining a "non-participant." Since relationships between brokers, dealers, and investment advisors in the financial community are frequently complex and interrelated, it is often difficult as a practical matter to determine if a firm is truly independent of the participants in a public offering. Therefore, to be a non-participant and not subject to restrictions of "gun jumping," the following qualifications, as set forth in the Study's proposed Rule 137, would have to be met: (1) the issuer must have a class of securities registered under section 12 of the '34 Act; (2) no consideration can be received, directly or indirectly, from the issuer, any member of the underwriting group, or any member of the dealer group in connection with the publication; (3) there can be no arrangement or understanding, direct or indirect, with the issuer, any underwriter, or dealer in connection with the publication; (4) the publication must be prepared, published, and distributed in the regular course of business by someone who is not and does not propose to be a member of the underwriting or dealer group.⁵⁴

54. *Id.* at 140-41, Appendix V-1.

3. When Restrictions Should Commence for Brokers and Investment Advisors

In the past, in determining if "gun jumping" restrictions should apply, the SEC has employed a subjective standard centering around the question of whether a broker has reason to believe that he will participate in a forthcoming distribution. The Study recommended that this standard be replaced by the more objective standard of when an "understanding" has been reached. Thus, a broker would become subject to restriction upon "reaching an understanding" with the issuer (or other person on whose behalf a planned distribution is to be made) that the former will become a managing underwriter, whether or not the terms and conditions of the underwriting have been agreed upon. Similarly, a broker, other than the managing underwriter, would become subject to restrictions when he reaches an understanding with the managing underwriter, or with the issuer or other person on whose behalf a planned distribution is to be made, that he will participate in the underwriting.

D. Secondary Distributions

A secondary distribution of securities is a public selling of securities obtained from the issuer, or a person in a control relationship to the issuer (control person), in a private offering. The '33 Act requires registration of all offers of securities made by any person to any other person unless specifically exempted. Since the '33 Act is concerned with offerings to the public rather than offerings limited to private investors who are able to fend for themselves, specific exemptions are provided for the latter type of offering. Thus, section 4(2) of the '33 Act exempts from registration "transactions by an issuer not involving any public offering,"⁵⁵ and section 4(1) exempts "transactions by any person other than an issuer, underwriter, or dealer."⁵⁶ The problems involved in secondary distributions are centered around the availability or non-availability of these two exemptions. For example, Company *A* sells a block of its securities to *B*, an individual. May Company *A* utilize the exemption of "not involving a public offering" provided in section 4(2), and escape the requirement of filing a registration statement? May *B* utilize the exemption provided in section 4(1) and resell the securities immediately without filing a registration statement? Also, if not immediately, how long does *B* have to hold the securities before he may utilize the exemption?

Obviously *B* is neither an issuer nor a dealer. Thus, if the section 4(1) exemption is unavailable to him, he must be an "underwriter." The term "underwriter" is defined in section 2(11) of the '33 Act as "any person who has purchased from an issuer, [or a control person] with a view to . . . distribution. . . ."⁵⁷ Although the term "distribution" is not expressly defined by the '33 Act, it has always been considered by the SEC to be essentially synonymous with the term "public offering," as used in the section 4(2) exemption.⁵⁸ Thus, in the above example the availability of the

55. 15 U.S.C. § 77d(2) (1964).

56. 15 U.S.C. § 77d(1) (1964).

57. 15 U.S.C. § 77b(11) (1964).

58. L. Loss, *SECURITIES REGULATION* 551 (2d ed. 1961).

section 4 (2) exemption to Company *A* and the section 4 (1) exemption to *B* turns on the "view" (*i.e.*, the intent) with which *B* purchased the securities.

Because of these interpretations of the terms "underwriter" and "distribution," the SEC has always used a wholly subjective test to determine if the section 4 (1) and 4 (2) exemptions are available. The test applied has been whether the person who buys unregistered securities from the issuer (or control person) has the view or intent of later reselling the securities to the public. This test presents the obvious problem of how to determine the purchaser's true intention. Issuers, purchasers, and the SEC have in the past looked chiefly to three interrelated factors to determine if an intent to "invest" or "distribute" was possessed by the purchaser at the time of the purchase. These factors have been the presence of an "investment letter," "change of circumstance" after the purchase, and the length of time the securities have been held. However, the presence or absence of any or all of these factors, in any degree, has not assured that the SEC will find that the purchaser does or does not have an intent either to "invest" or to "distribute."

An "investment letter" is a statement given by the purchaser in non-public offerings to the issuer (or control person) which affirms that he is purchasing the securities for investment purposes and not with a view to distribution. The ritual of an investment letter has long been an established practice in private offerings, although since the SEC's opinion in *Crowell-Collier*,⁵⁹ the value of such a statement as definite proof of an intent to invest is very doubtful. In *Crowell-Collier* the SEC stated:

An issuer may not establish a claim to an exemption under section 4 (1) merely by collecting so-called "investment representations" from a limited group of purchasers if in fact a distribution by such persons occurs.⁶⁰

Nevertheless, an issuer would be careless in not obtaining an investment letter since failure to do so might be deemed evidence of the issuer's disregard for the significance of the purchaser's intent with respect to the securities.⁶¹

The "change of circumstances" doctrine arose from cases where purchasers tried to use facts subsequent to the purchase to demonstrate their investment intent at the time of purchase and thus justify a resale of the securities utilizing the section 4 (1) exemption. In other words, the purchaser would contend that he had "investment intent" at the time of the purchase, but because of a change of circumstances, it is now necessary to resell the securities. What constitutes a sufficient change of circumstances to allow the securities to be resold without registration has not been precisely determined. However, any change in circumstances that can reasonably be anticipated will definitely not be a sufficient change. Thus, in

59. SEC Securities Act Release No. 3825 (Aug. 12, 1957).

60. *Id.*

61. WHEAT REPORT 171-72.

*Gilligan, Will & Co. v. SEC*⁶² it was held that it was not a sufficient change of circumstances when investors anticipated business success but were disappointed by the actual results. Also, it is apparent that the shorter the time between purchase and resale, the more drastic the required change must be.⁶³

In *Crowell-Collier* the SEC also indicated that the length of time between purchase and subsequent resale of the securities would be "one evidentiary fact" in determining if the purchaser had investment intent.⁶⁴ However, no set length of time will definitely establish the necessary investment intent. *Crowell-Collier* stated that holding the securities for one year would not automatically prove investment intent, and thus allow a section 4(1) exemption, although "the longer the period of retention, the more persuasive would be the argument that the resale is not at variance with original 'investment intent.'"⁶⁵ Therefore, it is generally felt that holding securities that were purchased in a private placement for a period of two to three years after purchase will allow the use of the section 4(1) exemption, but even this cannot be stated with certainty.⁶⁶

1. Consequences of the Present Standards

As can be seen from the above discussion, basing the availability of the section 4(1) and 4(2) exemptions on the presence or absence of "investment intent" in the mind of the purchaser at the time of the purchase creates much uncertainty. Moreover, when the test is "investment intent," such considerations as the number of shares involved or the need by the next purchaser for the protection afforded by adequate disclosure becomes irrelevant. For example, in the hypothetical noted earlier, if *B* can prove the requisite "investment intent," he may sell all of the securities without filing a registration statement (by utilizing the section 4(1) exemption) regardless of the need of his purchasers for the protection given by adequate disclosure.

More specifically, the Study felt there were four "consequences" of the "investment intent" theory that were detrimental to the administration of the securities laws. (1) The vague and imprecise standards of investment intent have allowed large numbers of securities to be sold in interstate commerce without adequately considering the need for disclosure. (2) The lack of objective tests to determine when and how shares issued in a non-public transaction may be offered publicly gives leeway to the unscrupulous or unprincipled counsel to give opinions that certain offerings are exempt from registration when in fact this may not be true. (3) An increasing number of requests for "no action" letters involving the sale of securities obtained in a private placement has placed an onerous burden on the SEC. (4) The problems of proof by the SEC as to the lack of "investment

62. *Gilligan, Will & Co. v. SEC*, 267 F.2d 461, 468 (2d Cir.), cert. denied, 361 U.S. 896 (1959).

63. SEC Securities Act Release No. 3825 (Aug. 12, 1957).

64. *Id.*

65. *Id.*

66. See Schneider, *Acquisitions Under the Federal Securities Law—A Program for Reform*, 116 U. PA. L. REV. 1323, 1337 (1968).

intent" at the time of purchase is extremely difficult, even in cases of flagrant violations, since intent to distribute must be shown. Purchasers and issuers who in fact possessed the necessary intent at the time of purchase are faced with the difficulty of dealing with a nebulous test in proving such intent.⁶⁷

2. Specific Proposals

In solving the problems of secondary distributions, the Study felt it would be necessary to move away from several longstanding interpretations of certain statutory language found in the '33 Act. It was the Study's opinion that the statutory language of the '33 Act dealing with secondary distributions should be given an interpretation which would reflect three areas of emphasis. First, the interpretation would be more consistent with the fundamental aim of the '33 Act in providing full and fair disclosure of the character of the securities involved. Second, the interpretation would reflect and utilize coordination between the disclosure requirements of the '33 and '34 Acts. For example, it would be possible to permit some secondary sales of securities of companies required to report, and thus disclose, under the '34 Act when secondary sales of securities of a non-reporting company would not be allowed without disclosure. Finally, the interpretation would assure a greater degree of predictability as to when section 4 (1) and 4 (2) exemptions were available by replacing the present subjective test of "investment intent" with tests as objective in character as possible.⁶⁸ In conjunction with this, the study recommended rules be adopted by the SEC dealing with the terms "underwriter," "distribution," and "restricted security."

a. Certain Persons Deemed Underwriters

The term "underwriter" is defined in section 2 (11) of the '33 Act. As discussed above, in determining if a person was an underwriter in a secondary distribution, the emphasis has been on the "has purchased from an issuer with a view to" part of the definition. The Study's proposed rule would shift the emphasis to that part of the definition which reads:

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 undertaking⁶⁹

Under the proposed rule, any person that disposes of a "restricted security" in a "distribution" would be deemed an underwriter within the meaning of section 2 (11).⁷⁰ However, this would not be the exclusive definition of an underwriter so that the investment banking firm performing a classic underwriting function for an issuer, or control person, in the distribution

67. WHEAT REPORT 174-77.

68. *Id.* at 178.

69. 15 U.S.C. § 77b (11) (1964).

70. WHEAT REPORT 204.

of securities would still be an underwriter since the firm takes with a view to distribution.⁷¹

The merit of the proposed rule is that it provides an objective test in determining an underwriter in a secondary distribution. Regardless of the state of mind or purity of intent at the time securities are purchased, if the securities when disposed of are "restricted securities" (as discussed below) and the disposition is a "distribution" (as discussed below), the person is an underwriter. Thus, a person should know at the time he purchases securities in a private placement how he can or cannot dispose of them, and as a result would not have to rely on proving his intent or waiting for a fortuitous change in circumstances.

b. Definition of New Term "Restricted Security"

Any security which was acquired directly or indirectly from an issuer, or from any person in a control relationship to the issuer, in a transaction or chain of transactions of which none was a public offering, would be a "restricted security" by the Study's proposed rules. This taint of "restricted security" would remain for a period of five years or until it was sold in a public transaction. Any security obtained in a stock dividend, stock split-up, or recapitalization when the original or exchanged securities were restricted, would be similarly classified. To avoid the circumvention of the rules by use of a shell corporation, one qualification to the rule that the taint will be removed after five years is that the issuer must have been an active, going business during the five year period. In this regard, an issuer which has had annual gross revenues of 250 thousand dollars or more from the conduct of its business for four of the five years will be considered an active, going business.⁷²

c. New Definition of "Distribution"

The term "distribution" is used in section 2 (11)'s definition of underwriter, and although it is a key word in the meaning of that section, it is not defined. In addition, Rule 154,⁷³ dealing with the brokers exemption of section 4 (4), is built around the term "distribution," but the rule has no direct application to the problems of secondary distributions. Thus, the Study felt it was essential to develop a definition of "distribution," as used in section 2 (11), which would apply to sales of securities by control persons and sales of securities by persons who have purchased the securities in a private placement.⁷⁴

In developing the definition, the Study focused on the need of purchasers for the protection of disclosure which is given by registration of offerings. Therefore, it was felt that a distinction should be made between companies required by sections 13⁷⁵ or 15 (d)⁷⁶ of the '34 Act to make reports

71. *Id.*

72. WHEAT REPORT Appendix VI-1.

73. 17 C.F.R. § 230.154 (1969).

74. WHEAT REPORT 185.

75. 15 U.S.C. § 78m.

76. 15 U.S.C. § 78o.

to the SEC and non-reporting companies.⁷⁷ If there has never been disclosure by a company of its business history, earnings, financial condition, etc., then obviously a sale of the company's securities to the public should be preceded by disclosure through the registration process of the '33 Act. On the other hand, if the company was a reporting company, and had thus previously disclosed the pertinent information, the Study was of the opinion that secondary sales of the company's securities to the public should be permitted if the quantity of the securities to be sold did not exceed an amount which the trading market could normally be expected to absorb within a reasonable period of time; and if no solicitation of buyers was necessary. With this distinction in mind, the Study recommended a rule defining "distribution" which would: (1) exclude non-public transactions from the term "distribution" and thus make registration of the securities involved unnecessary; (2) include in the term "distribution" any public offering of the securities of a company which is not subject to the appropriate reporting requirements of the '34 Act; and (3) exclude from the term "distribution" any public offering of the securities of a company which is subject to the reporting requirements of the '34 Act and is not delinquent in filing of the reports, provided the amount of securities involved and the method of sale are not inconsistent with "ordinary trading."⁷⁸

i. The Qualified List

Because the proposed definition of "distribution" distinguishes between reporting and non-reporting issuers, the Study felt that some method of making the distinction should be readily available to interested persons. Therefore, the Study proposed that the SEC formulate and maintain a list of the issuers which have filed an informative registration statement and are not delinquent in submitting the other significant reports required by the '34 Act. This list, called the "Qualified List," would be kept current at the SEC's headquarters and at each of its principal offices. The securities of any issuer on the "Qualified List" could be publicly sold without registration in transactions not constituting a "distribution," *i.e.*, if the amount of securities involved and the method of sale is consistent with *ordinary trading*.⁷⁹

ii. "Public Offering" and "Ordinary Trading"

The Study recognized that this definition of distribution would create the problems of deciding what is a public offering and what is ordinary trading. In relation to the first problem, the Study conceded that there would be close questions, as there is presently, involving the distinction between public and non-public offerings but felt unable to formulate an objective test of broad applicability that would eliminate the questions.

77. WHEAT REPORT 186. The study felt this distinction could only be made if the proposals made by the Study for improved reporting under the '34 Act were adopted by the SEC.

78. WHEAT REPORT Appendix VI-1.

79. *Id.* at 206-15.

However, the Study did recommend efforts to find and develop such an objective test.⁸⁰

In defining ordinary trading, the Study considered Rule 154⁸¹ which sets out quantitative tests for what is "ordinary trading" in determining the availability of the so-called broker's exemption of section 4(4). With appropriate modifications, the Study was of the opinion that the general framework of Rule 154 could also be used to determine what is ordinary trading in connection with secondary distributions. The Study therefore recommended that to qualify as ordinary trading no more than one percent of the outstanding shares of a security that is traded over-the-counter or, if the security is traded on an exchange, no more than the lesser of either one percent of the outstanding securities of that class or one percent of the reported volume of trading for any one week of the preceding four weeks could be sold to the public in a secondary distribution by, or on behalf of, any person within a six month period.⁸² Unlike Rule 154, any securities sold in a private placement in the six-month period would not be included in determining the quantity that could be sold. Although the SEC had previously indicated that all sales by members of "a group of closely related persons" would be deemed to be sales by any member of the group,⁸³ the Study recommended that only members of a carefully defined family group be considered together for purposes of the quantity limitation.⁸⁴ Finally, the SEC has stated that if a plan existed to sell the maximum quantity permissible in each of several successive six month periods, the sales would not be considered ordinary trading within Rule 154.⁸⁵ The Study recommended this limitation *not* be applied to sales within a secondary distribution.⁸⁶

As to the "method of sale" that would be considered consistent with ordinary trading, the Study proposed rules which differ from the present interpretation of Rule 154 in three important areas. First, Rule 154 limits the amount of commission that may be paid to "the usual or customary brokerage commission."⁸⁷ Since there is a wide variance in the commission that is charged in over-the-counter sales, this test is obscure at best. Therefore, the Study recommended that the commission which could be paid, and still be considered consistent with ordinary trading, be limited to the minimum commission required by the exchange on which the security was listed. If the security was not listed but traded only over-the-counter, the allowable commission would be the applicable minimum New York Stock Exchange commission if the security had been listed.⁸⁸ Second, Rule 154 prohibits all solicitation of buy orders except inquiry that a broker may make of other dealers that have recently appeared in

80. *Id.* at 157.

81. 17 C.F.R. § 230.154 (1969).

82. WHEAT REPORT Appendix VI-1.

83. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

84. WHEAT REPORT 196.

85. SEC Securities Act Release No. 4818 (Jan. 21, 1966).

86. WHEAT REPORT 194.

87. 17 C.F.R. § 230.154 (a) (2) (1969).

88. WHEAT REPORT 197-99.

respect to the security in an inter-dealer quotation service (commonly called "sheets" by the financial community). The Study recommended that brokers be allowed to inquire, regarding the security to be sold, of any *bona fide* broker-dealer regardless of whether the broker-dealer had recently appeared in the "sheets" in respect to that security.⁸⁹ Finally, a broker handling a Rule 154 order must remove himself from the "sheets" with respect to that security.⁹⁰ The Study's proposed rule would allow a broker to remain in the "sheets" while handling a secondary distribution sale, if the broker was a *bona fide* market maker for that security.⁹¹

iii. Mandatory Holding Period

The Study recognized that, under the proposed rules, one way to avoid registration would be to use ostensible private purchasers as conduits for the sale of securities to the public. Accordingly, it was felt that a mandatory holding period was necessary for securities purchased in a private placement from the issuer or from a control person. Thus, the Study recommended a holding period of one year during which a private purchaser could not in any event resell the securities publicly without registration.⁹² The purchaser could, of course, resell the securities during the period in other than a public transaction, *e.g.* another private placement. A concept of fungibility would be used so that if during the holding period the holder had purchased any additional restricted securities of the same issuer, the one-year holding period for all of the restricted securities would be measured from the last purchase of restricted securities.⁹³ Purchases of securities of the same class in the open market (thus not "restricted securities") and sales of either restricted or unrestricted securities would not affect the period of holding. If the securities were obtained through pledges, gifts, death, or distribution of a trust corpus upon termination, the holder would be allowed to "tack" the length of time the transferor had held the securities onto the length of time any holder has held the securities.⁹⁴ If the securities were obtained in exchange for the surrender of other securities, *e.g.* in a business combination or on the conversion of convertible securities, the period that the surrendered securities were held would also count toward the necessary one year holding period.⁹⁵ Securities acquired by reason of a stock dividend, stock split, or recapitalization would be considered to have been held for the same period as the underlying securities.⁹⁶

89. *Id.* at 196, Appendix VI-1.

90. SEC Securities Act Release No. 4818 (Jan. 20, 1966).

91. WHEAT REPORT 196, Appendix VI-1.

92. *Id.* at 199-200.

93. An exception to this fungibility provision would be made for securities privately purchased through the exercise of qualified or restricted stock options. Exercise of such options would not affect the holding period of shares previously purchased in connection with an option exercise.

94. WHEAT REPORT 200-01, 238-39.

95. *Id.* at 201, 237-38.

96. *Id.* at 241-43.

iv. Transactions Not Constituting "Distribution"

With the above interpretation of the term "distribution," a purchaser of securities in a private placement may in some instances make limited public sales of the securities purchased without being an "underwriter," and thus utilize the exemption from registration given by section 4 (1). Under present interpretations, a transaction will involve a public offering if any resale is made, and thus the issuer may not utilize the section 4 (2) private offering exemption. Therefore, the Study proposed that a rule be adopted that would prevent loss of the section 4 (2) exemption from occurring as the result of any public resale transactions which are excepted from the proposed definition of "distribution."⁹⁷

3. Practical Consequences of the Proposals

If Company *A* sells a block of its securities to *B* in a private placement, under the Study's proposed rules, the securities would be "restricted securities" for a five-year period because they were obtained in other than a public offering or public transaction. Without registration, *B* may not sell the securities publicly for one year.⁹⁸ After the one-year holding period, if Company *A* is a reporting company that is not delinquent in the filing of the required reports, *B* may sell, without registration, a limited quantity of the securities in ordinary brokerage transactions in any six month period without the sale being a "distribution." Since it is a "restricted security" but is not being disposed of in a "distribution," *B* will not be considered an "underwriter" and thus will have the benefit of the section 4 (1) exemption. The securities will no longer be "restricted securities" in the hands of *B*'s purchaser because the chain of transactions from the issuer to him now includes a public transaction. Although there has in effect been a public disposition of some of Company *A*'s securities that were privately placed with *B*, the Study's proposed rules would allow Company *A* to utilize the section 4 (2) exemption for the initial placement with *B*.

If during the one year holding period in the above example *B* buys and/or sells other securities of Company *A* of the same class in the trading markets, the holding period is not affected. If *B* buys or obtains other restricted securities during the holding period, he must then hold all of the restricted securities until their entire one year holding period has expired before he may utilize the ordinary brokerage transaction and section 4 (1) exemption as described in the preceding paragraph. If the additional securities were obtained by *B* by reason of gift, death, or termination of a bona fide trust, he may "tack" to the transferor's holding period to determine if the one year holding period has expired.

In the above example, if Company *A* had not been a '34 Act reporting company (or was delinquent in its reports), any public disposition, without registration, of the securities would be a "distribution" of "restricted securi-

97. *Id.* at 205-06.

98. This, of course, does not stop *B* from selling the securities publicly and utilizing an exemption other than section 4 (1). For example, he could use Regulation A or the intrastate exemption of section 3 (a) (11).

ties" under the proposed rule.⁹⁹ Therefore, the proposed rules would deem him an "underwriter," regardless of his intent at the time he purchased the securities, and the section 4(1) exemption would be unavailable. If, during the five-year period that the securities are "restricted securities," Company *A* becomes a '34 Act reporting company and is not delinquent in its reports, *B* may at that time utilize the ordinary brokerage transaction and the section 4(1) exemption as described in preceding paragraphs.

Two additional consequences of the Study's proposed rules need special attention. They are the effects the proposed rules will have on the private placement of convertible securities and on pledges of restricted securities. Presently, under Rule 155,¹⁰⁰ privately placed securities which are immediately convertible can never be sold publicly without registration. Upon conversion of the securities, no matter when it occurs, the securities cannot then be publicly sold unless it is demonstrated that at the time of conversion they were acquired with "investment intent." Rule 155 was adopted by the SEC to prevent the private placement of convertible securities from being a device for placing unregistered common stock in interstate public markets.

Under the proposed rules, the convertible securities would be "restricted securities" and when a conversion is made, the securities received would also be "restricted securities." The one-year holding period would be measured for both the convertible or the converted securities from the time the convertible securities were obtained. In all other respects the convertible or the converted securities would be dealt with under the proposed rules as "restricted securities." Thus, there would no longer be a need for Rule 155.

The resale of pledged securities is presently controlled by the doctrine set forth in *SEC v. Guild Films Co.*,¹⁰¹ and essentially consists of two propositions. First, a pledgee is considered to stand in the shoes of the pledgor and to act for the pledgor when it sells the collateral; and second, the pledgee can therefore sell the collateral without registration only if an exemption is available which would have permitted the pledgor to sell the same shares without registration.¹⁰² The Study recommended that this doctrine be completely discarded. Under the proposed rules if securities are transferred to a pledgee in a *bona fide* pledge, they will be "restricted securities" if they are: (1) already restricted securities, (2) pledged by the issuer, or (3) pledged by a person in a control relationship with the issuer, even though they may not have been restricted securities in the control person's hands as in the case of securities purchased on the market. Since the securities are restricted securities in the pledgee's hands, the pledgee has the same limitations on disposition of the securities as any other holder of restricted securities. If the pledgee does dispose of the securities

99. Again, *B* could still publicly dispose of the securities by using Regulation A or the exemption of § 3(a)(11).

100. 17 C.F.R. § 230.155 (1969).

101. *SEC v. Guild Films Co.*, 279 F.2d 485 (2d Cir.), cert. denied, 364 U.S. 819 (1960).

102. WHEAT REPORT 239.

in a non-public transaction, the proposed rules allow the transferee to "tack" the holding period of both the pledgor and pledgee.

E. Brokers' Transactions

Section 4(4) of the '33 Act exempts from registration "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market, but not solicitation of such orders."¹⁰³ The broker's exemption was placed in the '33 Act to give brokers an exemption when conducting normal brokerage transactions for a customer that was utilizing the section 4(1) exemption,¹⁰⁴ thus allowing an open market for securities at all times. The SEC's opinion in *Ira Haupt & Co.*¹⁰⁵ left the impression that any sale of unregistered securities to the public on behalf of a control person might violate the '33 Act. This resulted in adoption of Rule 154 which allows brokers to sell a limited quantity of securities for a control person. If the broker is unaware of circumstances indicating that the control person is making a public distribution of the securities, he escapes liability through Rule 154 even though the control person has violated the '33 Act.¹⁰⁶ However, if the broker sells securities for a non-control shareholder who, under section 2(11), is an underwriter of the securities and is violating the '33 Act by not registering the securities, the broker is also an underwriter and in violation of the '33 Act. The Study recommended the Rule 154 be revised to protect a broker if, after reasonable inquiry, he has no grounds to believe and does not believe that his customer's sales amount to a "distribution" under the proposed rules.¹⁰⁷

IV. CONCLUSION

In *SEC v. Ralston Purina Co.*,¹⁰⁸ the Supreme Court decided that if offerees of a security need the protection that disclosure made available in the registration process, and if the offerees do not have access to the information that would be disclosed, *i.e.*, the offerees are not "able to fend for themselves," the private offering exemption of section 4(2) of the '33 Act would not be available. On careful analysis, the criteria of "need" and "access" seem to have dictated most of the proposals made by the *Wheat Report*.¹⁰⁹ That is, disclosure is required if the investors need the protec-

103. 15 U.S.C. § 77d(4) (1964).

104. H.R. REP. No. 85, 73d Cong., 1st Sess. 16 (1933).

105. *Ira Haupt & Company*, 23 SEC 589 (1946).

106. *U.S. v. Wolfson*, 405 F.2d 779 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969).

107. WHEAT REPORT 224.

108. 346 U.S. 119 (1953).

109. One exception to this statement is particularly notable. This is the automatic removal of the restrictions on a "restricted security" after a five-year period if the issuer is an active, going business. After the restrictions are removed, the securities may be sold to the public without registration irrespective of the investing public's need for the protection of disclosure or access to the pertinent information provided by disclosure. Although this seems at variance with the '33 Act's objective of providing disclosure, there is justification for the removal of the restrictions after a certain period of time. Perpetual restraints on alienation are, and for a long period of time have been, looked upon with great disfavor. Moreover, as a practical

tion offered by such disclosure, and the information is not otherwise accessible under the reporting requirements of the '34 Act. For example, for the average "small time" investor, who is investing in a first public offering, the proposals seek to give protection by disclosure through more readable and understandable prospectuses; by requiring a preliminary prospectus to be delivered to the investor; and by restricting other publicity that would tend to "condition" the investor to the extent that information in the prospectuses would be disregarded. On the other hand, the proposals limit the disclosure required in prospectuses for a public offering by an issuer that is required to report under the '34 Act since the relevant information is already available to the interested investor.

Similarly, the criteria of "need" and "access" can be found in the proposals relating to secondary distributions. If securities which have been obtained in a private offering are held for one year, and the issuer is a '34 Act reporting company (*i.e.*, anyone has access to information about the company through the reports filed with the SEC), a limited quantity of the securities may be sold to the public in ordinary brokerage transactions without registration. Conversely, if the issuer is not a '34 Act reporting company, and thus a public investor would have no access to information about the company, the securities may not be sold to the public without registration.

The coordination that the *Wheat Report* has attempted to achieve is particularly significant since lack of coordination of disclosure between the '33 and '34 Acts has been a major weakness of securities law since passage of the '34 Act.¹¹⁰ As a result of the 1964 amendments to the '34 Act, companies with over one million dollars in assets and 500 shareholders are subject to extensive reporting and proxy requirements of the '34 Act. Yet, when these companies make a public offering of a security, the '33 Act requires disclosure of basically the same information that has been previously disclosed under the '34 Act. This duplication is costly in both time and money without being of any significant benefit to the investing public. If the desired coordination between the two acts is achieved, the *Wheat Report* should be considered a significant factor in the development of securities regulation.

To attain such significance, however, it is obvious that the proposals must be adopted by the SEC. Fortunately, in the time since the publication of the *Wheat Report*, the SEC has moved rapidly to adopt or formally propose many of the proposals discussed in this comment. For example, on September 6, 1969, the SEC proposed amendments to Form S-7 which

matter it is doubtful if the five-year holding period would be used to escape the registration requirements. Finally, the sale of restricted securities, or the sale after the restrictions are removed, is not exempted from the anti-fraud provision of the '33 Act. Therefore, if the securities were intentionally held for the five-year period for the purpose of selling to the public without disclosure, it would seem that a case of fraud, and thus liability, could easily be established.

110. Although lack of coordination of disclosure has existed since the passage of the '34 Act, it has become a burden to companies that have securities traded only "over-the-counter" since adoption of the 1964 amendments to the '34 Act, which greatly extended the reporting requirements. Thus, the loudest cry for coordination of disclosure requirements has come in recent years. See note 7 *supra*.

would greatly increase the availability of this form, as well as require the inclusion of a "source and application of funds" statement as recommended by the *Wheat Report*.¹¹¹ A short form of registration statement, to be called Form S-16, has been proposed for use in the instances recommended by the *Wheat Report*.¹¹² An amendment to Rule 174 which would eliminate the 40-day requirement for prospectus delivery in the case of securities of an issuer required to report by the '34 Act has been proposed along with adoption of Rule 15 (c)2-8.¹¹³ The latter rule would require a broker-dealer who is participating in an offering to take "reasonable steps" to secure a copy of a prospectus for any person requesting one, require the offering salesman to be furnished with a prospectus, and require the managing underwriter to see that distributing broker-dealers have enough copies of the prospectus to comply with the rule and section 5 of the '33 Act.

Further rules have been proposed to implement the proposals made by the *Wheat Report* in regard to the "gun jumping" doctrine.¹¹⁴ Also, although not suggesting the adoption of rules, the SEC has set out its views regarding any possible conflict between the restrictions of the "gun jumping" doctrine and the duty of issuers to disclose material corporate events as developed by *Texas Gulf Sulphur* and related cases.¹¹⁵

In the area of secondary distributions and brokers transactions, the SEC has moved rapidly to propose the adoption of rules which would implement all of the *Wheat Report* proposals discussed above in substantially the same form, with one major exception.¹¹⁶ This exception is the Study's proposal that the SEC publish and maintain an up-to-date "Qualified List" of issuers whose securities may be sold in limited quantities through ordinary brokerage transactions in a secondary distribution without registration. Although the SEC does not suggest adoption of this recommendation, it will offer a service by which an interested person can obtain the information upon inquiry.¹¹⁷

The *Wheat Report* thus represents a major step forward by the SEC. Many problems and problem areas that have existed in the securities field for many years have been thoroughly studied and proposals for their solution suggested. As noted above, the SEC has proposed to adopt most of the *Wheat Report's* proposals discussed in this comment. Professor Kenneth Davis, in his treatise on administrative law,¹¹⁸ is critical of regulatory agencies for "holding back from the use of their rule making power" and

111. SEC Securities Act Release No. 4996 (Sept. 6, 1969).

112. SEC Securities Act Release No. 5011 (Oct. 7, 1969).

113. SEC Securities Act Release No. 5010 (Oct. 7, 1969).

114. *Id.*

115. SEC Securities Act Release No. 5009 (Oct. 7, 1969).

116. SEC Securities Act Release No. 4997 (Sept. 6, 1969).

117. It is important to note that the adoption of the rules proposed in Release No. 4997, *supra*, note 116, relating to secondary distributions and brokers transactions is conditioned on the SEC adopting the proposals made by the *Wheat Report* in regard to improved reporting under the '34 Act. However, there should be little difficulty in meeting this condition because in SEC Securities Act Releases Nos. 8680-8686 (Sept. 6, 1969), the SEC proposed to adopt most of the *Wheat Report's* recommendations on improving reporting under the '34 Act.

118. K. DAVIS, *ADMINISTRATIVE LAW TREATISE* § 6.13 (1965 Supp.).