GUN-JUMPING PROBLEMS UNDER SECTION 5 OF THE SECURITIES ACT OF 1933

Address of

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I had the pleasure of addressing this audience briefly just a year ago today, at which time I described certain problems relating to the financing of small businesses. The Securities and Exchange Commission was then concerned with what it felt to be an essential lack of liaison between it and persons seeking financing in modest amounts and who might be eligible to file with the SEC under Regulation A. We had been given to understand that some businessmen and attorneys were inclined to place on the SEC part of the blame for the alleged difficulties experienced by small business in procuring adequate financing on the ground that procedure under Regulation A was unduly complex. Hence, it was said, such persons and their possible underwriters were discouraged from making public security offers. I then suggested that your body cooperate with us in organizing throughout the country a series of gatherings which would be designed to dispel this misconception and explain the techniques of filing under Regulation A in lay terms to the lawyers, accountants and underwriters.

I am happy to report that under the sponsorship of your Committee on Small Business, we participated in two of these gatherings during last spring, one in Denver and one in Cleveland. I thought both meetings were very successful. The pattern which evolved in this connection went even further and was even more helpful, I think, than we originally conceived. Our audiences were made up, as far as we were able to analyze their composition, in about equal parts of lawyers, underwriters and businessmen, with a sprinkling of accountants. The sessions were in two parts: the morning session which was devoted to an explanation of the filings under Regulation A by experts from the SEC staff; and a luncheon session at which representatives of the underwriters, the bankers, the Small Business Administration, the accountants and our own organization gave short talks, each clarifying in broad outlines the function of his own activity in the field of the financing of small businesses.

It is our sincere hope that this program so successfully launched under your auspices during the year just past can be continued and expanded in the year to come. All the statistics with which I have been furnished in the past few months indicate

that there will be a substantial increase in the demand for new capital, and in particular for equity capital during the winter ahead of us. During the third quarter of 1958, registration statements filed with the SEC became effective covering 275 issues of corporate securities involving $4.2 billions. This compares with similar figures for the third quarter of 1957 of 254 issues involving $3.3 billions. It is expected that corporate securities reaching the public market in 1959 will continue at the record levels of 1958. While the segregation of these figures as between what might be termed small business and larger enterprises is not available, it is reasonable to conclude that the same relative activity in financing small business may be expected as is the case for business in general.

We ought also to consider the effect upon this program of the passage by Congress of Public Bill 699, commonly referred to as the Small Business Investment Act of 1958. Congress was faced during the last session with what it considered a reasonable demand for the establishment of machinery which would facilitate the financing of small business. The legislation finally adopted represents a compromise between two schools of thought, one of which would have handed this entire task to a capital fund established out of federal money and the other of which would have left the entire job to private capital. As things stand, the private capital market becomes a statutory participant in the financing pattern established by this legislation. It is contemplated that the small business investment companies formed under the Act will be financed initially by private capital, which will be matched within certain limits by federal funds furnished by the Small Business Administration. The Act also contemplates that the investment of this pool of capital in any small business may eventually be liquidated by the issue and sale by the investment company to the public of the securities sold to it by the small business. As you may appreciate, the SEC is interested in this process from several points of view, and is working closely with the Small Business Administration in order to establish feasible techniques under which these new activities may operate. Proposed rules in this connection have been distributed for comment and are now being considered by the Commission for adoption.

It seems clear to me that the SEC and the investment bankers have an obvious duty in this situation, not only to continue the excellent program so auspiciously begun during the past year, but also to

expand and actively pursue it in order to publicize the mechanics of financing under the Small Business Investment Act. As I say, this legislation was drafted to preserve the functions of private capital within our economic structure. It is quite frankly an experiment. If it does not work, if it does not operate to facilitate access by the entrepreneur to the private capital market, I am perfectly sure that further legislation will be enacted which will bypass private capital and completely delegate this financing to government agencies. This I do not want to see, nor do I think you do, since it will unquestionably tend to leave the federal government in a permanent equity position in these businesses, a phenomenon which once established leads naturally to involving government in the ownership and management of industries which have never been thought of as proper fields for public control.

It is in view of this situation, its history and its implications that I again suggest that renewed efforts be made to discuss in every possible area the problems which small business has in its financing and the sources available to it for capital funds.

To turn to another and entirely different field of our mutual interests, I would like to discuss with you for a few minutes the impact of the registration and prospectus requirements of Section 5 of the Securities Act of 1933 on publication of information concerning an issuer and its affairs by the issuer, its management, underwriters and dealers. I have in mind particular reference to the problem of "gun jumping," which I understand from numerous conversations with members of the securities and investment banking business is a matter of serious concern to you. This is not a new problem, nor is it one which has not been pretty thoroughly discussed from time to time in the past. So far as I can find out, furthermore, the position of the Securities and Exchange Commission on the subject has remained unchanged for many years. The problem has numerous facets and its resolution is by no means easy, even under the simplest set of facts.

There has been an increasing tendency over the years to give publicity to corporate activities and affairs through many media of communication, a tendency which has been encouraged by the enlightened attitude of many financial institutions, particularly the

New York Stock Exchange. This practice reflects a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally of important business and financial developments. The SEC emphatically does not wish to discourage this trend. At the same time, it is essential that corporate management, underwriters, dealers, lawyers and public relations firms recognize that the Securities Act of 1933 imposes certain responsibilities and limitations upon persons engaged in the sale of securities and that publicity and public relations activities under certain circumstances may involve violations of this law. The inevitable result of failures to consider these matters is to cause serious inconvenience to issuers and underwriters in connection with the timing and marketing of securities issues.

The Securities Act of 1933, the cornerstone of the entire structure of federal securities legislation, has as one of its primary purposes the elimination of a situation found by the Congress to be a threat to investors and detrimental to the public interest. The contemporary legislative documents express a deep concern with the then existing distribution practices as the result of which investors, brokers and dealers were compelled to make blind commitments without adequate information under which they agreed to purchase securities in which public interest had been stimulated by prior publicity issued by promoters and underwriters. As expressed in House Report No. 85, 73rd Congress, 1st Session, (1933) p. 3:

> "Despite the fact that business demands the assumption of responsibilities of a character fully equivalent to those of trusteeship, compelling full and fair disclosure not only of the character of the security but of the charges made in connection with its distribution, the literature on the faith of which the public was urged to invest its savings was too often deliberately misleading and illusive. Even dealers through the exertion of high-pressure tactics by underwriters were forced to take allotments of securities of an essentially unsound character and without opportunity to scrutinize their nature. They then would be worked off upon the unsuspecting public."

The Congress determined in adopting the 1933 Act that these abuses had contributed to unsound securities markets, artificially inflated values and speculative hysteria and were among the factors responsible for heavy losses suffered by security owners. It was the clear purpose of Congress in this legislation to slow down the distributive process in order to prevent brokers and dealers from making blind commitments for securities which they must, of course, promptly sell to their customers if they are to stay in business. It was the stated purpose of this law to make certain that the information required in order to permit an informed and unhurried appraisal of the security offered be made a matter of public record by the issuer and underwriter prior to any solicitation by a seller of dealers or the investing public. In furtherance of these statutory purposes Section 5, the very heart of the 1933 Act, flatly prohibits any activity designed to further the offer or sale of non-exempt securities or to stimulate offers to buy from brokers, dealers and other investors, prior to the filing with the Commission of a registration statement containing the information specified in the Act.

Specifically, among other things, Section 5(a) of the Securities Act makes it unlawful to sell a security unless a registration statement with respect to such security has become effective. Section 5(b) makes it unlawful to send by means of facilities of interstate commerce or the mails for purposes of sale of any security unless the purchaser has received a prospectus with respect to it which meets the requirements of Section 10 of the Act or to send out any prospectus which does not so conform to Section 10. Section 5(c) of the Securities Act of 1933 makes it unlawful, with certain exceptions, for any person directly or indirectly to offer to sell a security unless a registration statement has been filed with the Commission.

To recapitulate what I have said, it is illegal in any way to offer a security prior to the filing of a registration statement. A security may be offered for sale after filing and before the effective date of a registration statement, provided that any prospectus employed for this purpose meets the standards of Section 10 of the Act. As a result, in general during this period, no written communication offering a security may be transmitted through the mails or in

interstate commerce other than a prospectus authorized or permitted by the statute or relevant rules thereunder. After the effective date, sales literature in addition to the prospectus may be employed legally, provided the Section 10(a) prospectus precedes or accompanies the supplemental literature.

The broad sweep of the basic prohibition contained in Section 5(c) is made clear by reference to the definition of the key term used. The prohibition is against an "offer to sell" which is defined in Section 2(3) of the Act to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value. These carefully chosen words reflect the Congressional mandate that the term, as so defined, shall not be construed to apply narrowly to communications which include express words of "offer" in the sense in which it is used in common parlance.

On the other hand, it has never been considered by anyone, let alone the SEC, that it is unlawful to disseminate normal corporate information to the public if such information is not a part of an offer to sell, a solicitation of an offer to buy, or a part of a selling effort. This fundamental truism was announced at an early date in Commission Releases Nos. 70 (1933), 464 (1935), and 802 (1936). In Release 464, the late Judge Burns, then counsel to the Commission, stated:

> "... even though your subscribers transmit their bulletins to their clientele through the mails or interstate commerce, such transmittal is not a violation of the Act if the subscriber does not in fact use the bulletins as selling literature. Whether or not a subscriber is using a bulletin as selling literature is, of course, a question of fact in each case as to which no generalization can be made. The intent with which the bulletins are used, as determined from all surrounding circumstances, would control the legality of circulation thereof by underwriters or dealers.

> "If an underwriter were to supplement a bulletin with selling literature or with a recommendation to the recipient as to the desirability of purchase, or were to attempt to obtain from the recipient some indication of interest however tentative in purchasing the described security, such action, in my opinion, would almost conclusively establish that the bulletin was being used in an attempt to dispose of or solicit an order for the purchase of the security."

In summary, let me reemphasize that the purpose of the Act, as plainly disclosed by its provisions and as it has uniformly been interpreted by the Commission is to prevent "every attempt" by issuers, underwriters and dealers by any means whatever to dispose of or to solicit offers to buy securities as to which registration is required, prior to the time when the information specified in the Act has been made public in a registration statement filed with the Commission and when a prospectus meeting the requirements of Section 10 of the Act is available for distribution to dealers, brokers and investors.

In determining what constitutes such an attempt, it is important to keep in mind the warning which Judge Burns gave in 1934, and to remember that the question of whether a communication is an offer within the meaning of the Act, must be answered in the light of all the circumstances surrounding its publication, including among other things, the content of the communication, its timing, to whom it was addressed or communicated, by whom it was published, the manner of its publication, and whether its over-all effect may or actually was to cause the public or brokers or dealers to make or solicit offers to buy, however tentative such offers may be. Furthermore, for the purpose of construing the Securities Act, the communication must be viewed in the light of the procedures employed by the securities industry and the effect which the communication is likely to have upon the securities distribution process.

It is perfectly clear, when any intelligent attention is given to this problem, that an issuer or an underwriter is not privileged to engage in a publicity campaign prior to the filing of

a registration statement in connection with a public offering of a non-exempt security. This does not mean that a corporation which is planning to bring an issue to market must close its advertising department, dismiss its public relations people and gag its officials and employees. Certainly, an issuer may continue the normal conduct of its business and it may continue its normal publications prior to the filing of a registration statement and even during the so-called "waiting or cooling off period." Thus, it may continue to publish advertisements of its products and services without interruption. It may send out its annual and other periodic reports to its security holders. It may publish its proxy statements, send out its dividend notices, and make routine announcements for the public press. The SEC does not normally regard these activities as any of its business. But when, on the other hand, public statements of various sorts begin to appear shortly before the filing of a registration statement which discuss such aspects of a business as its finances, its earnings or its growth prospects in glowing and optimistic terms, stressing in seductive fashion the favorable over the unfavorable, I think it is logical to conclude that there is an attempt to condition the market for the forthcoming sale of the issue, and that such statements are a part of the selling effort and are in violation of the law.

It has also been indicated to us that, in spite of our repeated efforts to clarify our understanding of the effect which the provisions of Section 5 have upon such activities, there still remain serious doubts as to whether a distributor or underwriter is safe in publishing the customary analyses of outstanding security issues. We have said before, and I repeat here that we have never raised any questions in this regard, so long as the organization which is publishing such reports is not engaged at the same time in the sale of unregistered securities. I again refer you to the statement of Judge Burns in Release No. 464, although this release as well as the others to which I referred must be read in this context under which they were issued. The problem has never been answered more logically.

The question of when such an organization becomes involved in the sale of a new issue and should therefore stop and analyze its program of financial analysis for the time being

does not seem to us to be particularly baffling or complex. We think that, ordinarily, a dealer is not required to pay much attention to the financing plans of an issuer until he offers to or is invited to become a member of the selling group. Neither do we believe it to be necessary for an investment banker to withdraw his existing analyses or refrain from issuing new ones until he has received indication that he is going to participate as an underwriter in an issue of securities of a given company. The syndicate managers must, we think, be a little more careful, since they may be involved in the selling effort as soon as they commence to negotiate a deal with the issuer. We see no reason why anyone should be confused by such an approach to this question, or why the institution of reasonable cooperation between the purchasing and the research departments of an underwriter should not avoid the slightest problem.

Perhaps the clearest example of an attempt by an issuer and its underwriters to make an offer in contravention of the statute is the recent and well publicized Arvida case. The facts in that matter are familiar to almost all of you in certain details. The whole story, however, has not appeared, so far as I know, except in the records of the Court and the Commission. It deserves some attention as a case study in what not to do. Essentially, it is as follows.

Mr. Arthur Vining Davis, a man of some substance and very widely and favorably known, formed a corporation last summer called Arvida Corporation to which he transferred some large tracts of Florida real estate which he had accumulated. This action was described in a press release published in some Florida papers on July 8, 1958, which simply announced the formation and purpose of the Corporation. Thereafter, negotiations with various financial concerns culminated in an understanding arrived at on September 18 of this year whereunder certain outstanding Wall Street houses agreed to underwrite a public offering of Arvida common stock. Thereupon, another press release was given out and a press conference held, as the result of which wide publicity was given, not only to the plans and projects of the Corporation, but to the contemplated public sale of the issue by the underwriters pursuant to their agreement. This release reads precisely like a letter which a distributor would send to a prospective purchaser in an effort to persuade him to invest in the enterprise. The only thing it does not do is specifically to ask the reader to send in his order.

Immediately upon the publication of this article, "expressions of interest", began to come in, one or two of which were, revealingly enough, entered on buy order forms. Our investigation revealed that, in two business days after the release, such "expressions of interest" totalling over $500,000 had been received by broker-dealers other than the underwriters. All of the indicia of the beginning of a distribution by security houses country-wide were present which normally follow the filing of a registration statement. The important point is that no registration statement had been filed, and that the SEC had not been given the opportunity which the law plainly states it must have to review the published facts upon the strength of which this public interest had been aroused. I might add that the information contained in this release and the whole tone thereof do not jibe in many respects with the content of the registration statement and prospectus which have subsequently been filed with us and which are currently under study.

Judging the activities and communications I have described in the light of all the circumstances surrounding the publicity given out by the issuer and its underwriters and in light of the procedures employed by the securities industry in distributing securities and the effect of the industry in their function in the distribution, it was, and is the considered opinion of the Commission that an offer of a security or a solicitation of an offer to buy within the meaning of the statute had been made. Certainly, in any view, the activities involved here related directly to a desire to promote an awakening and developing of a buying interest on the part of the public in a security. We believe that this was the beginning of a sales effort. If, in fact, activity such as was involved in the Arvida case were to be permitted, it would be proper for issuers and underwriters in any case to create a demand for a security and in effect accomplish its sale before the true facts were revealed in proper form to the public. This result would obviously be contrary to and defeat one of the fundamental principles and objectives of the Securities Act.

I have seen and heard statements from time to time that the efforts of the SEC to administer this statute in some way constitute an infringement on the freedom of the press. This is an idiotic remark which would never be conceived by one who had read the plain words of the law, or was familiar with the express

intent of Congress in enacting it or with the history which lies behind it. What the press may choose to publish with reference to financial affairs, whether fact or fancy fiction, is none of our business. Most financial and other corporate information, at least that concerning most established enterprises, can be gathered from open and public sources. Moreover, it is no matter of concern to us if the financial press chooses to publish any of the rumors which, some true, some false, are as indigenous to and pervasive in Wall Street as is the odor of roasting coffee. All that the law says is that no issuer or underwriter may be a party to any publicity campaign in connection with a forthcoming, but unregistered, issue of securities. That law we intend to enforce.

The SEC has for some time been aware of the pressure which has been brought to bear on issuers and underwriters to publicize coming issues. For many years, however, the bankers manfully resisted this pressure. The law was materially amended in 1954 to relax the rigidity of the limitations upon pre-effective offers, and we felt that the trade should have relatively little trouble complying with the amended Act. It also was amended to relieve the industry of the limitations of Section 4(1) which had the effect of prohibiting transactions by dealers in securities as to which a registration statement had been filed for 1 year after the effective date of the registration statement unless a prospectus had been sent or given to the purchaser. Among other things, this amendment, to which the Commission agreed, made it possible for dealers to send out their own literature concerning registered securities to their customers upon the expiration of 40 days after the effective date without worrying about the delivery of a statutory prospectus, provided the dealer was not then engaged in disposing of an unsold allotment or was not otherwise participating in an incompleted distribution.

The Commission believed and continues to believe that these changes in the law to legalize sales activities immediately after the filing of a registration statement and to permit a greater freedom with respect to sales literature after a distribution has in fact been completed or has presumed to be completed were a realistic and sensible recognition of the need for statutory changes

compatible with the economic facts of life. The amendments were not intended to and do not in fact change the fundamental principle of the law that sales efforts must not be started before filing of the required facts. Nor did the amendments change the fundamental principle of the law that an issuer, underwriter or dealer may not do indirectly what he is prohibited from doing directly. We do not believe that the ability of a seller to seek out or secure publicity free of charge whether before or after the filing date which if paid for would clearly violate the law changes the character or effect of his action in terms of the provisions of the Securities Act.

Shortly after the adoption of the 1954 amendments, however, a very large and newsworthy issue was placed on the market after a series of publicity releases which gave us very serious concern. The result was to whip up public interest to the point where the issue was to all intents and purposes completely sold and, in fact, greatly oversold long before any registration statement was filed. There is every indication that the negotiations with respect to the contemplated issue price were materially affected by the indicated demand which had at least in part been stimulated by this publicity. In short, the situation generally bore, to a detached observer, a troubling resemblance to the classic pattern of security distributions as they developed in the late nineteen twenties. In questioning whether the stock could have been sold at the offering price if the prospectus had been the first step in the selling campaign, I may point out that the market for the stock shortly after free trading commenced dropped below the offering price and, as I remember it, has never been up there since.

In view of this situation, and a number of other more recent indications that the securities industry was slipping into a rather nonchalant attitude toward the provisions of Section 5, the Commission determined to, and did issue its Release 3844 in October of last year, in which we attempted to remind the trade of the serious nature of this problem. We have since seized every opportunity which has presented itself to reiterate this warning. We can do nothing more, as I see it, nor most certainly can we do anything less.

From the very nature of the statute, which attributes very great importance to the subjective intent of the parties, it is completely impossible to lay down hard and fast rules for general application to this question. I would like to say again that there is ample room for legitimate corporate publicity under the law, but that it is the duty of the bankers and issuers to keep in mind the purposes of the law and to make sure that such publicity does not become mixed up with a securities sales campaign. The SEC has never had any reason seriously to complain of a lack of cooperation by the respectable element of the securities industry. I ask now for the industry to take a new and dispassionate approach to this serious problem, to consider the duties imposed on us by the Congress and to restrain itself within the limits established by law to the public issue and sale of securities. The SEC has enough to do to protect the investors in America against chicanery and fraud, and we begrudge every minute which we are required to spend in guarding them against "gun-jumping" by legitimate business. We believe that a little more care, a little more thought would be enough to avoid such problems.

In closing, permit me to express my appreciation and that of Commissioner Patterson for your cordial hospitality and for the opportunity to talk with you today about some of our problems. Many factors contribute to making our system of free enterprise work. The ability of industry to grow and prosper depends upon its ability to obtain capital. Access to capital, in turn, is dependent to a large extent upon the confidence which the investing public has in securities as a safe and profitable place to invest its savings. This confidence is in large measure a function of the extent to which corporate financial and related information is disclosed to investors. Our job is to extend and preserve this confidence, and our only reservation is due to the limited prohibitions of a carefully drawn and purposeful statute designed to see that the information so disclosed is actually fair, accurate and complete. We believe our interests and yours are identical, and that one of our primary purposes is to help you to expedite the flow of capital from American investors to American industry. If the SEC and the investment bankers can cooperate to this end, we will have made a notable contribution to the lasting strength of our national economy.