

CURRENT PROBLEMS UNDER SECTION 5
OF THE SECURITIES ACT OF 1933 AND RELEASE NO. 3844

Address of

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before
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The public and the business community are inclined to think of the Securities Act of 1933 primarily in terms of its "disclosure," and "anti-fraud" provisions. Issuers and syndicate managers who are bringing an issue to market tend to become preoccupied with determining the necessity for registration, with the content of a registration statement and prospectus and their informational requirements, with arriving at judgments as to materiality of and the necessity for discussion of subjects perhaps not specifically required by the registration forms, with the mechanics of the registration process and the timing of the various steps in the complicated business of putting together a syndicate and successfully placing an issue.

The public is apt to observe in the press from time to time some report of action by the Commission involving conduct by an issuer or a broker-dealer contravening the anti-fraud standards of the statute or involving the sale of unregistered securities. These actions are generally understood and are accepted without explanation or justification, either by the Commission or by the businessmen and professional people interested in the administration of the law. Being easily understood, it is perhaps natural that the impression should prevail that these are the only aspects of the statute of any real importance, that what remains is mere technicality.

However, you in the investment banking business and we in the Commission are keenly aware that one of the basic purposes of the Securities Act and one of the major changes in the conduct of your business required in order to implement the rule of full disclosure was to impose upon issuers, underwriters and dealers a then novel discipline in the mechanics of distribution as to when and in what manner securities may be offered and sold. This discipline was spelled out in Section 5 of the 1933 Act, which is the procedural heart of the statute from your point of view and ours, and in the definitions of the terms "security," "offer," "sale," and "prospectus" contained in subsections 1, 3 and 10 of Section 2.

From 1933 until October, 1954, the statute prohibited the making of offers or sales ^{1/} of a non-exempt security prior to the effective date of the registration statement. During that period, there was much concern over the seeming inconsistency between two fundamental theses of the Act, first that during the period between the filing date and the effective date, the public should have an opportunity to become informed about an issue and then that during this same period, no offer could be made. Every responsible member of the industry was anxious to comply with the law and yet was fearful lest, in distributing information about an issuer during the waiting period, he might be considered to be engaged in making an offer contrary to the statute.

Very shortly after the statute became effective, the Federal Trade Commission, "In response to inquiries concerning how far an underwriter may go in discussing and advertising a proposed new offering of securities prior to the effective date of a registration statement filed under the Securities Act," published its Release No. 70 in which it discussed this basic and very practical problem. The release pointed out that the law contemplates there should be public circulation of knowledge concerning matters contained in a registration statement but warned that: "On the other hand the Act is equally definite that no offer to sell shall be made until the expiration of the waiting period."

The essence of the new discipline to which I have referred is found in one short paragraph of that release, where it was said that: "During the waiting period, as well as prior thereto, Section 5 of the Securities Act makes it unlawful for the issuers, underwriters, and dealers (to whose transactions the Act is generally applicable) to make an offer to buy or to sell a security--always remembering that 'sell' carries within it the conception expressed in Section 2(3) of an offer to sell or a solicitation to buy. The same section also makes it unlawful to transmit any prospectus (the central feature of which under Section 2(10) is the fact that it offers a security for sale) relating to a security during this period prior to the effective date of a registration statement."

^{1/} By any means invoking the Federal jurisdiction. As originally written, the term "sale" was defined to include any offer or attempt to dispose of a security.

During this early period, the technique of the "red herring" prospectus was developed and the Commission endeavored to encourage its use at least to the dealer level. The securities industry, however, as stated in the industry report on the proposed amendments to the statute in 1941, 2/ continued to fear that, unless underwriters gave out no information at all during the waiting period, ". . . they are subjecting themselves to injunctions or criminal liability" or "possible revocation of their over-the-counter dealers' licenses . . . for willful violation . . ." of the Act.

In 1935, in Release No. 464, the Securities and Exchange Commission published an opinion of its General Counsel which discussed the effect of the Securities Act upon the publication by statistical services of bulletins or other circulars descriptive of securities for which registration statements had been filed, and the circulation of such bulletins or other informative literature by underwriters or dealers. The release pointed out "that there would be no apparent violation of the Securities Act in the distribution by these services of such material to their subscribers in the normal course of business, and that underwriters and dealers may, subject to certain restrictions, further distribute this material to their customers." In the course of his opinion, the General Counsel gave some description of the restrictions which he had in mind. He stated that the "legality of the submission of preliminary information under Section 5 is dependent upon whether or not it is used in connection with, or it itself constitutes, an 'offer to sell,' as that term is defined in the Act" and that "the making of any attempts to dispose of a security or to solicit offers to buy a security, fall within the prohibition of Section 5 of the Act during the twenty-day period preceding the effective date of registration, as well as prior to the filing of the registration statement. Accordingly, any circulation by underwriters or dealers of a bulletin descriptive of a particular security, which is in furtherance of an offering of such security for sale prior to the effective date of registration, or of a solicitation during that period of an offer to buy the security would fall within the prohibitions of Section 5 of the Act."

He went on to comment on "the problem created by the insertion in the bulletins of your ratings of the described securities and of your

opinion as to their investment value. As has been pointed out above, an underwriter or dealer who circulates with a bulletin or other purely descriptive matter his recommendation as to the desirability of the investor's purchase of the security would in all probability be held to have offered the security for sale. In my opinion, the insertion of such material by the statistical service creates a substantial risk that underwriters or dealers, in circulating the bulletins, would, where such opinion material is favorable, be held to have violated the Act through their participation in a recommendation of the security for purchase."

I have dwelt at some length on these releases for two purposes. In the first place, they show that the problem of determining what constitutes pre-effective or pre-filing offerings of securities has always been with us. I think further that this history shows that, in publishing Release No. 3844, we have not embarked upon some new adventure in statutory construction or of administrative policy, and that the present concern of the trade ought not to be ascribed entirely to any recent pronouncements of the Commission. These early releases were published for the same purpose for which we published Release No. 3844, namely, to make generally public the Commission's views concerning the type of activity which, in its opinion, might constitute a violation of the statutory prohibitions against pre-filing offerings by issuers and underwriters.

The Securities Act was amended in October, 1954, in an attempt to remove the confusion and the artificial distinctions which arose from the apparent inconsistency to which I have referred between the prohibitions against offers during the waiting period and the expressed policy of encouraging the dissemination of the information in a registration statement. As amended, the statute still prohibits sales and contracts to sell 3/ before the effective date of a registration statement but permits the making of offers to sell and the solicitation of offers to buy by issuers and underwriters immediately upon the filing of a registration statement by

3/ Excepting contracts between issuers and underwriters and among underwriters.

means of prospectuses authorized by the statute or the Commission's rules. ^{4/} The prohibition against engaging in a sales campaign prior to the filing of a registration statement remained unaffected. In other words, the statute today, as it has since 1933, prohibits any attempt to dispose of a non-exempt security prior to the filing of a registration statement.

This prohibition is none of the Commission's making. It reflects a Congressional policy expressed in the original Act and reaffirmed in 1954 that the offering of a security for sale or the solicitation of offers to buy a security as to which registration is required may not legally begin prior to the filing of a registration statement. We cannot ignore the clear intent of that policy which, while requiring fair and adequate disclosures in a registration statement and prospectus, also circumscribes the freedom of the prospective seller to use other types of information and to distribute other types of literature at certain times and under certain circumstances. It is my purpose today to try to explain how we feel that this statutory policy affects or should affect the conduct of issuers, underwriters and dealers in some of the situations which arise in the ordinary course of business.

Lawyers have repeatedly observed that many business problems would cease to be problems were it possible to give precise meaning to certain words. For example, how much life would be simplified if we had nice, neat definitions of universal application for such words as "control," "material," "underwriter," "fraud," "misleading," "adequate," "reasonable" or "prudent man." But these terms have a significance which affects conduct only in relation to the particular facts and circumstances of a given situation and such relevant facts and circumstances may present themselves in infinite variety.

The problem before us today stems from the definitions of "sale" and "offer" found in subsection 3 of Section 2 of the Act. Section 5 relates to sales, contracts of sale and to "offers"; i. e., to every attempt or offer to dispose of, or solicitation of an offer to buy, a

^{4/} See Rules 433, 434, 434A. It also permits oral offers with certain limitations.

security for value. In this context, it is obvious that the term "offer" is far from limited to an express and overt offer. Whether a given activity would fall within this definition therefore can be determined only by a consideration of all the facts and circumstances surrounding a particular case. Factors such as intent, knowledge and time would be important considerations in determining whether a person must be regarded in a particular situation as being involved in an attempt to dispose of a security within the intent and meaning of the Act. For these reasons, the Commission has never believed it appropriate to attempt to formulate a rule-of-thumb definition in this area and has endeavored to deal with the problem on a case-by-case basis. But as this body of case history has evolved, I think that certain principles or guides have become apparent which might be of help in this difficult but important field.

The provisions of Section 5 of the Securities Act apply in general to three classes of persons, that is, to issuers, to underwriters and to dealers. An issuer or its officials or employees cannot legally begin to offer a security to the public prior to the filing of a registration statement, nor, as we see it, can they engage in a publicity campaign prior to the filing which is part of an effort or plan having for its purpose the sale to the public of a non-exempt security. This does not mean, of course, 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. Most certainly an issuer may continue the normal conduct of its business and may communicate with its security holders and customers prior to the filing of a registration statement or during the so-called "waiting period." Thus, it may continue to publish advertisements of its products and services without interruption. It may send out its quarterly, annual and other periodic reports to its security holders. It may publish its proxy statements, send out its dividend notices and make routine announcements to the public press and to employees without objection from the Commission. Indeed, we do not normally regard these activities as any of our business nor do we wish to be concerned with them. But when, shortly before the filing of a registration statement or during the pre-effective period, public communications of various sorts begin to appear which discuss such aspects

of a business as its finances, its earnings or its growth prospects in glowing and optimistic terms, stressing the favorable over the unfavorable, I think we may be pardoned if we are so unkind as to suspect that this activity may not be entirely concerned with the sale of soap or machine tools or what have you.

It was clearly indicated in Release No. 3844 that the publication by an issuer of its annual report at the usual time and with the usual content though coincidental or approximately so with the filing of a registration statement would not appear to be in violation of Section 5. On the other hand, it takes no great imagination to visualize the annual report which contains puffing statements becoming the vehicle for a message to stockholders who are about to receive warrants to subscribe to a new issue of common stock of the issuer, which might raise serious questions whether the issuer was not in fact beginning the offering of the common stock by this means. Nor is such a course of action beyond the ingenuity of corporate officials or counsel. You, in Chicago, may recall that the annual report of Montgomery, Ward for the year 1954 was published while Mr. Wolfson was attempting to gain control of the company. Under our proxy rules as they then stood, the annual report was defined not to be proxy soliciting material. The inclusion in this annual report of comments upon Mr. Wolfson's activities was clearly a part of the management's campaign in the solicitation of proxies. That incident was in part responsible for an amendment to our rules in 1956, bringing that portion of an annual report commenting upon the opposition participants in a proxy fight within the purview of the proxy rules.

The questions relating to issuers which are most frequently presented concern press releases and speeches by corporate officials during the pre-filing or pre-effective periods. A press release by a corporation announcing some event in its business would not seem to us to present any particular problem. The announcement of a dividend, the receipt of a contract, the settlement of a strike, the opening of a plant or any similar event of interest to the community in which the business operates have never been looked upon with askance. However, that does not mean that purported news items which tout the companies' securities or which dwell upon the financial

aspects of the business ordinarily associated with the sale of securities shall be viewed in the same light.

Many of you are familiar with a practice of long-standing followed by many companies in preparation for a rights offering. Corporate officials know from experience that a certain percentage of rights are not exercised by security holders for various reasons. Accordingly, they have felt it desirable in order to prevent loss to the stockholders and underwriting expense to the corporation to notify their stockholders prior to the filing of a registration statement that the proposed offering would be made in order that the stockholders might be prepared to act when the subscription rights were issued. Such advance notice was, however, recognized as being an offer or at least a step in the offering taken prior to filing and therefore as a possible violation of Section 5. As a practical matter, the Commission has consistently agreed that such advance notice for this limited purpose was permissible under the spirit of the Act, if possibly not under its letter, so long as the content of the notice was limited to notice and was not embellished with material of a sales character. In this connection I refer you to Rule 135 under the 1933 Act.

Fairly frequent inquiry is made to us concerning the status of speeches by corporate officials before groups of financial analysts or similar trade organizations. We understand that such an address is usually scheduled by the societies some time in advance at a time when there may be no contemplation of an offering. It sometimes happens that the date so scheduled for the speech is sufficiently close to a proposed filing of a registration statement as to cause some concern to counsel for the issuer or underwriter. I do not believe that the Commission has ever expressed the view that such a speaking engagement made in advance with a financial analysts' society should be cancelled or even rescheduled. We think it is incumbent upon the executive, however, not to phrase his talk in such a manner as to constitute a selling effort, and we have from time to time expressed the view that any public distribution of the speech and of the material sometimes employed in connection therewith might well raise a serious problem under Section 5. Perhaps I can point up the latter observation to some extent. I think you would all agree that an issuer or an official of an issuer could not properly

distribute to the public, or to a group of people who might redistribute to the public, copies of a draft of a Securities Act prospectus with the old red-herring legend prior to the filing of a registration statement. The parallel is, to my mind, perfectly clear. And it is generally conceded, I hope, that a person should not be permitted in this field to do indirectly that which he should not do directly.

The problem which faces the broker-dealer in this respect differs in some measure from that facing the issuer. On the other hand, we believe that a managing underwriter, or a sole underwriter, has a duty and responsibility somewhat different from that of other broker-dealers who may or may not become participating underwriters.

The broker-dealer is in the business of selling securities and advising customers in securities matters and, in a sense, it could be said that all of his activities have as their ultimate objective the purchase or sale of securities. It is obvious, however, that the ordinary course of the business of a broker-dealer, and the business of a broker-dealer as a participant in a distribution of securities by or for the account of an issuer or a controlling person under the Securities Act, are two separate and distinct functions. Basically, I suppose, it is only when these two functions by inadvertence or deliberate design collide or merge, depending upon how you view the matter, that any problem arises.

A ready-made analogy and another aspect of this same fundamental problem is found in the limitations placed on the trading activity of a broker-dealer during the period preceding the marketing of a registered issue. In substance, Rule 10(b)6 of the Commission's rules under the Exchange Act provides that an issuer, an underwriter or prospective underwriter, or any other person who has agreed to participate in a distribution may not bid for or purchase securities of the class and series being or to be distributed or attempt to induce any other person to purchase such securities prior to completion of his participation in the distribution. ^{5/} A prospective underwriter is defined as a person

5/ The Rule contains a number of exceptions for transactions of a character not likely to effect the market price, or conducted in conformity with other Commission rules, as well as a special exception permitting certain over-the-counter purchases up to 10 days before the proposed commencement of the distribution.

who has agreed to submit or who has submitted a bid to become an underwriter where the securities are offered at competitive bidding, or who has reached an understanding with the issuer or other persons on whose behalf a distribution is to be made, that he will become an underwriter, whether or not the terms and conditions of the underwriting have been agreed upon. The rationale underlying this rule is clear. An underwriter who is going to participate in a public distribution of a security ought not to be free to effect transactions in the security under circumstances which might affect the free play of the market place so as to benefit those preparing for the distribution.

Now, the Commission is fully conversant with the power of the public press, the printed word and the technique of radio and television. We are not unaware that a nice piece of publicity properly timed and skillfully executed can be just as effective in affecting the free play of the market place as is a series of securities transactions. The principles which concern us here are essentially the same as those applicable to securities trading. We do not believe that a managing underwriter should engage in any publicity activities with respect to an issuer, or the securities of an issuer which is planning a public offering of a registered security which would be improper if done by the issuer. Further, we believe that a managing underwriter should certainly not engage in publicity activities at a time when, under Rule 10(b)6, he would consider that it would be inappropriate for him to effect transactions in the company's securities. It might be well to keep in mind in this connection that most of the illustrative cases cited in Release No. 3844 involving conduct by underwriters were cases in which the underwriting firm was a managing underwriter or the sole underwriter.

It has been pointed out that in many cases the firm, which has traditionally been a managing underwriter for an issuer, is aware that the issuer's plans will require the public sale of additional issues of securities periodically in the future and has every reason to assume that the traditional business relationship

5/ (continued) This latter exception is designed to meet certain peculiar problems in the over-the-counter market where prospective underwriters may include those firms who normally make the market.

will be continued. The question has been asked whether the Commission considers that under these circumstances the firm, in order to obviate the risk of violation of Section 5, must avoid giving out any comment or advice to its customers and others concerning that issuer and its securities. We do not take that position. Further, the Commission believes that the firm ought to discharge what it considers to be its duty and obligation to its customers as a broker-dealer by reporting on and advising concerning events of significance in the business of the issuer. When the firm knows, however, that a particular financing has been determined upon and that the firm will be a managing underwriter, it seems equally obvious that the timing and content of the advice thereafter given its customers through reports and brochures will determine how these documents must be viewed in relation to the forthcoming offering and the provisions of the Securities Act. If the firm has published a report on the business of the issuer and the issuer thereafter should, due to market conditions, unexpectedly file a registration statement, the fact that the proposed offering was not in contemplation at the time of publication of the brochure would seem to be persuasive that the firm was not engaging in a sales effort with respect to the forthcoming issue.

The second type of situation which seems to have concerned several firms is presented when the firm publishes periodically and in the usual course of its business, either in accordance with a pre-arranged schedule or from time to time, reports and analyses of industries, i. e., the so-called industry surveys or reports which deal with selected companies in a particular industry. This problem has been presented not only by firms who from time to time may be managing underwriters but also by firms who in the past have been and in the future expect to be invited to join underwriting groups marketing issues of companies in such industries. As I have already explained, the Commission believes that after a broker-dealer firm knows that a particular financing is being prepared for market and that it will be a managing underwriter, the publication of an industry report on that industry prior to the effective date of the registration statement should, as a general rule, be avoided. However, it is conceivable that there could be a form of industry report which was so statistical in character or so devoid of material of a sales nature as to raise no question. The types of report so far

considered by the Commission in the questions presented to it have not been so limited and have usually contained specific or implied recommendations.

The broker-dealer firm which is not customarily a manager for the issuer but which may from time to time be invited to participate in an underwriting has, as we see it, a problem different at least in degree. As we understand it, these firms are less likely to know in advance that particular issuers have determined to bring a particular issue to market at a particular time. Many of them learn of a forthcoming offering only when they are approached as prospective underwriters shortly before the filing of a registration statement. They then frequently discover that they have distributed brochures, recommendations and opinions to their clients just prior to receiving an invitation to join the group or they may have spent considerable sums and much time in the preparation of a report which is scheduled for release on a date which is just after the firm has received such an invitation or just at or about the time it learns that a filing will be made in which it anticipates that it will receive an offer of a participation. These firms are quite naturally and reasonably concerned lest the work of their research departments will in effect prejudice their position and their opportunities to participate as underwriters or lest the expense and time spent on research must be wasted.

I do not believe that the Commission knowingly has penalized any broker-dealer firm caught in this predicament. When the publication is scheduled for distribution after the firm has received information as to its participation, we have suggested that the report might be modified so as to delete material specifically discussing or recommending the particular issuer, or to limit the presentation concerning that company to previously published statistical data. We do not intend to prejudice the normal routine activities of a firm in the conduct of its broker-dealer business, nor the relationships between that firm and its customers in situations where the firm, without knowledge of a prospective participation in a distribution, has sent to its customers the type of communication normally sent in the conduct of its business. The Commission does believe very strongly, however, that the research and new business departments of broker-dealer firms should be on speaking terms with each other and that a businessman's judgment

ought to be examined in these situations with an awareness that he has a responsibility for a certain amount of self-discipline under the statute.

The Commission does not desire to interfere with the financial plans of issuers. It derives no pleasure in taking disciplinary action against brokers and dealers. It would much prefer to see the industry recognize the problem and deal with it on a sensible basis. At the same time, I think you should remember that the so-called clearance of the Commission is no guarantee of the point of law or fact which is passed on. Under the Securities Act, every participant in a distribution takes certain risks. We can tell you that the Commission would not feel impelled to interfere with a proposed transaction under a given state of facts, but we cannot tell you whether a judge and jury would decide that the same actions are part of the selling effort, hence constitute a violation of the Act and hence impose certain civil liabilities. It is the duty of the issuer and the underwriters and their counsel to determine for themselves the nature and extent of the risk and be governed accordingly. We are perfectly willing to give our opinions in these matters, though I think that it should not be necessary to seek our advice in every situation of the character I have been discussing today.

The fact is that all through the history of the rulings of the Commission in dealing with this question runs a consistent and simple logic. If the material submitted is reasonably to be considered as a part of the selling effort, it comes within the purview of the statute. If not, then it is none of our business. The ultimate determination must be made on an ad hoc basis, and must involve the exercise of judgment in evaluating matters of degree. One firm observes another's practices and enlarges on them a little bit. A little firm observes the conduct of a big firm and the little firm rightfully concludes that the type of conduct followed by the big firm is equally permissible for it. Bit by bit a practice spreads and in the words of a former Chairman of the Commission: "I think there is a kind of unadmitted subconscious feeling, even on the part of those familiar with the business, that if the S.E.C. does not move in to thwart a particular practice of doubtful integrity, the practice becomes ipso facto validated." I do not understand that this result follows.

The sole purpose of Release No. 3844 was to remind you that the primary responsibility for the observance of Section 5, which hasn't been talked about very much since the 1954 amendments, remains in your hands. The Commission has in mind preparing a further release which may serve in some measure to clarify Release No. 3844 along the lines we have been discussing today. I would like to hear your reactions to this discussion which may give us some help in this rather difficult task.