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"Gun-Jumping" and the Broker-Dealer's Dilemma

One of the more troublesome problems facing the corporation about to go to the public for capital is how to handle publicity about the public offering on one hand and general corporate disclosures on the other. The pervasiveness of the problem is illustrated by the impact it has on those whose business it is to analyze significant corporate developments and make investment recommendations or decisions--broker-dealers, investment advisors and financial analysts.

Perhaps part of the problem may be traced to the very use of the ominous-sounding term "gun-jumping." The term has been loosely defined to refer to both the premature offer of securities before a registration statement has been filed with the SEC (a violation of Section 5(c) of the Securities Act) and the premature sale of securities before a registration statement has taken effect (a violation of Section 5(a) of the Act).

I would like to focus on the gun-jumping problem primarily from the standpoint of the financial analyst and broker-dealer, for two reasons. First, some of the more interesting and subtle aspects lie in that area. And second, there are four pending SEC rule proposals which, if adopted, might provide substantial guidance to the investment community about investment information and advice during the registration period.

Let me make it clear at the outset that since the Commission still has under consideration the proposed new gun-jumping rules, I have formed no final judgment on whether or in what form any such rules should be adopted. It should be equally clear that my remarks today do not necessarily reflect the views of my colleagues on the Commission or on the Commission's staff.

Two functions

For the broker-dealer the gun-jumping problem derives from the dual functions he performs. On the one hand, the broker-dealer serves as a financial analyst, making objective appraisals of the merits of various securities and issuers in order to make investment recommendations to his customers. This is an investment advisory function (despite the absence in most cases of any special fee). Some of the broker's customers might have initially purchased such securities on his recommendation. It has sometimes been said[1/] that the broker-dealer has a continuing obligation to his customers to furnish current information and advice.

Of course, shareholders of companies receive annual reports, proxy statements and other communications from management which may provide investment guidance. But the invaluable "extra" the broker-dealer adds is professional analysis and advice. His customers expect him to render this and, hopefully, his experience and ability enable him to render it well.

In addition to analyzing materials which are sent directly to shareholders by management, the broker-dealer is able to call upon other sources of information. Thus, periodic reports which are filed by companies pursuant to the Exchange Act may contain useful information for securities analysis. I might add that, if pending proposals to broaden the content of these reports are adopted, their usefulness as a source of investment information will be greatly enhanced. The broker-dealer can serve as a prime instrument in the dissemination of the information contained in such reports, thereby expanding their value as media of current corporate disclosures.

Broker-dealers may have access to other sources of information as well, such as interviews with management and personal examination of a company's facilities. The broker-dealer may thus be able to generate an up-to-date analysis of a company and to draw investment conclusions from that analysis which the ordinary investor would, at the very least, find difficult to do.

1/*See, e.g.*, Wheat Report, p. 145.

But the broker-dealer has a second function, apart from providing investment advice. He is a purveyor of the securities whose issuers he analyzes. He may buy and sell securities for his own account and as agent for his customers. In the usual case, this aspect of his business is where he makes money; as I indicated, such investment advice is generally rendered without separate charge. If the customer agrees with his broker's recommendations, he will ask the broker to act on the recommendation by buying or selling securities. Where ordinary trading transactions are involved, the potential conflict between rendering investment advice and executing transactions based on that advice is at a tolerable level. Rules concerning churning, unsuitable recommendations, and failure to know your customer, are aimed at keeping that potential conflict within tolerable limits, just as is the general development toward professionalization of members of the securities industry.

But where a registered public offering is involved, the conflict is sharpened between the broker's investment advisory function and his specially compensated sales or distribution function.

If the broker-dealer is a member of the underwriting syndicate or dealer group, he will receive compensation for selling the publicly offered securities to his customers substantially greater than customary commissions in normal trading transactions. Moreover, if he fails to sell his allotment, he stands to lose a good deal. This also is different from the normal brokerage posture. Thus, the incentive is greater to make statements about the securities and issuer that go beyond the type of conservative, purely factual disclosure required in a registration statement and prospectus. Hence, the specific requirements of the Securities Act, which provide that a public offering of securities may be made only in a certain prescribed way. The prescription is intended to ensure that the investor will, in general, have available full, fair and objective disclosures about the securities being offered on which to base his investment decision.

The three periods

Thus, the Act provides that, prior to the filing of the registration statement, no offers or sales by the issuer or any prospective participant in the distribution of the securities to be registered may be made, either oral or written, if through the mails or instrumentalities of interstate commerce.

After the registration statement has been filed, oral offers (including recommendations) may be made as long as they are factually correct and complete. The only written offers which may be made during this so-called waiting period between filing and effectiveness are those that take the form of the statutory prospectus, filed as part of the registration statement. The waiting period, between filing and effectiveness of the registration statment, is a time during which investors and their advisors should have the opportunity, in the words of a 1964 Commission release,[2/] "to become acquainted with the information contained in the registration statement and to arrive at an unhurried decision concerning the merits of the securities." And, of course, before effectiveness, no sales may be made.

After the registration statement has become effective, sales may be made, as long as a final prospectus is furnished to the purchaser before or with confirmation. To the extent that additional offers are made after effectiveness, written offers are permitted as are oral offers. However, any written offers must be preceded or accompanied by a copy of the final prospectus. In addition, any dealer must deliver copies of the prospectus to purchasers for 40 days after the effective date of the registration statement. This period is lengthened to 90 days in the case of first-time registrants.

The familiar provisions which I have just described raise two interpretive inquiries: what constitutes an offer? Who is a participant? If it is an offer by a participant, the Act applies and that is that. This audience, however, knows it is not that simple. So let me discuss the matter further, taking up the second question first.

2/Release No. 33-4697.

A "participant"?

The initial question any broker-dealer must ask to determine whether he is subject to the gun-jumping rules is whether he is a "participant" in a public offering. The requirements apply with equal force to those who participate in distributions or public offerings of securities, as well as to corporate issuers. This is because under the Securities Act, an underwriter, as that term is defined in the Act, is subject to the registration requirements. An underwriter is not merely someone who is a member of an underwriting syndicate; the term broadly encompasses any person who participates in a distribution of securities.

A broker-dealer is clearly a participant in a public offering or distribution if he is a member of the underwriting syndicate, dealer group or otherwise receives consideration from the issuer or any underwriter with respect to the public offering. Although ordinarily it will not prove difficult to determine whether a broker-dealer is a participant, the question is not without its subtleties. For example, if there is an informal understanding that Broker-Dealer A will recommend securities underwritten by Broker-Dealer B even though A is not a member of the syndicate, in return for which Broker-Dealer B will recommend securities underwritten by A under like circumstances, a reciprocal arrangement involving an element of consideration exists. This would present opportunities for abuse of the Securities Act prohibitions on unrestricted selling efforts. Under such circumstances, I would think brokers so involved would be deemed participants in both distributions.

Another problem area involves publicity generated by the issuer, but facilitated by an otherwise non-participating broker-dealer. If, for example, management of an issuer in the process of going public conveys projective data to a broker-dealer in the expectation that the broker will publish this data and disseminate it to customers with a "buy" recommendation, then the broker may be aiding and abetting a gun-jumping violation by the issuer, even though the broker is not formally a member of the selling group.

A recent example will serve to illustrate difficulties brokers may encounter in this area. I preface the example by stating that since it involves a position taken by the staff of the Commission--and not a position of the Commission itself--I do not necessarily regard it as a firm precedent. A broker-dealer firm ran ads in newspapers with respect to a proposed rights offering. The ad stated that the offering was "your chance to make money" and invited the public to a series of meetings to be held to discuss the proposed offering. The broker-dealer was also mailing soliciting letters of the same type to potential customers. Although the offering was not to be underwritten and although it was established that the issuer knew nothing about the ads and had done nothing to encourage them, the Commission's staff informally requested that the broker-dealer discontinue the ads and letters and postpone the public meetings. The staff's view was that the promotional effort directed specifically at the securities under registration promoted their proposed distribution for which the broker-dealer firm would earn commissions from soliciting exercise or sale of the rights.

Obviously, if carried to an extreme, it could be argued that almost any favorable recommendation of a stock might be construed as facilitating the distribution of new securities to be publicly offered and as providing an economic benefit to the broker-dealer. That a recommendation to buy by itself makes a participation goes too far. Such a construction would be not only harsh, it seems to me, but inconsistent with the purpose of the federal securities laws.

So let us now take a broker-dealer who is not a member of the underwriting syndicate or the selling group and does not have any arrangement direct or indirect with the distribution apparatus. Are there nevertheless inhibitions on what this broker-dealer can say or recommend to his customers about securities that are the subject of a public offering? That requires some analysis. Suppose the offering is of securities where there are securities of the same class already outstanding. Let us further assume that it is a reporting company, so there is plenty of information around on which to base recommendations. In that situation the true nonparticipant is free

to advise his clients, orally or in writing, as he chooses. I am assuming, of course, that the recommendation is made in good faith and on a reasonable basis. If there is some manipulative scheme being carried out, Rule 10b-5 reaches that.

Certainly, if his recommendation is adverse, to sell, there is no conceivable purpose served by seeking to preclude such divergence in viewpoint from the opinion of the sponsoring underwriter. (If anything, it is to be encouraged!) And, of course, a sell recommendation to an existing holder is hardly an "offer" of additional securities being underwritten.

Even if the recommendation is favorable, to buy, I can see no basis to apply "gun-jumping" to the true nonparticipant. Nor do I think it necessary that the analytical basis for the recommendation must necessarily come from the prospectus itself. The analysis might rely on general industry trend data and technical market data, neither of which are necessarily reflected in the prospectus itself. Even if the recommendation were based on predictive material, I don't see the objection, although this could be more troublesome because the usual source of predictive material is the management of the issuer and this raises the aiding and abetting problem I mentioned earlier.

What I have just said must be qualified with respect to the post-effective period. If a broker-dealer makes a recommendation and thereby solicits a buy order after effectiveness, he cannot be sure that the particular security he is selling will not be from the distributed offering, which for purposes of prospectus delivery requirements continues for 40 days after the commencement of the offering. If the broker sells securities which were part of the public offering, he becomes a participant in the distribution at the time of such sales. Therefore, while his earlier conduct may present no problems, he can totally protect himself after effectiveness only by accompanying a written recommendation with a prospectus. The proposed rules which I shall discuss later would largely dispose of this post-effective problem.

Now let us assume the issuer is not already a publicly held company. In such circumstances, as the court cases and the Commission's promulgations have consistently indicated, almost any favorable announcement or prediction outside the four corners of the registration statement may have the inevitable effect, in the words of a 1957 Commission release, of "conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort."3/ There are no securities other than those being offered to which the recommendations can apply. Therefore, where there is a new issuer involved, even though the broker may not be a member of the selling group, he should refrain from any favorable recommendations except in conjunction with the prospectus, if there is any possibility that he may be active in the after-market. Here, unlike the case of the broker engaged in post-effective participation in the distribution of a seasoned issuer's securities, there is a requirement that prospectuses be delivered for 90 days after effectiveness. There is no proposal to change that requirement. Thus, the broker engaging in post-effective transactions in newly issued securities of a first-time issuer may become a participant. At that point, again unlike the case involving a seasoned issuer, the broker's pre-effective recommendations could become gun-jumping violations. This is because, as I have noted, the earlier recommendations could only have applied to the publicly offered securities and the broker's post-effective participation in the distribution would tend to confirm that he was an indirect participant in the pre-effective period as well, but simply expected to sell only in the after-market.

The question of participation is a central one, since it is the fulcrum on which turns the question of whether the broker-dealer or analyst is subject to the gun-jumping rules.

3/Release 33-3844.

An "offer"?

Assuming that the broker-dealer is a participant in the distribution, the next question is what type of conduct might be deemed an "offer" of the securities to be distributed publicly, thereby invoking the gun-jumping prohibitions. In other words, to what does the offer apply?

To begin, a recommendation to sell a security, or against buying it, could hardly be construed as an "offer" except in unusual circumstances--such as where there is an exchange offer. If a broker wishes to make an adverse "don't buy" or "sell" recommendation, as I indicated earlier (assuming he has a basis for it), I see no impediment to his doing so at any time either orally or in writing.

Where the recommendation is to buy, it is possible to distinguish on a theoretical basis between recommendations respecting an issuer's already outstanding publicly held securities and offers to sell the new issue to be distributed. Practically, this distinction is often difficult to administer. In many cases, particularly for participants in the offering, it is simply not possible to draw the line. In those cases, the policies of securities regulation are best served by prohibiting the participating broker-dealer from disseminating any information or recommendations about the issuer except in compliance with gun-jumping rules that are carefully drawn to prevent preconditioning abuses. Where the broker-dealer is truly nonparticipating in the offering, the distinction is easier to make and greater breadth is possible.

The proposed rules

While the staff of the Commission has always made itself available for informal consultation on possible gun-jumping questions,[4/] it has become increasingly clear that there is a

4/Release No. 33-5009.

need for more definitive guidelines in the area. Currently, the only Commission rules on gun-jumping have been Rule 134, which permits certain very limited written notices outside the statutory prospectus to be circulated after the registration statement has been filed (including tombstone ads), and Rule 135, which permits limited notices to be distributed even before filing, but only in the case of rights, exchange and employee offerings.

Last fall, the Commission promulgated for public comment a series of proposed rules,[5/] growing out of the Wheat Report, which were designed to reduce some of the existing uncertainty in application of the gun-jumping doctrine, particularly as it may affect the investment industry.

In brief summary, proposed new Rule 135 would permit an issuer to give pre-filing notice of not only rights, exchange and employee offerings, but also merger-related offerings and indeed any public offering. The content of the pre-filing notice is also proposed to be somewhat expanded. The notice must state that the offering will be made by means of a prospectus and contain only the name of the issuer, the title and amount of the securities to be offered, the time of the offering, and certain basic information of a limited nature as to any rights offering, exchange offer, business consolidation or employee offering.

Many of the public comments which the Commission has received on this proposed revision of Rule 135 suggest that some additional information be permitted, including whether the public offering will be primary or secondary; whether it will be underwritten; if so, whether on a competitive bid, firm commitment or best efforts basis; the name of the managing underwriter; and a brief description of the issuer's type of business and of the securities to be offered. These comments are still under consideration, and it is not possible for me to indicate whether the rule or any of the suggested changes will be adopted.

5/Release No. 33-5010.

Of course, proposed Rule 135 is not intended to preclude the sort of customary corporate disclosure which the Commission has always countenanced. Thus, ordinary advertising for the company's products or services, the dissemination of periodic shareholder reports and routine press releases as to material corporate events may and should continue even during registration. At the same time, it might be well for company officials to advise the Commission's staff in advance of any proposed major publicity campaign or highly unusual corporate development as to which public disclosure is contemplated during registration. A special problem exists in the area of advertisements for mutual funds or companies selling investment company shares which are in continuous distribution and hence, continuous registration. Here, advertisements which do not comply with the specific tombstone requirements may constitute offers to sell fund shares and thus run afoul of the Securities Act.

Proposed Rule 137 deals solely with a broker-dealer or investment advisor which is not and does not propose to be a member of the underwriting syndicate or selling dealer group, and does not receive any consideration from or enter into any arrangement with the issuer or participating dealers. Such a broker-dealer or investment advisor would be permitted to publish and distribute information, opinions and recommendations in the regular course of its business respecting the securities of the issuer during the registration period, but only if the issuer is a reporting company filing periodic reports with the Commission under the Exchange Act.

In my view, this proposed rule merely represents the embodiment of existing law and practice, except that it is rather cautiously limited to reporting company securities. At least two public commentators on the proposed rule have suggested that it should apply equally to non-reporting companies. The difficulty to me with this suggestion is that it tends to discount the disproportionately greater significance which might be attributed to any such information or recommendations in the absence of other public information about the issuer in the Commission's files. It raises problems comparable to favorable recommendations on a first-time offering. It does seem to me that financial analysts and other members of the investment community should be somewhat hesitant to form factual conclusions about any company which has not been subjected to the requirements of public reporting, at least for purposes of public customer recommendations.

The proposed rule recognizes that in the case of reporting companies, there is an independent source of information, prepared in accordance with Commission rules and forms, to which the financial community is able to refer and check when it is formulating investment recommendations. On the other hand, the only publicly filed information about a non-reporting company is the registration statement itself. The underlying thesis of the proposed rule is that this should constitute the best evidence of what the company has done and the basis for any investment decisionmaking.

I might also point out here, because it is relevant to the present problem a broker-dealer has in making recommendations in the post-effective period, that proposed Rule 174 would totally eliminate the 40 day prospectus delivery requirement for reporting companies. However, the 90 day delivery requirement for new issuers would continue.

Proposed Rule 138 recognizes a special situation--the fairly large seasoned issuer filing a registration statement on Form S-7 or S-9 which has outstanding securities of a distinctly different class. If common or convertible preferred stock of such an issuer is outstanding, and the issuer wishes to offer a non-convertible debt security or a non-convertible, non-participating preferred stock, there seems little reason to prohibit a dealer, even a participating dealer, in the regular course of its business from giving information, opinions or recommendations relating solely to the outstanding common or convertible preferred. The proposed rule would permit that. Similarly, the rule permits a dealer in the regular course of business to publish information about a non-convertible debt or preferred security where the offering is of common or convertible preferred. One could imagine abuses here, and the regular course of business qualification was intended to prevent them.

Finally, proposed Rule 139 would permit any dealer, even a dealer participating in the distribution, to render information, opinions or recommendations in the regular course of its business about the securities registered if (1) the issuer is a reporting company; (2) the information or recommendation is contained in a publication regularly distributed for at least two years; (3) the publication contains a comprehensive list of securities currently recommended; (4) the recommendation is

given no special prominence and does not include projective data beyond the current year; and (5) a recommendation at least as favorable was included in the last previous publication.

As you can see, the permissive language of the rule is hedged by quite a few conditions. Since my summary of these proposed rules is necessarily brief, I am sure that each of you will want to examine the proposed rules carefully and completely.

Some of the public comments we have received concerning proposed Rule 139 suggest that the two-year publication provision could be shortened if the publication appeared weekly or monthly and that a dealer should be permitted at least to delete an adverse or "sell" recommendation in all cases, even though this might be construed as a more favorable recommendation.

In substance, the proposed rules, if adopted, would mean that issuers could with reasonable insulation from securities law liability issue concise, factual notices respecting proposed public offerings of their securities. Members of the investment community, including broker-dealers, investment advisors and financial analysts, would be able to rely upon largely objective standards to determine when and how they might comment on the securities of a company in registration.

Where the company is a new issuer or an issuer otherwise not filing periodic reports with the Commission under the Exchange Act, the proposed rules would provide no basis in and of themselves for any claim of exemption from the gun-jumping doctrine.

If the company is a seasoned issuer filing periodic reports with the Commission, a broker-dealer or investment adviser not participating in the distribution could, in the regular course of business, supply its customers with information and advice as it would normally do if there were no public offering contemplated. In addition, even participating dealers could, in the regular course of business, furnish information and advice about a company's outstanding junior

security where the public offering was to be a non-convertible senior security, or about an outstanding non-convertible senior security where the public offering was to be a junior security. They could also continue to furnish information and advice about securities in a publication which they had been regularly distributing for at least two years, provided such data was given no special prominence and the recommendations were not more bullish than previously given.

The proposed rules would answer many of the questions which currently confront the investment industry. But they would not provide a complete answer to every gun-jumping problem. For one thing, the rules are limited to cases involving reporting companies. Where a new issuer is involved or a company otherwise not subject to the reporting requirements, the basic concepts of "participation" and "offer" which I have discussed will still require consideration in every case.

The proposed rules do not provide guidance in some of the more unusual distributive situations, such as shelf registrations. The Wheat Report suggested some common sense guidelines in this area, but did not propose specific Commission rules. It seems to me that where securities are registered for the shelf by the issuer for use in possible future acquisitions, no gun-jumping problem will ordinarily arise until the securities are actually sold. Until that point, broker-dealers could not normally be participants since there is no underwriting involved. Of course, if a particular broker-dealer assists the issuer in an acquisition for which shelf-registered shares are issued, he would have to be careful to avoid gun-jumping questions. After the shelf securities are issued, the 40 day prospectus delivery requirement might apply, but it would not preclude continuing recommendations by broker-dealers as long as the delivery requirements were observed (for example, pursuant to Rule 153).[6/]

Where the shelf registration is for the purpose of permitting a secondary distribution, I believe that a broker-dealer should not be deemed a participant in the distribution until he actually receives an order to sell some of the

6/The Commission's staff has construed the prospectus delivery requirement as extending for only one 40 day period after effectiveness, regardless of any post-effective amendments. As I have indicated, proposed Rule 174 would abolish the 40 days delivery requirement for reporting companies.

registered securities. This is the Wheat Report's view. Assuming the transaction could be executed promptly, this would impose relatively little restriction on continuing recommendations. Again, of course, I am not speaking to manipulative schemes prohibited by Rule 10b-5.

Prior Cases

I have not said anything about litigation in the gun-jumping area up to now. Actually, there has been relatively little involving broker-dealers. One reason for this is that where violations on the part of a broker-dealer are detected, the particular broker will usually drop out of the selling group rather than hold up the public offering. As you probably know, the most common administrative tool which the Commission uses if there have been gun-jumping violations is to deny acceleration of the registration statement.

I would like to think that another reason for the absence of a great deal of litigation involving broker-dealers has been the generally responsible attitude on their part. It has been a long time since the Commission has encountered situations such as in the Van Alstyne, Noel case[7] in 1946, where the managing underwriter engaged in nationwide publicity, formed a selling group and even entered buy order tickets for customers, all before the registration statement was filed. Or the Arvida case,[8] in 1959, where the managing underwriters had issued press releases and held a press conference shortly after the public offering had been agreed upon but before filing. There information was announced concerning not only the terms of the proposed first financing, but also information concerning the prospects and plans of the company. It has not been quite so long since the Gearhart & Otis case[9] in 1964 where a broker-dealer circularized to dealers two months before the filing of a registration statement two articles discussing the prospects of a product of the company. Even though the articles contained no reference to the issuer or underwriter, the Commission found them to be the first step in the sales campaign for the securities.

7/22 S.E.C. 176.
8/38 S.E.C. 843.
9/Release No. 34-7329, aff'd, 348 F.2d 798 (D.C. Cir. 1965).

To be sure, the Commission is sensitive to publicity during the registration period which might have the effect of conditioning the market for the public offering. Nevertheless, I do not believe that the financial community as a whole should have to forget about holders of already outstanding securities during the registration period and refrain from analyzing the company's business with a view to making investment recommendations and decisions. There is clearly a need to strike a balance between, on one hand, providing reliable public information about a company which is already public and, on the other, avoiding the pitfalls of preconditioning the market for securities to be publicly offered.

It remains to be seen whether the proposed new rules will be adopted and whether they will appropriately achieve this balance. Be assured we are giving serious thought to this area.

Thank you.