ADDRESS

of

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THE INVESTMENT BANKER

and the

REGISTRATION AND PROSPECTUS REQUIREMENTS

OF THE SECURITIES ACT

The work of the Securities and Exchange Commission under the Securities Act and the Securities Exchange Act touches the day-to-day business lives of every one of you in two ways. In the first place, at least in the special fields in which that job has been delegated to us by Congress, we are charged with examining the rules of the game as they have been developed over the course of years, and deciding whether these rules have a background of common sense and fairness which makes it wise to sanctify them with legislative or administrative approval, or whether in the course of their development the rules of the game as it has been played have lost touch with the conscience and sense of fair play of the community and should be revised. When the rules have been examined, and either sanctified, or changed by Congressional action or by regulations of the Commission, the second part of our job comes into play: the job of seeing that the game is played according to the rules as they have been so sanctified or changed.

Just as there are two main parts to the Commission's work, so there are two kinds of speeches which can be made about the Commission's work. One of us can try to give you an idea of the way in which what you might call the Commission's mind is working on some problem of general policy, such as segregation, stabilization, margin requirements or the like, and to indicate to you the broad outlines of the Commission's program. If I were to make such a speech, I should doubtless be trying, perhaps without saying so, either to procure your cooperation in the development of a new policy which the Commission has decided to foster, or to give you a hint of the shape of things to come and a warning to you to mend your ways. You, if you listened to me, would be trying not so much to catch my specific words as to glean from my expression, my emphasis, or from what I didn't say, just what kind of a rabbit the Commission was going to pull our of the hat next.

The other kind of speech is perhaps not so much a speech as a lecture. It concerns itself not with whether the rules are wrong as they stand, or with what they ought to be, but with what they are. It recognizes that although you are all of you vitally concerned with what the Commission may do next, you are even more immediately concerned with what the Commission has done - with the meaning of those rules which are, at least for the present, crystallized as the rules of the game in our legislation or in our regulations. It concerns itself not with problems of policy, but with the problems of interpretation and administration which - I think - every one of you meets every business day of his life. It recognizes the sad fact that even when the rules of the game have become crystallized, nobody can understand them without a lexicon. Partly because I spend most of my time answering questions that you and thousands of others like you put to us in the

Commission every day, and partly because no one seems to have tried it before, I am going to try this morning to be that lexicon - or, at least, I am going to try to be a brief synopsis of some of the important parts of the lexicon. If when I get through any of you think that I have left out the important questions or have touched upon them too lightly, or have been just plain ununderstandable, you are welcome to say so, and I will see what I can do to be more complete and clear. For the present, however, I propose to confine myself solely to the Securities Act, a big enough field in itself to keep us all busy all morning.

The first, and most obvious, problem which confronts an investment banker under the Securities Act, whether he is acting as underwriter or dealer, is of course the apparently simple question of when he may sell securities which are not registered under the Securities Act. The simple answer, given without the exceptions, is - never. That is the cornerstone of the Securities Act: "Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly - (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell or offer to buy such security...." If that were all of the Act, none of us would have much trouble in understanding it.

When we come to the exceptions, however, the question becomes a little more complicated. First of all, we have the various types of securities which are expressly exempted from the registration requirements of the Act. You are probably familiar with most of these- securities outstanding before the effective date of the Act (at least, so long as they are not reoffered by the issuer or an underwriter) domestic governments and municipals, commercial paper, railroads, securities issued in voluntary exchanges or in corporate reorganizations under Section 77B of the Bankruptcy Act, and issues sold exclusively to residents of the state where the issuer is incorporated and doing business. This is not a complete, or even a very accurate, list, but it may serve for now. Secondly, we have the various types of small issues - not over $100,000 - exempted by the Commission's rules rather than by the statute itself. Exemption under these rules depends upon a rather complex set of conditions which are spelled out in the rules themselves, and which I do not think it necessary to try to describe.

However, even when you have satisfied yourself that the security you wish to handle does not come within any of these categories, you still have not solved the whole problem. In addition to the security exemptions I have mentioned, the Act exempts certain classes of *transactions* in securities, whether they be registered or not; and in particular, provides that transactions by dealers not participating in the distribution shall be exempt from the registration provisions of the Act unless they occur within one year after the first date of public offering by the issuer or underwriter. Consequently, if the security with which you are concerned has never been "offered to the public" by the issuer or underwriter - and by "offered to the public" the Act means, we believe, "offered for sale to the public in the United States" - you may handle it without regard to whether it has been registered and even though it has been outstanding less than a year. Warrants which have been distributed by a corporation to its stockholders without

consideration, stock issued by way of stock dividend, securities issued in corporate mergers, reclassifications or consolidations pursuant to stockholders' vote and not by way of sale, all may be safely dealt in by dealers without registration even though they may have reached the hands of the public. The same is true of securities originally offered by way of sale, but in transactions which were private in character, or which were confined exclusively to purchasers abroad. In cases of this kind it is not even important, at least from a logical point of view, that the securities shall have been held by their original purchasers for any given period of time; provided they were originally sold exclusively to foreign investors, or to private purchasers in the United States, who purchased for investment and not with a view to resale, they will not in our opinion have been "offered to the public" within the meaning of the Act. However, an issuer cannot of course be permitted to avoid registration under the Securities Act by the simple device of selling his whole issue to one or two people, or to foreigners, and claiming that it is a private offering, if he has any reason to suppose that the first purchasers are proposing to turn around immediately and resell the issue to the American public. Purchasers of that kind would themselves be underwriters, and the transaction would clearly be public in character. Only if the original purchasers were bona fide buying for investment could the transaction properly be regarded as private, and consequently, even though the length of time for which the security has been held by the original purchaser is theoretically immaterial, there would be great danger as a practical matter in handling a security very recently issued under a claim of private offering. The exemption would depend upon the actual intention of the original purchasers, and their actions in reselling after only a short period of time would naturally cast considerable doubt as a matter of evidence upon their intentions.

So far, I have assumed that the securities in which you are interested have already been sold or otherwise disposed of by the issuer or underwriter, and are now outstanding. A further variant of the problem, however, and one on which we are very frequently asked for opinions, arises with respect to when-issued trading in securities not yet offered by the issuer. Generally speaking, when-issued trading by dealers is just as illegal as trading in non-exempt, unregistered securities already outstanding. A dealer offering a security for sale on a when-issued basis is violating the Securities Act just as much as the issuer or underwriter would be if they were to start their distribution before the effective date of the registration statement.

As in the case of outstanding securities, however, this general principle too is subject to qualification. When the security is of a character, such as a municipal or a railroad security, which does not require registration under the Act, when-issued trading will likewise be perfectly proper. The same is true of securities to be exempt by reason of the circumstances under which they are to be issued, such as securities to be issued in voluntary exchanges or in reorganizations under Section 77B, but in these cases it should be remembered that at the time when the when-issued trading takes place no one can be absolutely certain that the securities when issued will in fact be exempt. Perhaps the issuer may find its exchange offer less successful than anticipated, and may be obliged to retain some investment banker, for a commission, to solicit exchanges. One of the conditions of

exemption for securities issued in voluntary exchanges is that no such commission for soliciting the exchange shall be paid, and consequently such payment would defeat the exemption. If, therefore, you propose to trade on a when-issued basis in securities which will be exempt not because of their inherent characteristics but because of the circumstances under which it is expected they will be issued, the only safe course is to make your contract conditional upon the actual existence of the exemption for the security when issued. Otherwise, you may find yourself in grave danger of being compelled to choose between violating your contract or delivering a security in violation of the Securities Act.

One further angle of the when-issued trading problem deserves consideration. As I mentioned a little while back, warrants given away by a corporation to its stockholders without consideration are not regarded as being "offered to the public", and therefore need not be registered, even though the securities which may be purchased by exercise of the warrants must be registered before the warrants are distributed. Since the warrants themselves will not have to be registered, the question has frequently been raised whether the warrants may be traded when-issued before the effective date of the registration statement covering the stock subject to the warrants. This question, I must confess, is one to which we have not yet been able to find a satisfactory answer. From a strictly logical standpoint, it seems difficult to conclude that a dealer selling or offering a warrant to subscribe to stock is also in any legal sense selling or offering to sell the stock subject to the warrant; the dealer does not own the stock subject to the warrant, and by his very act of selling the warrant he puts it beyond his power ever to own the stock. From an economic point of view, however, I think you will all agree that a market for warrants to subscribe to additional stock is very little different from a market in the additional stock itself, and that the considerations which prompted Congress to prohibit the creation of markets in stock before effective registration may well apply with equal force to the creation of markets in warrants to purchase the stock. The problem is one which we have had under serious consideration for some time; and I hope that in the near future it may be possible to publish an interpretative opinion clearing the matter up. In the meantime, I can only suggest that the conservative dealer should regard such trading as being of doubtful legality.

In the discussion thus far, I have been talking about actual sales of securities, whether on an issued or when-issued basis. The word "sale", however, as used in the Securities Act, has a very broad meaning - much broader than the meaning which most of us would give to it in ordinary usage. Not only does it include what we all think of as a sale; it includes also any contract to sell or dispose of a security, any solicitation of an offer to buy a security, or, in short, any attempt of any kind to dispose of a security for value. Moreover, (with one exception) no distinction is made between attempts to dispose of a security to the public generally, and attempts to dispose of a security to professional buyers, such as underwriters and dealers.

This one exception, of course, is pretty important, Specifically, it is an exception from the definition of the term "sale" of "preliminary negotiations or agreements between an issuer and any underwriter." This means,

as you all know, that in spite of the general prohibitions of the Act, the issuer of a security which is not exempt and is to be registered before being offered to the public may legally use the mails, even though the registration is not yet effective, to initiate discussions with prospective underwriters, and to enter into underwriting arrangements. What is perhaps not so clearly understood is the fact that the exception, which I quoted to you *verbatim*, goes no farther than to permit negotiations and agreements between the *issuer* and underwriters. Underwriters themselves are not permitted, before registration becomes effective, to take any steps to arrange the formation of a subunderwriting or selling group any more than they are permitted to offer or sell to the public generally during the waiting period. Furthermore, although the restrictions of the Act are in general directed towards the *seller*, rather than the *buyer*, of securities, in this one instance the buyer is prohibited from offering to buy to the same extent that the seller is prohibited from offering to sell. It is just as illegal for a dealer to write to an underwriter and ask for a place in a subunderwriting or selling group as it would be for the underwriter to write to the dealer asking him to take a commitment for a portion of the issue, or to write to members of the public asking for their orders. "Otherwise," as the House Committee said in its report on the Act, "the underwriter, although only entitled to accept such offers to buy, after the effective date of the registration statement, could accept them in the order of their priority and thus bring pressure upon dealers, who wish to avail themselves of a particular security offering, to rush their orders to buy without adequate consideration of the nature of the security being offered."

I said a little while ago that the word "sale" as used in the Securities Act means more than it does in ordinary speech, that it includes not only a sale as such, but any attempt of any kind to dispose of a security for value. This is a very important fact to remember, since it means that a violation of the Act by jumping the gun is not confined to cases where a formal tender and request for purchase orders is made. Almost any communication designed to procure purchasers, and actually tending to have that effect, is a "sale" within the meaning of the Securities Act.

However, in construing the word "sale" as it is used in the Act it is also necessary to remember the fundamental purpose of the twenty day waiting period. If this period is to have the effect of checking the abuses connected with high pressure salesmanship, it can do so only if during the period prospective purchasers have a real rather than a merely theoretical opportunity of access to the basic information upon which the investment value of securities depends. As you know, registration statements filed in Washington are immediately open to inspection by the public, but information in the Commission's files in Washington is of little direct value to the investment banker in California, or even in North Carolina. Consequently, although circulating information regarding a registered security to prospective purchasers may well be in violation of the Act even though not accompanied by a formal offer to sell, circulation of similar information *prior* to the effective date of registration may in many circumstances be in furtherance of the purposes of the Act, and not in violation of its provisions. This is the ground upon which the serding out of a red herring prospectus by the issuer or underwriter to prospective purchasers can be justified. To avoid violation of the Act, of course, a red

herring prospectus should be carefully limited to a fair summarization of the salient information contained in the registration statement, and should be used only for the purpose of circulating that information, and not as a solicitation of orders. Any emphasis on favorable factors or recommendation or expression of opinion as to the merits of a security, or any making of sales even after the effective date of registration pursuant to orders received before that date, or to persons who received only the red herring prospectus and did not receive a copy of the prospectus in its final form, would raise a pretty substantial inference of fact that the red herring prospectus had been used as an attempt to dispose of the securities, and that its use had violated the Securities Act.

Discussion of the red herring prospectus leads naturally into the second major problem which the investment banker faces in operating under the Securities Act, namely, the problem of the application of the prospectus requirements of the Act. This problem raises two main questions: first, when must a dealer or underwriter furnish a purchaser with a regular "offering" prospectus of the kind filed with the registration statement, and second, what other kind of communications or advertisements may a dealer or underwriter use in offering securities for sale. In considering these questions, I will confine myself exclusively to the case of registered securities, since, as I have indicated, if the securities are unregistered, it must mean either that any offering of them by an underwriter or dealer would be in violation of the Act, or that the securities or the transaction of offering were exempt from the registration and prospectus requirements.

The answer to the first question, when must a dealer or underwriter furnish the purchaser with a regular offering prospectus, is simple. Assuming, of course, that the mails or interstate commerce are used in the sale, an underwriter, or a dealer who has taken an allotment from the issuer or underwriter, must continue to furnish such a prospectus in distributing his allotment, until his distribution is completed. If an underwriter or distributor gets rid of all his securities and then acquires more in the market, he may be exempt from this necessity even though the shares he gets back are part of what he distributed; but until that happens - until he has completed the distribution, even though it may take twenty years - every sale made by a distributor must be accompanied or preceded by a full prospectus. If the sale is more than thirteen months after the original offering date, the information in the prospectus must be as of a date not more than twelve months ago; and even before the expiration of the thirteen months period the prospectus must be complete and accurate as of its date in all material respects.

Dealers not participating in a distribution are subject to no such life sentence. In fact, the Securities Act is only incidentally concerned with such dealers. Primarily, the Securities Act is concerned with distribution, not trading, and its specific purpose would be served without any requirement that the ordinary dealer - who simply acquires shares in the market and has no remote connection with any plan of distribution - should ever deliver a formal prospectus. However, Congress feared that a test based upon actual participation in distribution might be an unsatisfactory one, difficult for dealers to understand and difficult for the Commission

to enforce, because of its essentially factual nature. Here is the language of Congress on the point: "Recognizing that a dealer is often concerned not only with the distribution of securities but also with trading in securities, the dealer is exempt as to trading when such trading occurs a year after the public offering of the securities. Since before that year the dealer might easily evade the provisions of the act by a claim that the securities he was offering for sale were not acquired by him in the process of distribution but were acquired after such process had ended, transactions during that year are not exempt. The period of a year is arbitrarily taken because, generally speaking, the average public offering has been distributed within a year, and the imposition of requirements upon the dealer so far as that year is concerned is not burdensome". Whether or not Congress was right in its belief that a test based upon actual participation in distribution would be too difficult to apply, or in its belief that the one year prospectus requirement finally adopted would cause no undue hardship, is another question of policy which I will not discuss now. In this connection, however, you will perhaps recall that the original Securities Act lifted the prospectus requirements only after a year from the last, rather than the first, date of public offering. This at least was clearly a mistake - no dealer could reasonably be expected to determine at his peril when that vague process called a "distribution" was completed. The mistake was soon caught, and in 1934 the Act was amended to read as it now stands.

Generally speaking, that disposes of the question of when an underwriter or dealer must deliver his prospectus. My second question is whether and when an underwriter or dealer may use any other kind of communication or advertisement to call the attention of prospective purchasers to the securities offered. This question is a little more difficult to answer. The first thing to remember is that the Act generally prohibits the use of any prospectus concerning a registered security unless it complies with the formal prospectus requirements of Section 10, that is, unless it is a formal "offering" prospectus of the kind filed with the registration statement, or is a "newspaper prospectus" of the special type permitted for advertising securities registered on Form A-2. Consequently, the question can be answered only by knowing exactly the technical meaning which the Act gives to the term "prospectus".

Every investment banker knows what he means by a "prospectus". The word has an ancient and honorable history; my dictionary tells me that it was first used in its present sense as far back as 1777. But not every investment banker knows that the Securities Act merely adopted the word as a convenient short hand way of describing the entire range of methods by which one person may endeavor to sell a security to another. "Prospectus", as defined in the Act, includes not merely the time-honored prospectus as we have known it, but every communication, written or by radio, which offers a security for sale, solicits an offer to buy a security, or attempts in any way to dispose of a security for value. "Attempts to dispose of a security" is a broad term, as those of you, if any, who are lawyers, will be fully aware. Whether a particular letter or advertisement is a prospectus will consequently turn not upon the application of general rules but upon a consideration in each case of whether the communication as a whole, read in the light of the circumstances of its use, is in fact an attempt to dispose of a security. A letter or

advertisement may have plastered all over its face statements that it is not a prospectus, that it is merely informative, that it is addressed only to banks, brokers or dealers, or that it is not an offer to sell a security; if it describes or refers to a security, directly or indirectly, in such a way as to make it possible for the reader to identify the security referred to, and if it is sent by a person ready and willing to fill orders to a person expected to give orders, it will be a prospectus.

What I have said is the general principle, and like so many other general principles, subject to qualification. Although the Securities Act broadly defines a prospectus as including any communication that offers a security for sale, the Act recognizes two exceptions to this principle. The first of these is intended to permit a dealer who has already sent a true prospectus - giving the fundamental factual information required by the policy of the Act - to follow this prospectus up with supplemental information of whatever kind and in whatever form he wishes. As stated in the Act, "a communication shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of Section 10 was sent or given to the person to whom the communication was made, by the person making such communication or his principal".

Taking the language of this section literally, you will note that its requirement is merely that the full prospectus shall have been *sent* prior to or at the same time with the supplemental communication. On its face, this section would permit a dealer to put a prospectus in third class mail, and as soon as he had dropped it in the slot send out a telegram or a letter by first class mail, describing the security he was trying to sell in complete disregard of the prospectus requirements. Obviously, such an interpretation would in many respects completely defeat the effectiveness of the prospectus requirements, and consequently I have no hesitation in expressing the opinion that the Commission and the courts would construe the section in the light of its evident purpose, and hold that a communication lost the benefits of the section unless the full prospectus had been sent or given under such circumstances that, considering the means used for its transmittal, the prospectus could reasonably be expected to reach the person to whom it was addressed prior to or at the same time with the supplemental communication.

The second important exception to the general rule covers the so-called tombstone advertisement. Here again, I must quote the Act, as its specific conditions are very important. "A notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of Section 10 may be obtained and, in addition, does no more than identify the security, state the price thereof, and state by whom orders will be executed." If you consider carefully the language I have just read, you will see that the reason why a tombstone advertisement is legal is not that it does not offer a security for sale (the financial legal cult seems to have felt that a protestation on this point gives the tombstone some additional immunity), but that even though it offers a security for sale it is arbitrarily excluded by the language of the Act from the definition of prospectus, and from the prohibitions against incomplete prospectuses. It is absolutely unnecessary to include in a tombstone advertisement a legend stating that the advertisement is not an offer; within the meaning of the Securities Act, and

for practical purposes, that is just what it is - an offer of a security for sale, and to say it is not is not only unnecessary but also probably untrue. What is important is that if it contains the information required to be contained, and contains no other information than that expressly permitted, it may legally be published in the newspapers or circulated by mail even though it does offer a security for sale.

I have spoken of the information required to be included in an advertisement of this kind. The one affirmative requirement, you will note, is that the advertisement state from whom a full offering prospectus may be obtained. This statement *must* be included, or else your advertisement will be a prospectus. Undoubtedly Congress felt that people whose attention was directed to a registered security by means of such an advertisement should be given affirmative advice that more detailed and complete information was available upon which they could base their decision whether or not to purchase, and should be told where that information could be procured.

Assuming that the advertisement includes the required statement, there are still plenty of headaches left in deciding just how much additional information may be included. What, for instance, is sufficient - and not too much - to "identify" a security? "Class A Common Stock of the XYZ Company" clearly comes within the bounds; "Class A Common Stock of the XYZ Company, a conservative, well-managed investment trust" equally clearly goes too far. Even though the comment as to the conservatism and good management be unimpeachably true, it is not part of an identification of a security but is a description of its merits. The line lies somewhere in between. Every case of course depends upon its own facts, but as a general rule I should like to suggest that a fair construction of the words "does no more than identify the security" will permit only such identification as would be necessary and appropriate to enable a prospective purchaser to approach a dealer and indicate specifically the particular security in which he is interested. The precise information permitted by this test would, of course, depend upon the formal name of the security, whether there were other securities of the same issuer from which the security in question must be distinguished, and other similar factors, and would in some part be affected by the custom of the trade at the time and place involved. Information unnecessary for such identification and included for the purpose of indicating the character of the issuer or of its business, or the quality of the security, or other purely descriptive purposes, would exceed the bounds of the identification permitted.

Just one more word, and I will give the floor to anyone who wants to ask questions, or to start telling me what the Act means, or ought to mean. Throughout this discussion I have used the words "underwriter" and "dealer" rather than "investment banker", because those are the words used in the Securities Act and I assume that all of you act at times as underwriters and at times as dealers. I have not so far used the word "broker", which of course describes another important part of your business. This is for the reason that the Securities Act in its definition of "dealer" includes a dealer acting for the account of his customers in a brokerage capacity as much as it does a dealer selling or buying as principal for his own account. However, although the Act for the most part treats brokers and dealers alike, there is one vital distinction, one concession made to a dealer acting as

broker which is not made to a dealer acting for his own account. This distinction will be found in subparagraph (2) of Section 4 of the Act, which exempts from the registration and prospectus requirements of the Act all "brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders."

This section too deserves to be read carefully if you wish to understand fully its implications and limitations. Even though you act purely as broker, your transaction will not be exempt if you have solicited the order, and furthermore, the solicitation itself, if it is a solicitation of an order to buy a specific security, will be a "sale" for the purposes of the Act just as much as if you offered to sell the security to your customer as dealer. Some of you may recall Mr. Throop's opinion published recently in the Conference News of the Investment Bankers Conference, Inc., in which he pointed out the violation involved in letters from financial houses to their customers, calling their attention to prospective offerings of securities in process of registration, and inviting commissions to purchase the securities as soon as they became effectively registered. If this kind of thing were permitted, the whole issue could for all practical purposes be placed in the hands of the buying public before effective registration, or even before the registration statement was filed. Although the point is not expressly mentioned in Mr. Throop's opinion, it is of course equally true that a solicitation of a buying order *after* registration is likewise a "sale". Any such solicitation, if made through the mails and within a year after the public offering, should therefore be accompanied or preceded by a full prospectus; and even if the solicitation itself is oral, the prospectus should accompany the security when the mails are used to complete delivery.

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