

CHAPTER III

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CHAPTER III

THE FORM AND CONTENT OF '33 ACT PROSPECTUSES

A. Introduction

The Commission can take pride in the evolution of the '33 Act prospectus into a document widely regarded as being of unusual value.^{1/} Largely as a result of the process of careful staff review, numerous improvements have been made over the years in prospectus disclosures involving both textual and financial items.^{2/} This process can be expected to continue. Some suggestions aimed at making the prospectus more useful to investors and their advisers are contained in Part C of this Chapter.

If '34 Act reports can be improved as recommended in Chapter X, it should be possible to reduce the emphasis which has been laid on the '33 Act prospectus as the key to full disclosure. The steps in this direction which are recommended by the Study are described in Part D of this Chapter.^{3/} They include,

1/ Illustrative of this viewpoint is a comment made to the Study by an investment banker. He observed that the best way to begin a study of a company is to acquire a prospectus. Even a prospectus several years old will, he said, often shed valuable light on a company's basic situation and the caliber of its management.

2/ An analysis of this process based on his own long experience has recently been written by former Commissioner Byron D. Woodside. See Woodside, Development of S.E.C. Practices in Processing Registration and Proxy Statements, 24 Bus. Law. 375-380 (1969).

3/ Recommendations relating to the dissemination of '33 Act prospectus are contained in Chapter IV.

principally, a substantial expansion of the availability of the short registration Form S-7. Further steps to coordinate the disclosures required under the '33 and '34 Acts should be considered after the Commission has had the benefit of a period of experience with improved '34 Act reporting. Additional simplification of Form S-7 and extension of its availability may well be possible. For certain reporting companies, it may be feasible to reduce the scope of the prospectus to cover only the essential disclosures relating to the plan of distribution. This could be combined with an appropriate legend referring to the issuer's reports and proxy statements under the '34 Act and telling the reader how to obtain them.

With rare exceptions, however, the prospectus delivered to the investor should be a concise, coherent document focusing on the particular distribution. Careful consideration was given by the Study to proposals for the development of a "wrap-around" prospectus form which would compress between specially prepared cover and end pages, recent '34 Act Reports and proxy statements on file with the Commission. It was decided that such a prospectus would be more likely to confuse than to assist the average investor.

- B. By way of background, the record shows an effort by the Commission over the years to improve the usefulness of the prospectus, in part by classifying issuers and types of offerings in accordance with particular disclosure needs.

The content of the prospectus is expressly prescribed under Section 10(a) and Schedule A of the Act. However, the Commission

may prescribe additional information or may permit any of the prescribed information to be omitted as it deems necessary or appropriate in the public interest or for the protection of investors. In exercising such powers, the Commission is given authority by Section 10(d) to classify prospectuses “according to the nature and circumstances of their use or the nature of the security, issue, issuer, or otherwise. . .” and to prescribe for each class “the form and content which it may find appropriate and consistent to the public interest and the protection of investors.” The breadth of this authority is widely accepted.^{4/}

^{4/} See e.g.: 1 Loss, Securities Regulation 236 (2d ed. 1961):

“Sec. 10 generally, as well as comprehensive rule making authority in Sec. 19(a), gave the Commission broad powers to alter the contents of the prospectus as specified in the statute and to classify prospectuses according to the nature and circumstances of their use.”

Schneider, Reform of the Federal Securities Laws, 115 U. Pa. L. Rev. 1023, 1034, n. 55 (1967).

“The SEC has the power to promulgate registration forms [a fortiori, prospectus forms] which do not cover all the items in Schedule A of the 1933 Act . . . Doubt about this power should be put to rest by years of practice with abbreviated forms . . .”

Heller, Address during Conference on Codification of Federal Securities Laws, 22 Bus. Law. 821, 827 (1967):

“I believe the Commission’s rule-making power under both Acts is ample to deal with the contents of the prospectus.”

The Commission has periodically re-evaluated its registration forms, which govern the content of prospectuses, in the light of its administrative experience. A number of forms appropriate to specific disclosure needs have thus been developed. Efforts have also been made from time to time to encourage the preparation of more readable prospectuses.

1. The early development of the two-part registration statement: Forms S-1, S-2 and S-3.

Prior to 1941, a registration was accomplished by filing two forms: a registration statement, comprising a lengthy series of questions and answers, and a prospectus, wherein the information in the registration statement had to be repeated in narrative form.

The first step in simplification occurred in 1941 when the Commission adopted Form S-3 for mining companies in the promotional stage. This action followed “lengthy study, including discussions with the trade of methods to make the registration process easier without losing any of the necessary safeguards of investor protection.”^{5/} The new form was designed to “eliminate duplication and non-essential requirements.”^{6/} This was accomplished principally by permitting the prospectus to be filed in narrative form as one part of the registration statement. A second part of the registration statement consisted

^{5/} Securities Act Release No. 2672, Adoption of Form S-3, 1 (September 29, 1941).

^{6/} Id.

of information of a character which did not require its circulation to investors, such as bulky exhibits.

The Commission thereafter followed the two-part format of Form S-3 in adopting new or revised registration forms. Later in the year 1941, Form S-2 was adopted for certain commercial and industrial companies in the developmental stage.^{7/} Form S-1, the basic registration form now in use, was adopted in 1942 in connection with a general revision of the forms then in use under the statutes administered by the Commission.^{8/} The 1942 version of Form S-1 included changes in the requirements for financial statements “designed to simplify and shorten such data by permitting ... omissions or partial omission of certain schedules . . .”^{9/}

Form S-1 was further simplified in 1947. In proposing the 1947 revision, the Commission stated:

While Form S-1 represented an improvement over the Commission’s earlier forms, a recent review of the requirements of that form in the light of the Commission’s experience in recent years indicates that this form can be further simplified. It is, therefore, the purpose of the proposed revision to eliminate requirements which experience has shown do not produce information essential to the prospective investor’s appraisal of registered securities, and at the same time to clarify the requirements of the form in certain limited respects so as to inform a registrant more fully as to the nature of the information deemed essential.^{10/}

^{7/} Securities Act Release No. 2681 (October 17, 1941).

^{8/} Securities Act Release No. 2887 (December 18, 1942), adopting Form S-1 as an option to Forms A-1, A-2 and E-1. (These old forms were repealed in 1946. Securities Act Release No. 3171 (November 20, 1946).)

^{9/} Securities Act Release No. 2887, 3. (December 18, 1942).

^{10/} Securities Act Release No. 3171 (November 29, 1946).

2. Registration forms for different classes of registrants and offerings: Forms S-8, S-9, S-14, and S-7.

The 1950's saw additional revisions of Form S-1^{11/} and the adoption of Form S-8 and S-9.

Form S-8, adopted in 1953,^{12/} may be used by an issuer required to file reports pursuant to Sections 13 or 15(d) of the Exchange Act for stock purchases, savings or similar plans offered to companies which meet certain conditions. Since such plans are generally offered to persons who have access to information concerning the issuing company, the information required in the prospectus is limited essentially to a description of the plan, the issuer's securities and financial condition and recent significant development concerning the issuer's business.^{13/}

^{11/} One of the more significant revisions was the proposal that the summary of earnings be accepted in lieu of the required profit and loss statements. Securities Act Release No. 3406 (January 25, 1951).

^{12/} Securities Act Release No. 3480 (June 16, 1953). Form S-8 was made applicable to employee stock options in Securities Act Release No. 4533 (August 30, 1962).

^{13/} The Study concentrated its effort on the principal registration forms, and did not give full consideration to possible amendments to Form S-8. When the form was adopted, the Commission noted that it was responding to the suggestion that "the investment decision to be made by the employee is of a substantially different character than is involved where securities offered for the purpose of raising capital are sold upon the best obtainable terms." Securities Act Release No. 3480 (June 16, 1953). In those cases where the issuer of the securities is filing reports within the Commission under the '34 Act and (in the case of stock purchase plans) the plan requires the employer to contribute at least a certain percentage of the purchase price, it may well be possible to limit the prospectus to a brochure or other appropriate document describing the particular plan, the securities being offered, and the employees' rights and obligations thereunder. Moreover, undertaking "C" should be reconsidered. If unlisted securities of a reporting company registered on Form S-8 are purchased on exercise of a "qualified" or "restricted" stock option and registration and prospectus delivery requirements of the '33 Act need not apply to any later resale of such securities unless such resale amounts to a "distribution" under proposed Rule 162 (see Appendix VI-1) by a controlling person of the issuer.

In adopting Form S-9 for high-grade debt securities, the Commission indicated its expectation that “prospectuses and registration statements on this new form will be substantially shorter than heretofore and will, therefore, be substantially easier both for the issuer to prepare and for the Commission to process.”^{14/} This new form was based on the theory that “much of the information required by the general registration form is not of material significance to investors in view of the senior position of the securities, the history of the issuer [and] the earnings coverage, etc., of the companies eligible to use the form.”^{15/}

The Study has observed that, at present, prospectuses using Form S-9 are considerably shorter than the average prospectus on Form S-1. Moreover, the Commission’s staff is generally prepared to review a registration statement on Form S-9 as rapidly as the issuer’s needs require, barring any substantial problems in the qualification of the trust indenture under the Trust Indenture Act of 1939 for the securities to be offered. The staff is able to expedite its review because of its familiarity with issuers eligible to use the form, most of whom periodically seek new financing, and the care which issuers and their counsel take in preparing the prospectus and indenture.

^{14/} Securities Act Release No. 3509, p. 1 (July 21, 1954).

^{15/} Id.

Form S-14 was adopted in 1959^{16/} to facilitate registration of public offerings of securities previously issued in merger or acquisition transactions specified in Rule 133(a), if the registrant was subject to, and solicited proxies from its shareholders in accordance with, the Commission's proxy rules. The information required in the prospectus is that specified by Regulation 14A, supplemented by certain other information including the terms of the underwriting. Thus, the registrant is not required to develop an additional complex disclosure document for the offering in addition to the merger proxy statement. In some cases, a cover and back page can simply be "wrapped around" a copy of that statement.

The latest effort on the Commission's part to simplify the registration process for a particular class of issuers involved the adoption in November 1967 of Form S-7. This Form is similar to Form S-1 except that the registrant is not required to describe its business history or properties or to provide information concerning its management. The Commission acted on the theory that for the class of companies eligible to use the new form^{17/} adequate disclosure in

^{16/} Securities Act Release No. 4115 (July 16, 1959).

^{17/} The registrant must be a reporting company under Section 12 of the '34 Act which has complied in timely fashion with the reporting and proxy solicitation requirements of that Act. Other important requirements are that it must have been engaged in business of the same general character since the beginning of the last five fiscal years; a majority of its board of directors must have been directors of the registrant for at least three fiscal years; it must not have been in default on its indebtedness, preferred stock or long-term leases during the past ten years; its consolidated sales or gross revenues must have totaled \$50,000,000 for the last fiscal year; its consolidated after-tax net income for such year must have been at least \$2,500,000; and its consolidated after-tax net income for each of the preceding four fiscal years must have been at least \$1,000,000.

these specific areas could be assumed to have been made in reports and proxy statements filed over the years pursuant to the '34 Act. By this means, the new form sought to achieve a limited degree of coordination between the disclosure requirements of the two Acts.

In first proposing Form S-7, the Commission stated its objectives as follows:

The Commission anticipates that prospectuses and registration statements on this form would be substantially shorter than heretofore and would, therefore, be substantially easier both for the issuer to prepare and for the Commission to process. For this reason, bearing in mind the information about the issuer publicly available, the Commission hopes to be in a position to consider favorably, in such cases, requests to shorten substantially the waiting period between filing and effectiveness of statements on the new form. The success of this program depends, of course, on the cooperation of issuers and underwriters in preparing the registration statement so that Commission review and comment can be held to a minimum.^{18/}

Adoption of the form was accompanied by a release in which the Commission observed that its action was “in the nature of an experiment” the results of which would be subject to review.^{19/} The Study has attempted such a review and its evaluation follows.

The Study interviewed a number of investment bankers which had underwritten offerings of securities registered on Form S-7. They expressed satisfaction [sic] with the form and its purpose, particularly with the shorter time involved in staff review.

^{18/} Securities Act Release No. 4849, p. 1 (November 16, 1966).

^{19/} Securities Act Release No. 4886 (November 29, 1967).

The Study carefully reviewed twelve of the sixty-nine registration statements filed on Form S-7 between the date of adoption of that form and June 30, 1968. It was observed that the staff had completed its review of eight of these twelve statements in 14 days or less. The shortest review period was 6 days. The review process included satisfying all staff comments on disclosure deficiencies. The average time between filing and effective date as to all sixty-nine statements was 22 days. By contrast, during the period immediately prior to June 30, 1968, the average time between filing and effectiveness of a registration statement on Form S-1 was from 6 to 8 weeks.

Although they are being processed more rapidly, registration statements on Form S-7 examined by the Study were not appreciably shorter than well-prepared statements on Form S-1. The length of the twelve S-7 prospectuses extensively reviewed by the Study ranged from a minimum of seven pages (in the case of a modified employee stock option offering) to a maximum of 36 pages (in the instance of combined offering of sinking fund debentures and convertible subordinated debentures). Eight of the 12 prospectuses were from 26 to 30 pages in length. This has been due, in part, to the inclusion of unnecessary information in the S-7 prospectuses. For example, the Division of Corporation Finance reported that in studying the registration statements filed on Form S-7 through June 30, 1968 twenty-two (32%) included capitalization tables which are not required and 63 (91%) included descriptions of business which substantially exceeded the requirements of Form S-7.

It should be noted, however, that Form S-7 has been in use only a little over one year. It is hoped that, with time, the securities industry and bar will become more familiar with the new form and will cooperate in achieving the goal of a shorter prospectus.

The Study concludes that the “experiment” to date has been generally successful. At a later point in this Chapter (pages 96 to 98) the Study discusses its recommendation that the category of companies eligible to use Form S-7 be significantly expanded.

3. Efforts to achieve a more readable prospectus.

The Commission has long been aware of the problem created by prospectuses which are so long or complex that the average investor cannot readily understand them. In 1936, the Director of the Commission’s Division of Forms and Regulations observed that “if the prospectus is to serve its purpose, it must not be prepared with a view to making it a detailed book of reference with respect to the issuer and its securities.”^{20/} a year later, he expressed the view that “there is no doubt that in many instances prospectuses have been so long and cumbersome as partially to destroy their usefulness.”^{21/}

When the first edition of his treatise on Securities Regulation was published in 1951, Professor Loss cited the unreadable

^{20/} Securities Act Release No. 874 (July 2, 1936).

^{21/} Securities Act Release No. 1503 (July 12, 1937).

prospectus as one of the four basic problems which stood out in any survey of the effectiveness of the registration scheme.^{22/} In the 1961 edition, he indicated some improvement, observing that “prospectuses do seem on the whole to be considerably shorter than they were in the thirties and forties.”^{23/}

The Commission once stated that “the prospectus is meant to be an epitome or summary . . .”^{24/} The record discloses a continuous effort by the Commission through rules, staff guidelines and the use of the acceleration policy to achieve such a prospectus.

Commission rules under Regulation C provide that the contents of prospectuses must be “clearly understandable” and expressed in condensed or “summarized form,” in “reasonably short paragraphs or sections.”^{25/} Summaries of documents must be in “succinct and condensed form.”^{26/} In addition, the prospectus must contain a “reasonably detailed table of contents.”^{27/}

Section 8(a) of the Act requires the Commission to give due regard to “the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of the holders thereof can be understood . . .” in

^{22/} 1 Loss, Securities Regulation 148-66 (1st ed. 1951).

^{23/} 1 Loss, Securities Regulation 265 (2d ed. 1961).

^{24/} Securities Act Release No. 3429 (November 11, 1951).

^{25/} Rule 421 (b) and (d).

^{26/} Rule 422.

^{27/} Rule 421(c).

considering an issuer's request for acceleration of the effective date of its registration statement. Rule 460, which sets forth the Commission's policy in responding to requests for acceleration, provides, among other things, that the Commission will consider "whether there has been a bona fide effort to make the prospectus reasonably concise and readable, so as to facilitate an understanding of the information to be contained in the prospectus."

Finally, in guidelines published to assist those affected by the registration requirements,^{28/} the Commission's staff has encouraged registrants to reduce the size of the prospectus by "careful organization of material, appropriate arrangement and subordination of information, use of tables and avoidance of prolix or technical expressions and unnecessary detail."^{29/} In addition "[w]here appropriate to a clear understanding by investors. . ." the factors which made a particular offering risky or speculative must be set forth in an introductory statement.^{30/}

The Study has set forth the Commission's past efforts in some detail in order to place the needs of the present in perspective. Unfortunately, too many prospectuses still become effective which are

^{28/} The latest version of these staff guidelines was published, following opportunity for public comment, in December 1968, Securities Act Release No. 4936 (December 9, 1968).

^{29/} Guides, Item 5.

^{30/} Guides, Item 6.

extraordinarily difficult to comprehend. Some, usually involving large conglomerate corporations, are of extreme length. Additional efforts on the Commission's part are necessary to make all prospectuses readable and understandable documents.

- C. Further steps should be taken to assure that prospectuses will be useful and informative to investors.
1. The Commission's staff should decline to review and the Commission should refuse to accelerate unnecessarily long, complex or verbose prospectuses.

The Commission recently directed its staff to adopt new procedures to assist it in processing the substantially increased volume of registration statements filed under the '33 Act "until such times as normal procedures may be resumed."^{31/} If a registration statement under these new procedures is "poorly prepared or otherwise presents serious problems," the staff will not comment on it, and will so notify counsel. The staff will also notify counsel that acceleration of the statement will not be recommended.

The Study recommends that this policy be followed whenever a prospectus is unnecessarily complex or verbose.

In addition, it is believed that the staff could take affirmative steps to make prospectuses shorter and more readable. Negative statements in response to items of disclosure in the registration forms are not necessary. Information should not be repeated unless it is

^{31/} Securities Act Release No. 4934 (November 21, 1968).

essential to fair disclosure. Lengthy descriptions of a company's business should be required to be appropriately condensed. Consideration should be given to the further development of techniques for condensation of the financial statements of large and complex corporations.

2. If the text of the prospectus is necessarily lengthy, a "guide" to the text should be required in lieu of the typical table of contents.

The length of many '33 Act prospectuses has caused concern among lawyers, analysts and state securities administrators interviewed by the Study. All concur in the judgment that many prospectuses do not adequately inform the average investor.

A related matter of special concern to state securities administrators is the fact that in the traditional underwritten distribution of securities, investors generally receive no disclosure document until copies of the final prospectus are mailed to them with confirmations of sale.

A possible solution to these related problems was first proposed in the summer of 1967 by the Midwest Securities Commissioners' Association.^{32/} By official resolution, that organization asked the Commission to require in the case of all first public offerings of securities:

^{32/} See Pringle, Summary Prospectus Proposal of Midwest Securities Commissioners' Association, 23 Bus. Law. 567 (1968).

(a) that the reverse side of the cover page of the prospectus contain summarized data on the issuer, and

(b) that the cover page, together with such summarized data on the reverse side thereof, be distributed as a “summary prospectus” to all customers to whom securities are expected to be sold at least 48 hours “before any sales are made.”

It was recognized that the Commission lacks power under the '33 Act to require the use of such a summary prospectus. However, the suggestion was made that the Commission use its anti-fraud powers under Section 10(b) of the '34 Act to implement the requirement.

Soon after the Midwest Securities Association took the foregoing action, the Prospectus Committee of the North American Securities Administrators formulated a proposal similar in form but not limited to first public offerings. The latter proposal was approved in principle at the annual conference of the North American Securities Administrators in the fall of 1967.^{33/}

The Study has considered with great interest and sympathy the proposals of the Midwest Securities Commissioners and of NASA. On two occasions, members of the Study conferred at length with members of the NASA Special Committee on Summary Prospectus. Alternatives were explored, including procedures for better dissemination

^{33/} See Proceedings of the Fiftieth Annual Conference of the North American Securities Administrators (1967), pp. 70-79.

of the preliminary prospectus in advance of the effective date. According to information given by the Committee to the Study, one state administrator had suggested that, in lieu of the use of a separate summary prospectus, a summary of salient facts be required in the “red herring” and that the red herring then be required to be distributed to customers a reasonable time prior to the effective date.

Subsequent to these meetings, the Study made a careful analysis of the sample summary prospectuses prepared by the Committee. A number of prospectuses prepared for first public offerings were examined to determine how they might be effectively summarized, and the Study itself drafted a number of sample summaries. The conclusions of the Study were as follows:

First, the Commission should respond affirmatively to the request to the state securities administrators that investors be provided with an appropriate disclosure document prior to the effective date of the registration statement, at least in all first public offerings. Accordingly, the Study proposes an amendment to Rule 460 which would make reasonable efforts to effect such a distribution at least 48 hours prior to the desired effective date a condition of acceleration. (Further details of this proposal are given in Chapter IV at pp. 113-16.)

Second, the document so distributed to investors should be the red-herring prospectus. Where such prospectus exceeds a specific length, there should appear in the prospectus immediately following the cover page a “guide” to its contents, consisting of a brief summary of certain important information plus clear references, in plain English, to those pages in the prospectus where additional material information on designated topics may be obtained.

The Study found, through practical trial, that summarizing a prospectus is an extremely difficult undertaking. The prospectus should, ideally, consist of no more than a concise statement of the material information about an issuer.^{34/} Further condensation of a well-prepared prospectus runs the risk of overlooking data which may have an importance to investment judgment equal to the data selected for a one or two page summary. Condensation of the required financial statements (which are, themselves, essentially a summary presentation of financial data) is especially hazardous, and the hazard is greatly increased if such a condensation is provided in a

^{34/} The perils of summarizing are highlighted by a story told by former Chairman Manuel F. Cohen about Commissioner (later Judge) Jerome Frank, who was given to the writing of lengthy opinions. One day his legal assistant summoned up the courage to suggest to the Commissioner that perhaps a 60 page opinion which the latter had drafted could be shortened. “You do it, then,” ordered Frank. The assistant came up with a 10 page version. “Splendid,” Frank remarked, “we’ll put this first.”

document separate from the prospectus. The gross asset, liability and shareholders equity amounts and (to a lesser degree) the gross sales and earnings figures are of little importance in themselves. In some instances, particular items in the balance sheet or summary of earnings in the prospectus may be highly significant in analyzing financial condition and results of operations; in other instances, different items may be significant for this purpose.

A particularly difficult problem arises in highly speculative first public offerings where an “introductory statement” is appropriate.^{35/} The requirement of such a statement represents the response of the Commission’s staff, based on many years of practical experience, to the need for a prominent summary of factors which should be considered with particular care by investors. The summary prospectus format suggested by the state securities administrators would not permit the inclusion of the typical introductory statement.

A separate summary which includes precisely designated items may create an additional difficulty. The identity of the underwriters may be very significant in one offering and of little importance in another. Similarly, the identity of management officials or of the company’s auditors may be of greater or lesser importance depending

^{35/} A summary of the factors which make the offering one of “high risk” must be set forth “immediately following the cover page of the prospectus,” and must consist of “carefully organized short, concise paragraphs.” Included among the factors which should be disclosed in this fashion are “absence of operating history,” “absence of profitable operations in recent periods,” “erratic financial history,” and “the nature of the business.” See Securities Act Release No. 4936 (December 9, 1968) Item 6.

upon the particular case. In most instances, description of the usually traditional features of the stock being offered is of no great importance; however, corporate styles change and the factual data required in the prospectus concerning the rights, preferences and restrictions associated with the securities being offered cannot be omitted without risk.

The Study recognizes the essential validity of the suggestion of the state securities administrators. It is of the opinion that when a prospectus exceeds a certain specified length, a "guide" to its contents, including a summarization of certain basic data, should be required. Such a guide would serve, in essence, as an expanded table of contents, and the latter could be omitted. The Study noted with interest the use of a similar technique in offering circulars for bond offerings not required to be filed with the Commission. Thus, immediately inside the cover of the "official statement" dated March 26, 1964 for an issue of \$2,000,000 of bonds of the West Orange, Texas Independent School District, there is an excellent one-page "Synopsis of Essential Facts" with references to pages in the circular where further details appear.

In a very few prospectuses filed with the Commission, a similar synopsis is voluntarily provided on the cover page or on the inside cover page.

In attempting to develop standards for a guide, the Study found that a fair number of prospectuses used in first public

offerings contain, in a relatively few pages of text, a readable, condensed statement of the material facts about the company and the offering. For example, the prospectus of Friendly Ice Cream Corporation, dated August 6, 1968, is 25 pages in total length. The financial statements (including the notes and opinion of the auditors) take up 10 of those pages and the list of underwriters 2. Eliminating these pages, the cover page, the table of contents and a map, the total text does not exceed 10 pages. It is difficult to see the necessity of further condensing this already condensed text, and the bulk of the prospectus as a whole is not such as to discourage a reader.

The Study therefore recommends that a guide to the prospectus be required only where the text of the prospectus (exclusive of the list of underwriters) exceeds 10 pages. If a guide is required, it should be substituted for the more abbreviated table of contents but should ordinarily be limited to one or two pages. The exact format for the guide will vary to a degree from case to case but, in general, it should include the following:

- (a) A brief statement of the business in which the issuer is engaged, with reference to those pages in the prospectus where such matters as the history of the business, products, properties, and competitive factors are described in greater detail.

- (b) A reference to the introductory statement (if there is one) and to the several items covered therein.
- (c) A statement of the number of units outstanding of the class of securities being offered, and the location in the prospectus of details of the capital structure of the company and of the description of the offered securities.
- (d) A summary, for the past 5 years, of the gross revenues and net income of the business, the net income per share, and dividends paid per share, showing, where called for, the effect of extraordinary items and outstanding convertible or residual securities. Reference should be made to the more complete income statements in the prospectus.
- (e) A brief statement as to where control of the issuer resides, with reference to more complete data if contained in the prospectus.
- (f) A statement identifying the nature of the information included in the prospectus concerning the management (such as, for example, names of officers and directors, their remuneration, pension benefits, bonus benefits, stock options, and transactions they have had with the issuer) with reference to the location of detailed information in the prospectus.
- (g) If material litigation is described in the prospectus, a statement to that effect and an appropriate reference.

3. More informative disclosures are needed in particular areas.^{36/}

(a) Sales and earnings of separate segments of a diversified business

The Commission has recently proposed revisions to certain of its registration forms to provide investors with information as to the “approximate contribution which various lines of business make to a company’s profitability . . .”^{37/} The conferences held by the Study strongly substantiated the need for this additional information in the prospectus.

Appropriate segment reporting is equally necessary on a periodic basis, in the Study’s opinion. In Chapter X, the Study recommends that annual reports on Form 10-K contain a breakdown of sales and earnings similar to that ultimately specified by the Commission for ’33 Act registration forms.

^{36/} The Study has not attempted to detail in this Chapter the miscellaneous changes in Form S-1 which are (1) presently needed, or (2) will be needed if recommendations made by the Study in other chapters of this report are accepted. These include (1) changes to conform Item 20 to the present requirement of the proxy rules, (2) revision of instruction 2 to Item 10 to conform that instruction to the proposed instructions to Item 3 of Form 10, (3) changes in Item 17 to conform to existing and proposed changes in the proxy rules, including an increase in the \$30,000 figure, and (4) deletion of undertaking A as no longer necessary.

^{37/} Securities Act Release No. 4922 and Securities Exchange Act Release No. 8397, Proposed Revisions of Forms 10, S-1 and S-7 (September 4, 1968); published for additional comment, Securities Act Release No. 4949 and Securities Exchange Act Release No. 8530 (February 18, 1969).

(b) Statement of the source and application of funds.

Many persons who consulted with the Study indicated their belief that a statement of the source and application of funds (sometimes referred to as a “flow of funds statement”) is a valuable tool for the investor and security analyst which should be required in prospectuses and annual reports filed with the Commission. Both major stock exchanges now recommend its use in annual reports to shareholders^{38/} and a growing number of companies are following this recommendation.

One experienced analyst observed:

“A table on source and application of funds . . . has obvious value in forecasting dividend policy, in indicating a company’s ability to meet its debt service requirements, and in suggesting whether a company can finance its capital expenditure program from internally-generated funds, or whether it may have to resort to raising capital through debt or equity issues. . . it cannot be constructed from the balance sheet or income account. . .”

A flow of funds statement generally consists of two sections reflecting, for a given period, sources of funds in one section and expenditures of funds in the other. It should not be confused with the so-called cash flow statements used by some companies, particularly those engaged in real estate investment. Such cash flow statements show only funds generated from operations. This may lead investors to confuse “cash flow” generated from operations with net income.

^{38/} See, e.g., American Stock Exchange Guide Section 612 (April 15, 1968).

The argument was advanced that a flow of funds statement is really unnecessary, since the skillful analyst can construct such a statement for himself from a comparison of conventional balance sheets and the income statement. This does not appear to be true in all cases, except perhaps in a very rough manner. In any event, it is preferable to have a reliable statement prepared by those familiar with the detailed information.

The Study recommends that, following development of appropriate standards for the source and application of funds statement for inclusion in Regulation S-X, such a statement be required in the prospectus.

(c) Adjusted earnings of life insurance companies.

It is well known that investors face great difficulty in comparing the earnings of life insurance companies. In an effort to achieve a rational basis for comparison, various organizations and individual firms in the investment community have developed adjustment formulae. However, the financial statements used in a life insurance company prospectus are unadjusted. This is also typically true of the annual reports to shareholders furnished by life insurance companies.

The problem results, at least in part, from the accounting practices followed by the life insurance industry. Life insurance companies are required under state laws to file complex and lengthy

“annual statements” or “convention blanks.” The conservative financial reporting practices required to be followed in preparing these statements reflect the objective of insuring adequate protection of policy holders rather than providing meaningful information to investors. These practices are reflected in the financial statements used in prospectuses. For example, the cost of writing policies and obtaining premiums is charged to operations as incurred, although premiums are taken into income over the life of a policy. Thus expenses may not be matched properly with revenues. Consequently, the reported earnings of a company writing an increasing volume of insurance (which is sufficiently profitable to recover the cost of writing such insurance) will understate the true earning of the company. This is because in a period of increasing premium volume, this method of accounting penalizes the statutory underwriting results by increasing operating costs in the amount of the deferrable expenses on the increased premium volume. Conversely, if a company is in a period of declining premium volume, the statutory underwriting results are benefited because credits to the profit and loss account are based on the higher premium volume in the past and charges are based on the reduced current volume.

The Study compared the various adjustments made by different brokerage and advisory firms to the earnings figures of a life insurance company as reported in its annual report to shareholders for the year 1967. Eight different adjustment formulae were employed.

Each produced a different result. The company reported earnings of \$1.85 per share. The adjustments produced figures which ranged from \$1.95 per share to \$2.49 per share.

The Study conferred with the Adjustments Committee of the New York Association of Insurance and Financial Analysts, which has developed a suggested adjustment formula for industry-wide use. The Study also conferred with a committee of the AICPA which is studying the reporting problems of life insurance companies in depth. The work done by the Adjustments Committee is highly promising, and the Study hopes that that committee will promptly confer with the AICPA Committee. The Commission should await the conclusion of the work being done by the AICPA but should encourage an early conclusion to that work in the hope that a troublesome problem of disclosure may finally be solved.

(d) Management background and experience.

A number of persons who conferred with the Study emphasized the view that a key factor in investment analysis is an appraisal of management. They believed that the Commission's disclosure forms fail to elicit adequate information concerning the background and experience of management.^{39/} Responsible officials of the Division of Corporation Finance concur in these views.

^{39/} See, e.g., Parker, A Professional's Thoughts – Needed Information, 24 Bus. Law. 63, 66 (1968).

Specific suggestions were: that disclosure should be obtained of the age of officers and directors; their education; their experience in the business engaged in by the company; insolvencies or bankruptcies in which they had been involved; and criminal convictions.

The Study recommends that:

- (1) although it is a close question, disclosures as to age and education should not be required;
- (2) broader disclosure of business experience over a period of 10 years (in lieu of the present 5 years) should be required;
- (3) insolvencies or criminal proceedings within the past 10 years involving directors and executive officers may be material to an evaluation of their ability and integrity. On the other hand, lengthy items in the forms calling for disclosure concerning all relevant types of misconduct or financial difficulties would not only complicate the forms but might be offensive. Procedures should therefore be adopted so that registrants and the staff are informed of such situations, where they exist, rather than learning of them in some cases but not in others. Appropriate decisions as to materiality and disclosure can then be made.

(4) the '33 Act registration forms, Schedule 14A of the proxy rules, and Forms 10 and 10-K should be modified accordingly. (See proposed revisions in Forms 10 and 10-K, and proposed new Form 10-Q, appendices X-2, X-3 and X-4, respectively.)

4. The question involving projections of sales and earnings is debatable; however, at present the Study does not believe that such projections should be permitted in prospectuses.

A number of experienced security analysts suggested to the Study that the Commission should permit “controlled” projections of sales and earnings in prospectuses and other documents filed with the Commission. These analysts are in the business of estimating the present and future value of securities based on predictions of sales and earnings. Management projections of sales and earnings serve as a valuable check on their own conclusions. The British disclosure system recognizes this to a limited degree and the Study carefully considered the merits of British practice. Moreover, the Study recognizes that most investment decisions are based essentially on estimates of future earnings.

Lawyers, underwriters and company officials were generally opposed to the analysts' suggestion. Even if projections were not required but only permitted, it was observed that problems of civil liability would be insurmountable unless projections in prospectuses were expressly granted immunity from Sections 11 and 12 of the Act.

This would be extremely difficult for the Commission to do. Moreover, from a management standpoint, projections may change rapidly during a given year as changes occur in the factors on which they are based. Inclusion of such changing projections in a prospectus, which might be used long after it became effective would give rise to significant problems.

It has been the Commission's long-standing policy not to permit projections and predictions in prospectuses and reports filed with the Commission. Such documents are designed to elicit material facts. Their factual character is widely recognized. Investors and their advisers are at liberty to make their own projections based on the disclosures resulting from the Commission's requirements. A real danger exists, in the Study's judgment, that projections appearing in prospectuses and other documents filed under the securities laws and reviewed by the Commission would be accorded a greater measure of validity by the unsophisticated than they would deserve.

For these reasons the Study concludes that the Commission's policy on projections should not be changed.

D. Assuming improvement in the content and dissemination of '34 Act reports, a closer coordination of '34 Act and '33 Act disclosures is justified.

1. Form S-7 should be made available to a wider range of companies

The experiment with Form S-7 has been described at an earlier point in this chapter (pp. 74-7). The policy of coordination

between '33 and '34 Act disclosures reflected by that form should be extended if the improvements in '34 Act disclosures recommended by Chapter X are adopted.

It was the Commission's judgment, when Form S-7 was under study, that elimination of certain disclosures in the statutory prospectus could be justified only if those disclosures had been made in other materials filed under the '34 Act for a substantial period of time. Thus, Form S-7 would be available only to issuers seasoned by the process of periodic disclosure. The Study concurs in this judgment. However, two principal changes are suggested which are not inconsistent with the foregoing.

First, the Study believes that the requirement that "the registrant has been engaged in business of substantially the same general character since the beginning of the last five fiscal years" should be removed. It has proven difficult to apply in practice. If the registrant has had no substantial change in its business during the past five years, the form should require only a brief identification of the nature of the business, together with an appropriate breakdown of sales and earnings by segments of the business. If the business has changed through acquisitions or otherwise, a brief description of the changes can be added. For this purpose, the Study suggests that Item 5(a) of the form be revised to add the following sentence:

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

Second, the Study recommends elimination of the requirement that a company have sales or gross revenues of at least \$50,000,000 for the last fiscal year and a reduction of the present net income requirement from \$2,500,000 for the last fiscal year (and at least \$1,000,000 for each of the four preceding fiscal years) to \$500,000 for each of the past five fiscal years. The Investment Bankers Association supplied the Study with valuable data indicating the number of companies which would be able to comply with these criteria. According to the IBA data, a total of 1,462 companies which filed annual reports with the Commission from 1962 through 1966 would have been eligible to use Form S-7, assuming they could meet the other requirements of the form.

2. A short prospectus form should be permitted for certain secondary offerings on exchanges.

If a registered secondary offering of securities is to be made through a prearranged, special solicitation of customers with the aid of extra selling incentives, delivery of a copy of an informative prospectus to such customers is both practical and rational. However, if the offering is to be made on the exchange without a special solicitation of customers, a requirement that

copies of a full prospectus be delivered to other brokers on the floor who may buy part of the offered securities becomes burdensome and serves little purpose. Recognizing this, the Commission adopted Rule 153, permitting delivery of copies of the prospectus to the exchange to substitute for deliveries between brokers.

In secondary offerings to which Rule 153 applies, the Study is advised that the prospectus frequently disappears into a file drawer at the exchange and is seen no more. Although Rule 153 does not eliminate the requirement of delivery of the prospectus to any solicited customer in connection with a sale to him of the offered securities, in practice the Study is advised that rarely, if ever, is there a demand for prospectuses for this purpose. As a practical matter, no distinction exists between the offered securities and any other securities of the same class simultaneously offered by other brokers.

Under these circumstances, the Study believes that to require a company with a class of shares listed on the exchange to prepare a full prospectus makes little sense. If registration is required despite the fact that the offeror is charged no more than the minimum commission,^{40/} a registration statement (and form of prospectus) which essentially incorporates by reference the issuer's pertinent '34 Act filings should be sufficient. A proposed form for such statement is submitted in Appendix III-1.

^{40/} This could occur if the quantity limitations provided under the Study's proposed Rule 162(c) are exceeded. See Chapter VI, at pp. 191-5.

A broker handling the sale on an exchange of securities registered on the proposed new form is an “underwriter” as defined in Section 2(11) of the '33 Act and is subject to Section 11 liability under that Act. By hypothesis, however, he will charge the seller no more than the applicable minimum commission and will not have the economic incentive to conduct the painstaking examination of the issuer’s affairs normally made by an underwriter in connection with a conventional financing. Nor will the broker have had the opportunity to prepare, or to participate in the preparation of, the disclosures in the registration statement. For these practical reasons, and to eliminate troublesome uncertainty on the point, the Study believes that the Commission would be justified in adopting a rule to define the scope of the broker’s investigation which would be appropriate under such circumstances.

The proposed rule is set forth in Appendix III-2. It provides, in essence, that, for the purposes of Sections 11(b)(3) and 11(c) of the '33 Act, the broker will be deemed to have made a reasonable investigation and to have had reasonable ground to believe that statements made in the registration statement if he has read the registration statement and the documents incorporated by reference therein and is not aware of any false or misleading data contained in such documents. The proposed rule would apply where (1) the order is not received until the registration statement is effective; (2) none of the proceeds of the offering will benefit

the issuer; (3) the broker receives no more than the applicable minimum commission; and (4) the broker obtains a statement in writing signed by the seller that, to the seller's knowledge, the prospectus does not contain false or misleading information.

It is entirely possible that a similar procedure can be developed for secondary offerings of over-the-counter securities where the seller's broker does no more than offer the securities to market makers. Various problems with such a procedure would require a careful review, however, and the Study was unable to reach a final conclusion as to its practicability prior to completion of this report.

3. A short prospectus form would be appropriate for stock to be issued by reporting companies on exercise of publicly-held warrants.

Where an issuer makes a registered public offering of warrants, it is considered thereafter to be making a continuous offering of the underlying securities. Conventional requirements for currently updating the registration statement and for prospectus delivery apply.

The warrant holder exercising his warrant, however, is influenced primarily by the market price for the underlying security. This price reflects the collective decision of the market as to the value of the underlying security which is ultimately based on information currently available. In the case of a reporting company,

that information would consist basically of the kinds of data contained in the issuer's reports and proxy statements filed with the Commission.

No significant additional protection to investors would appear to be gained by requiring the issuer to prepare and deliver a full prospectus to warrant holders under these circumstances. The prospectus required by the terms of the '33 Act to be delivered to the warrant holder could, in the Study's judgment, be a short, one or two page document referring the reader to the pertinent documents on file with the Commission. The registration statement proposed on pp. 98-9 for Rule 153 sales (Appendix III-1) is adaptable to this purpose. As a condition to its use in lieu of Form S-1, no commission or other remuneration should be paid or payable for the exercise of the warrants.

An amendment to Rule 427 to permit use of the new form is contained in Appendix III-3.

4. A short prospectus form would be appropriate for stock to be issued by a corporation on conversion of the publicly held securities of an affiliated corporation.

The offer involved where issuer A offers securities convertible into securities of issuer B is similar to the continuous offering of securities underlying an issue of warrants. Such an offering usually occurs where a foreign subsidiary of a domestic corporation finances its operations through a foreign dollar offering of debt

securities convertible into common stock of the parent.^{41/}

The initial offering need not be registered if confined to persons residing outside the United States.^{42/} Registration of the securities issuable on conversion is required because the exemption in Section 3(a)(9), normally applicable to conversion of convertible securities, applies only where the issuer of the convertible and of the conversion securities is the same. The Study questions whether, under these circumstances, the delivery of a full prospectus on conversion adds significantly to the protection of investors. A decision to convert is not likely to be based on facts of the kind set forth in a prospectus. It will largely be influenced by other considerations. Absent exemption, however, a prospectus must be used. A short prospectus of the type recommended for issuance of shares on exercise of warrants would seem appropriate.

^{41/} See, e.g., Investment Company Act Release No. 5269 (February 9, 1968).

^{42/} Securities Act Release No. 4708 (July 9, 1964).