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A. Introduction

Two periods are, in general, involved in any consideration of the dissemination of prospectuses: the period prior to and the period after the effective date of the registration statement. Except in certain "best efforts" underwritings, the actual offering of securities occurs during the first of those periods and the sale of the securities is confirmed to the purchasers when the second period begins.

The absence of better pre-effective dissemination to prospective investors has been criticized for many years. Recently, as mentioned in the previous Chapter, the North American Securities Administrators have made recommendations dealing with pre-effective dissemination. A touch of irony is to be found in the comment ascribed to an English investment banker: "What you chaps have is not a prospectus but a retrospectus." Although pre-effective dissemination presents some difficult problems in light of the structure of the '33 Act, the Study believes that improvement is possible, particularly in connection with public offerings by non-reporting companies where it is most needed.

The Study also explored in detail the problems and benefits of post-effective prospectus delivery, considering in this connection the views of underwriters, lawyers and many others. It was the opinion of the Study that for this period (as for the pre-effective period) a valid distinction can be drawn between the reporting and non-reporting issuer, permitting present post-effective delivery requirements to be reduced where appropriate.

B. At present, adequate use is not made of the prospectus in the pre-effective period.

1. Efforts by the Commission over the years to secure better pre-effective dissemination of the prospectus have been only partially successful.

From the beginning, a difficult and somewhat paradoxical problem has confronted the Commission in administering the '33 Act.

The fundamental thrust of the Act was to inform investors through the medium of a prospectus. In the language of the House Report, the information required was "indispensable to any accurate judgment upon the value of the security."[1/] Stress was laid in the House Report on the so-called "waiting period." One of its purposes, at least, was to prevent the distribution of an issue "before the investing public could digest the information demanded."[2/] Nevertheless, until the 1954 amendments, no "offer" of a security could be made prior to the effective date. And the Act provided

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1/ H. R. Report No. 85, 73d Cong., 1st Sess., 3 (1933).

2/ Id. at 3.

for delivery of a prospectus only in connection with actual delivery of the security itself, of any written offer of the security, or of the confirmation of sale.

Over the years, the Commission has sought ways to reconcile the apparent purpose of the Act with those substantive provisions which deal with the prospectus.

A first step was taken by the Federal Trade Commission late in 1933. That Commission issued a release authorizing the distribution, prior to the effective date, of what has come to be known as the "red herring" prospectus,[3/] thereby affording an officially sanctioned procedure for underwriters to communicate the details of an offering to dealers. Under the theory of the release, the red herring did not offer the security for sale. In 1935, this same concept was extended by an opinion of the Commission's general counsel to summaries of information in prospectuses prepared by statistical services and sold by them to underwriters and dealers for distribution to potential investors.[4/] Such summaries came to be known as "blue cards."

These measures failed to achieve the desired objective and, in 1941, the Commission proposed legislation which would have required

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3/ Securities Act Release 70 (November 6, 1933).

4/ Securities Act Release No. 464 (August 19, 1935).

the delivery of a form of prospectus to a prospective investor a reasonable time before he contracted to buy the security. An "identifying statement" was also proposed to be used as a means of locating persons interested in receiving a prospectus.[5/] A counter-proposal was made by the securities industry, to the effect that (1) a sale would be final if a prospectus had been sent in time to reach the investor not later than the business day before the sale, and (2) all others could repudiate the sale if they had purchased within seven days after the effective date and had notified the seller of their intention not to proceed by noon of the business day after purchase.[6/] Neither proposal was adopted.

In 1946, a Commission rule (Rule 131) was adopted to formalize the "red herring" practice.[7/] It expressly permitted distribution of the red herring to "any person." Acceleration of the effective date of a registration statement was to be conditioned upon distribution of the red herring a reasonable time in advance of the effective date to all underwriters and participating dealers.[8/] Prospective investors were not mentioned.

5/ SEC Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, H. R. Com. Print, Com. on Int. and For. Commerce, 77th Cong., 1st Sess. (1941).

6/ Investment Bankers Assn., et al., Report on the Conferences with the SEC and its staff on proposals for Amending the Securities Act of 1933 and the Securities Exchange Act of 1934 (1941).

7/ Securities Act Release No. 3177 (December 5, 1946).

8/ This policy is now contained in Rule 460.

In 1952, the Commission tried another approach. Rule 132 was adopted, permitting the use of the "identifying statement" first proposed in the 1941 legislative program. The identifying statement was intended to be similar to the card summaries prepared by statistical services except that it was limited to sixteen categories of information, could not contain a summary of earnings, and was subject to review by the staff. It was designed to locate persons who might be interested in receiving a "red herring' or final prospectus.[9/] However, in actual practice, the identifying statement turned out to be no more than the red herring legend and a detachable form requesting a copy of the prospectus. Its use died out and Rule 132 was repealed in 1956.

The 1954 amendments expressly provided that offers of a security might be made during the waiting period. Congress also sought to achieve a wider dissemination of information to investors during the waiting period by requiring in Section 10(b) the adoption of rules permitting the use of summary prospectuses.

The Commission responded by adopting Rule 434A, which authorized a "summary prospectus" to be used by certain issuers. Its use was never widespread, however, and only a handful have been filed within the past five years.

9/ Securities Act Release No. 3453 (October 1, 1952).

During the 1962 hot issue period, the Division of Corporation Finance developed the informal policy of requiring pre-effective delivery of an amended preliminary prospectus to prospective investors as a condition of acceleration in first public offerings where highly speculative factors were reflected in an introductory statement. This procedure has been used sparingly in recent years, however, and was not generally revived during the recent period of high activity in the new issue market.

The Study has been advised that the practice of statistical services in preparing summaries of prospectuses (the so-called “blue cards”) for use by underwriters and dealers during the pre-effective period has been discontinued.

In light of the foregoing, it appears that the problem of reaching the investor with prospectus information during the pre-effective period remains substantially unsolved.

2. <u>A wide variation exists among underwriters and dealers in the dissemination given to prospectuses during the pre-effective period</u>.

In order to gather data concerning present-day practices in disseminating the preliminary prospectus during the waiting period, the Study took a representative sample of first and repeat offerings of common stock during 1967, and examined all data in the Commission’s files submitted in connection with the request for acceleration.

The variations in practice were large. In one first public offering and in one repeat offering, a single preliminary prospectus was delivered to each underwriter prior to the effective date. Distribution of preliminary prospectuses, however, averaged 50 per underwriter in the case of first public offerings and 67 per underwriter in the case of repeat offerings. In a number of instances, the distribution of preliminary prospectuses greatly exceeded those averages: one first public offering involved the distribution of over 11,000 such prospectuses to the underwriting group.

Distribution of preliminary prospectuses to dealers was negligible in the majority of cases. For first public offerings, it averaged less than four per dealer. In several offerings, no preliminary prospectuses were distributed to dealers, and in others, the report showed one per dealer. The average for repeat offerings was 1.7 preliminary prospectuses per dealer.

It was not possible to determine how many preliminary prospectuses distributed to underwriters or dealers found their way into the hands of ultimate investors, but again, based on conversations held by the Study with underwriting firms, a large variation in practice appears to exist. Some firms make it a practice not to distribute the preliminary prospectus except to institutional investors. Others have adopted the policy, applicable in particular where they act as the managing underwriter, of making a broad and immediate distribution of the preliminary prospectus to their customers soon after the registration statement is filed with the Commission. In some instances, the Study was advised that branch offices of an underwriting firm may receive no copies of the preliminary prospectus, or of the amended preliminary prospectus. Other firms send sizeable quantities to their branch offices.

It appears to be the general policy among underwriting firms consulted by the Study to respond, if they can, to the request of a customer for a copy of the preliminary prospectus.

C. The Study recommends rules requiring (1) delivery of each preliminary prospectus to all salesmen offering the security and (2) delivery of a preliminary prospectus to customers within a reasonable time prior to the effective date in all first public offerings by non-reporting companies.

1. Analysis of proposed Rule 15c2-8 and proposed amendments to Rule 460.

(a) Proposed revision of Rule 460.

The prospectus in the case of a first public offering is a uniquely valuable document. In most instances, it contains the first comprehensive disclosures about the issuer. It is the product of joint effort and examination in depth, stimulated by the liability provisions of Section 11 of the '33 Act. As a matter of good policy, the utmost in the way of benefits to investors should be obtained from this document while its disclosures are of optimum timeliness.

Assuming the correctness of that statement of policy, it follows, in the Study's judgment, that present practices with regard to the pre-effective dissemination of the prospectus in first public offerings are unsatisfactory.

The Study considered this problem with two groups which are particularly concerned with the form which any suggested solution might take: The North American Securities Administrators and the Investment Bankers Association of America. Based in large part on its conferences with special committees from each of these groups (which were of great value to the Study) the following recommendation is submitted:

To the extent practicable, all prospective investors in a first public offering should receive a copy of the preliminary prospectus a reasonable time in advance of the effective date, and well in advance of the mailing to them of a confirmation of sale. The requirement in this respect should be flexible, since some underwriting firms will prefer to make such distribution immediately after filing and others will deem it advisable to wait until they receive such comments as the Commission's staff may have to make on the disclosures in the registration statement. Dealers as well as underwriters should make the prospectus available to their customers. The requirement cannot be absolute, however, without unnecessarily disrupting the processes of distribution of securities. If customers become prospective investors in the securities at the last moment prior to the effective date, it would not be feasible to hold up the effective date on that account, nor is it sensible to require that they receive a preliminary prospectus when they will almost immediately receive the final prospectus.

The Study found that the desired flexibility could best be obtained by adding the foregoing requirements to Rule 460 as a condition of acceleration. The proposed amendment to Rule 460 (see Appendix IV-1)[10/] states that the Commission would ordinarily be satisfied by a written statement of the managing underwriter to the effect that copies of a preliminary prospectus complying with Rule 433(a) have been or are being distributed to all underwriters and dealers expected to participate in the offering so as to enable each underwriter or dealer to mail copies thereof, a reasonable time prior to the desired effective date, to all persons to whom it then expects to mail confirmations of sale. A reasonable time should ordinarily be not less than 48 hours. The managing underwriter's statement should affirm that it has been advised by each such underwriter and dealer that the necessary distribution has been made,

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10/ Information as to Commission policy with respect to requests for acceleration is presently found in three separate locations: (1) Rule 460, (2) Rule 461 and (3) Guide No. 19 of Guides for Preparation and Filing of Registration Statements (Securities Act Release 4936, December 9, 1968). The proposed amendment to Rule 460 combines these sources of information into a single rule; if it is adopted, Rule 461 and Guide 19 could be rescinded.

On the very infrequent occasions when the Commission requires "recirculation" as a condition of acceleration, it is important that changes made in the preliminary prospectus to correct material inaccuracies or inadequacies be called to the attention of recipients. The amended preliminary prospectus should, on such occasions, be accompanied by a memorandum of changes. Revised Rule 460(c)—changed to Rule 460(d)—so provides.

or will be made, immediately after copies of the preliminary prospectus have been received.

The question remains whether a similar policy should apply in the case of offerings when the issuer is a reporting company. Here, of course, it can reasonably be assumed that information will be available concerning the affairs of the issuer and the prospectus will not be so unique a form of disclosure. The Study determined that, as a first step and pending a review of its effectiveness, the new acceleration policy should apply only to first public offerings.

(b) Proposed Rule 15c2-8.

From the outset, it was intended that the prospectus would act as a deterrent to the fraudulent oral sales pitch.[11/] The objective remains a valid one. It cannot be reconciled with a prevailing practice in which many salesmen who offer newly issued securities largely by telephone never see the preliminary prospectus, and customers who may wish to review the proposal more carefully, or to check what the salesman told them, may be unable to obtain a copy of that document.

Section 15(c)(2) of the '34 Act permits the Commission to "prescribe means reasonably designed to prevent such acts and

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11/ "The full revelations . . . should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose." H. R. Report No. 85, supra., n. 1, p. 8.

practices as are fraudulent, deceptive or manipulative . . .” In the Study’s judgment, a rule would be appropriate under that section to implement the following policies:

(1) A broker-dealer participating in an underwriting should take reasonable steps to see to it that any person who desires a copy of the preliminary prospectus prior to the effective date (or of the final prospectus, between the effective date and the termination of the distribution or expiration of the applicable 40 or 90 day period, whichever occurs last) is furnished such copy promptly.

(2) Each salesman who is expected to offer the securities for sale should receive a copy of the preliminary prospectus and any amended preliminary prospectus. If offers are expected to be made after the effective date, he should receive a copy of the final prospectus before making such offers.

(3) A managing underwriter should be under obligation to take reasonable steps to see to it that (a) all other underwriters and dealers participating in the distribution are promptly furnished with sufficient copies of the necessary documents to enable them to comply with the foregoing, and (b) all dealers are furnished with sufficient copies of the final prospectus, as requested, to enable them to comply

with the delivery requirements in Section 4(3) of the '33 Act.[12/]

In a sense, the proposed rule (see Appendix IV-2) would take over where the Commission's acceleration policy ends, by providing for continuing dissemination of the prospectus after the effective date when such dissemination is essential.

2. Possible alternatives to the proposed rules.

(a) Retain present procedures and practices with modifications.

Critics of the '33 Act flatly asserted that investors do not read prospectuses and it is therefore useless to devise procedures designed to further the dissemination of prospectuses to the ordinary investor. Unfortunately, the Study was not equipped to conduct an empirical review of the reading habits of investors. Even if such a review were to be made, it is questionable how much it would prove. The preliminary prospectus has been laboriously prepared, printed and filed with the Commission. It is available to and used by the professionals. The argument for making it available to the ordinary investor who is expected to be a purchaser of the securities offered seems a strong one, even if only a small minority of such investors actually make use of it. The Study is

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12/ See pp. 121-2 of this Chapter, where elimination of the 40 day delivery requirement as applied to transactions involving the registered securities is recommended.

of the opinion that a significant minority would do so, based on expressions of belief by a number of sophisticated representatives of the industry and by a number of experienced state administrators.

An attorney who has long specialized in the securities field advised the Study that, in his opinion, the principal value of the prospectus lies in curbing over-zealous selling. He would retain present dissemination practices, with one modification. The cover page of each final prospectus would be required to contain a conspicuous legend cautioning the investor to read the prospectus, and pointing out specifically his rights under Section 11 of the '33 Act and rights of rescission under state law. A post card would be attached, addressed to the SEC, on which the investor could report inconsistencies between the disclosures in the prospectus and the salesman's representations.

The Study concluded that this suggestion should not be adopted. Practical difficulties are presented. A number of states (New York, for example[13/]) have adopted the Statute of Frauds provision of the Uniform Commercial Code applying to investment securities. That Section provides that where the broker acts as principal, a contract for the sale of securities is not enforceable unless (1) a writing signed by the party sought to be held or his agent is sufficient to indicate a contract of sale has been made; (2) delivery of the security has been accepted or payment has

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13/ McKinney's Consolidated Laws of New York, Book 62 1/2 , Part 3, Uniform Commercial Code, Sec. 8-319.

been made; or (3) the purchaser has failed to object to the confirmation of sale within 10 days of its receipt. However, state laws on this subject vary, and it would be difficult if not impossible to provide a meaningful disclosure which could be universally used. Moreover, it can be argued that preventive effort should be applied at an earlier stage than the final prospectus. In this connection, the Study is impressed by the value of the special procedures which have been used by the Division of Trading and Markets and by the Commission's regional offices in the case of highly speculative offerings. When it is informed that such an offering is contemplated, the Division arranges a conference with the underwriters and discusses the obligations of the underwriter under the securities laws. The Division will normally inform the underwriter in advance that the offering will be subject to surveillance. The Study believes that this procedure has prevented potentially serious fraud in a number of instances.

(b) Require delivery of a prospectus prior to any offer of the security.

It has been recommended that, as a means of preventing fraud, the Commission should adopt a rule under the '34 Act requiring broker-dealers to furnish any potential customer with a copy of the available prospectus prior to any offer of a security as to which an initial registration statement is on file. Such a rule would effect a major change in present-day distribution processes. Aside from questions of statutory interpretation, the Study is of the opinion that more limited measures will be responsive to the undoubted need for better pre-effective dissemination and should be tried.

D. The 40-day post-effective prospectus delivery requirement in the case of reporting companies presents numerous difficulties. Assuming improvement in the content and dissemination of '34 Act reports, this requirement could be eliminated.

The Study acknowledges the fact, based on conferences with numerous lawyers and representatives of the securities industry, that the post-effective prospectus delivery requirements imposed on dealers by Section 4(3) of the Act are disregarded or overlooked in numerous instances. These requirements, effective for 40 days after the earlier of the effective date or the date on which the first bona fide offer to the public takes place (or for 90 days in the case of first public offerings) apply only to the registered security. They do not affect the availability of the broker's transactions exemption of Section 4(4). Thus, if the security is sold by a broker in an unsolicited transaction, no prospectus need be delivered.

The 40 day requirement applicable to securities which have been the subject of a previous offering is especially troublesome from the standpoints of compliance and administration. In most cases, such securities will already have an established market. As a practical matter, it is often impossible for a dealer to determine whether the particular securities involved in a trade are those recently registered or those which were previously outstanding. If such a dealer is to deliver a copy of the prospectus with every trade, however, he will need more prospectuses than are obtainable in many instances.

The Study considered the possibility of applying stronger enforcement measures to guard against any violation of Section 5 of the '33 Act during the course of post-offering trading. It was concluded that, apart from first public offerings, the efforts which would be necessary could more profitably be expended elsewhere. The question is one of judgment, but the Study would recommend that emphasis be placed on improvement in the content, timeliness and dissemination of '34 Act reports in striving for the goal of informed public markets.

Accordingly, if such a step can be coordinated with the improvements in '34 Act reporting recommended by Chapter X, the Study would recommend that the requirement for prospectus delivery in the case of reporting issuers be removed. This can be done under the authority of Section 4(3)(D) by amendment of Rule 174 (see Appendix IV-3).

E. In first public offerings by non-reporting companies, the 90-day prospectus delivery requirement serves a valid purpose. It should be retained and steps taken to assist dealers in complying.

Consideration largely different from those referred to in the preceding section of this chapter apply in the case of offerings by non-reporting companies. Here, there is no repository of information about the issuer. The only source of such information for a substantial period of time will be the prospectus. The first annual report on Form 10-K would not be due until after the first full fiscal year following the last full fiscal year for which certified financial statements were provided in the prospectus.[14/] Under the Study's proposal in Chapter X, the first quarterly report would not be filed until 45 days after the first quarter ending after the registration statement is effective. This means that no information concerning the company could be expected under the reporting requirements until after the end of the 90 day prospectus delivery period.[15/]

Moreover, in most instances the securities publicly traded during the 90 day period will be largely if not entirely those registered for the public offering. For this reason, practical problems associated with post-offering prospectus delivery are minimized.

14/ Rule 15d-1.

15/ In almost all instances, the applicable period would be 90 days. That period, however, applies if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement. It is possible for a suspension of the reporting requirements otherwise applicable to such an issuer to occur under Section 15(d) if the number of record holders of the previously registered securities drops below 300. In that case, even though the issuer was non-reporting, the applicable period for prospectus delivery in the event of a new offering would be 40 days.

It is the Study's opinion that the prospectus delivery requirement, as applied to non-reporting issuers, serves an important purpose and is workable, assuming cooperative efforts on the part of the Commission and the securities industry to make it so. Representatives of the industry who conferred with the Study agreed with this conclusion.

Proposed Rule 15c2-8 contains a provision requiring managing underwriters to provide any dealer with sufficient copies of the prospectus, on request, to meet the latter's delivery obligations. The Investment Bankers Association of America currently publishes for the benefit of all of its members a weekly list of all current issues as to which the prospectus delivery requirement applies, with the date on which the requirement for each issue terminates and the name of the managing underwriter from whom prospectuses can be obtained. It is possible that this helpful publication could be made available to all dealers.