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1

APPROACHING SECURITIES LAW

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Chapter 1

Approaching Securities Law

§ 1:1 Introduction

Although there may be areas of law a bright lawyer easily can learn on his or her own from the statutes, rules, and cases, federal securities law is not one of them. Give an eager and talented, but uninitiated, lawyer the Securities Act of 1933 and its rules and cases, provide a few weeks of cloistered study, and the lawyer is likely to emerge encyclopedic but confused. Securities law, and the Securities Act especially, is tricky—it is a puzzle that can be put together in many ways that look right, but only one of them is. The purpose of this book is to help in approaching this puzzle.

§ 1:2 Historical and Cultural Perspective

§ 1:2.1 History Repeats Itself

In recent years, the practice of corporate and securities law has been dominated by a focus on "SOX" or "SarbOx"—the

Sarbanes-Oxley Act of 2002.[1] More recently, as a result of the subprime mortgage crisis and its fallout, the public and Congress have again fixated on greed, fraud, and other wrongdoing. No description of legislation said to be as sweeping as either Sarbanes-Oxley or the proposals being debated in response to the current crisis would be complete without the thoughts of the U.S. president. Consider the following excerpts from a presidential speech:

> [R]ulers of the exchange of mankind's goods have failed through their own stubbornness and their own incompetence, have admitted their failure, and have abdicated. Practices of the unscrupulous money changers stand indicted in the court of public opinion, rejected by the hearts and minds of men.
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> The money changers have fled from their high seats in the temple of our civilization. We may now restore that temple to the ancient truths. The measure of the restoration lies in the extent to which we apply social values more noble than mere monetary profit.
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> [T]here must be an end to a conduct in banking and in business which too often has given to a sacred trust the likeness of callous and selfish wrongdoing. Small wonder that confidence languishes, for it thrives only on honesty, on honor, on the sacredness of obligations, on faithful protection, on unselfish performance; without them, it cannot live.
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> Restoration calls, however, not for changes in ethics alone. This nation asks for action, and action now.
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> [I]n our progress . . . we require . . . safeguards against a return of the evils of the old order: there must be a strict supervision of all banking and credits and investments, so that there will be an end to speculation with other people's money. . . .

These excerpts, however, were not President George W. Bush's call for passage of accounting reform or his comments on the corporate and investment banking scandals such as Enron, WorldCom, Citi-Group, JPMorgan Chase, or Merrill Lynch. They also are not President Barack Obama's words as he calls for greater responsibility and oversight of the financial markets. No, these words are from President Franklin D. Roosevelt's inaugural speech in 1933, which focused on a major issue of the 1932 presidential race—the sanctity

1. Pub. L. No. 107-204, 116 Stat. 745 (2002).

of the U.S. capital markets. As discussed below, Congress took up the challenge, quickly passing the two cornerstone acts of federal securities laws—the Securities Act of 1933 and the Securities Exchange Act of 1934—and more securities legislation as well.

But the problems that led to the passage of the Sarbanes-Oxley Act and the securities laws of the 1930s are not new. They are as old as mankind and probably will be with us as long as mankind exists. Late seventeenth- and early eighteenth-century promoters of English companies, both incorporated and unincorporated, foisted doubtful schemes upon the investing public. Trading in shares led to widespread speculation and wild fluctuations in securities trading markets, resulting in alternating booms and panics. For example, more than one thousand persons subscribed in a single day for shares of a company formed "for carrying on an undertaking of great importance, but nobody to know what it is."[2]

Legislative action followed. Influenced perhaps by the plan of the South Sea Company to acquire the entire English national debt, Parliament passed the Bubble Act of 1720 when the speculative enterprises had reached their apex. Officially named "An Act to Restrain the Extravagant and Unwarranted Practice of Raising Money by Voluntary Subscriptions for Carrying On Projects Dangerous to the Trade and Subjects of this Kingdom," the Bubble Act did little other than restrain the growth of corporations. Ways were found to circumvent its vague provisions, however, and by the time of its repeal in 1825, the Bubble Act had become ineffectual for its intended purposes.[3]

Early American law carried forward some of the principles of the Bubble Act, which precluded incorporated joint stock companies. Throughout the early 1800s, however, primarily through legislative fiat, corporations flourished. Later in the century, state involvement waned and corporations continued to flourish as a means to the growth of several burgeoning industries, primarily the railroads. These industries had large capital requirements, which resulted in the development of a variety of financial instruments. Another round of abuses, however, led to the creation of the Interstate Commerce Commission in 1887 and passage

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2. 8 W. HOLDSWORTH, HISTORY OF ENGLISH LAW 214, 215 (7th ed., London, Methuen Sweet & Maxwell 1956–65).
3. *See* J.W. HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES 3 (1970).

of the Sherman Antitrust Act in 1890. On the private front, the shareholder suit was developing as a means to curb corporate fraud and abuse.[4]

At some time in the late nineteenth or early twentieth century, the American corporation became the dominant institution of modern social and economic organization. Large portions of American industrial wealth were changed from individual ownership to the management of large publicly owned corporations. States, eager for the revenue to be derived from corporate activities, removed restrictions and safeguards from their corporate statutes and advertised their corporate laws like products. Companies were formed where the cost was lowest and the laws the least restrictive. In Justice Brandeis's words, "The race was one not of diligence but of laxity." One of the first "races to the bottom" in corporate governance was underway; however, it was not to be the last.

§ 1:2.2 *Origins of the Federal Securities Laws*

Much as the Sarbanes-Oxley Act of 2002 grew out of the corporate scandals of 2002 and beyond, the major U.S. securities laws were quintessential New Deal legislation that grew out of the 1929 stock market crash and Franklin Roosevelt's 1932 presidential campaign. Securities law reform was one of the planks of the Democratic platform: "We advocate protection of the investing public by requiring to be filed with the government and carried in advertisements of all offerings of foreign and domestic stocks and bonds true information as to bonuses, commissions, principal invested, and interests of the sellers."[5] Within weeks of his inauguration, Roosevelt moved to begin the reform. A former Federal Trade Commissioner named Huston Thompson was given the task of drafting the Securities Act.[6] His bill went to Congress in March 1933, accompanied by a message from the President stating his desires as to the thrust of the legislation. It quickly

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4. An excellent history of state incorporation laws in the United States can be found in Justice Brandeis's dissenting opinion in Liggett Co. v. Lee, 288 U.S. 517, 541 (1933).
5. *Why the Federal Securities Act Was Passed*, 13 CONG. DIG. 130, 131 (1934).
6. The source of most of the following story is Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).

became apparent that the Thompson bill was not consistent with those desires. The President agreed with Louis Brandeis that "sunshine is said to be the best of disinfectants; electric light the most efficient policeman,"[7] and he wanted regulation through disclosure requirements. Although this philosophy was embodied in the 1932 campaign plank, the Thompson bill went in another direction. It mandated what has become known as "merit regulation." This scheme, much used in state securities law, gives a governmental body the power to pass upon the merits of securities offerings and to prevent unworthy offerings.

In early April, a new drafting team was formed. The members' identities, their intellect, and the constraints on them as they worked are important parts of the tale. The group, which was assembled by Felix Frankfurter, consisted of James M. Landis, a Harvard Law School professor; Thomas G. Corcoran, a government lawyer recently out of a securities law practice; and Benjamin V. Cohen, a practicing lawyer. Each was brilliant, and from the statute they created it is apparent that they delighted in mental challenges involving interwoven complexities and neatly hidden traps.

The team set to work on a Friday. For political reasons, they did not scrap the Thompson bill. They used it as a base for amendment, while drawing heavily on the English Companies Act of 1929. By late Saturday they had a draft that, more than seventy years later, still constitutes the main body of the Securities Act. The Act is a masterpiece, an intellectual *tour de force.* It is fun to work with once you know how. For now, realize that when one works with the Securities Act, one plays a complex mental game devised by three exceptional minds over a weekend.

The Securities Exchange Act of 1934, the other statute discussed in this book in some detail, is the second part of the securities regulatory scheme that was contemplated as early as the 1932 Democratic campaign.[8] It is substantially longer than the Securities Act, and its coverage is much more diverse. It also is more straightforward, making it easier to work with than the

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7. LOUIS BRANDEIS, OTHER PEOPLE'S MONEY 92 (1914).
8. The 1932 Democratic Party campaign plank quoted above went on to call for regulation of securities exchanges "to the full extent of federal power." *Why the Federal Securities Act Was Passed, supra* note 5, at 131.

Securities Act. Although the two acts shared Benjamin Cohen as a draftsman,[9] the Exchange Act lacks the idiosyncratic sparkle that makes the Securities Act at once more interesting and difficult.

The Securities Act and the Exchange Act constitute virtually the entire body of general federal securities regulation. Most securities lawyers deal primarily with these two Acts. There are, however, a number of other federal securities statutes, each of which deals with a specialized area. The most important of these statutes were:

(1) the Public Utility Holding Company Act of 1935,[10]

(2) the Trust Indenture Act of 1939,

(3) the Investment Company Act of 1940, and

(4) the Investment Advisers Act of 1940.

The Holding Company Act, now repealed, was the most specialized of these statutes, and it engaged the fewest lawyers. It was also the most fascinating. If it were passed today, it would be viewed as avant-garde. When it was passed in 1935, it was revolutionary. The statute's most controversial aspect was its forced breakup of utility company systems, which were multi-layered groups of affiliated corporations controlled by powerful holding companies.

The Trust Indenture Act of 1939 is also highly specialized. As its title suggests, it relates to trust indentures which are contracts between the issuer of debt securities and a trustee. The Trust Indenture Act contains a variety of provisions designed to protect the holders of debt securities covered by an indenture. Included in the Act are provisions establishing requirements for trust indentures and relating to who may serve as a trustee, along with provisions governing the conduct of trustees. The Act applies to most indentures relating to securities that are required to be registered under the Securities Act.

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9. *See* Halsted, *Securities and Exchange Act of 1934 Regulating Stock Exchanges, Trading in Securities, Etc. Under Administration of the Securities and Exchange Commission*, 2 J. MARSHALL L.Q. 145, 145 (1936).

10. PUHCA was repealed effective February 8, 2006, with many functions of the SEC being transferred to the Federal Energy Regulatory Commission.

The Investment Company Act of 1940, which regulates mutual funds, and the Investment Advisers Act of 1940, which regulates investment advisers, are aggressive statutes aimed at specific groups within the securities industry. Like the Holding Company and Trust Indenture Acts, each of these statutes is the main preserve of a small percentage of securities lawyers. These four specialized acts share one important attribute—each is best approached by a lawyer who understands the Securities Act and the Exchange Act.

§ 1:3 Sources of Federal Securities Law

The various federal securities statutes are, of course, the primary source of federal securities law. Congress, however, has given the Securities and Exchange Commission, which it created in section 4 of the Exchange Act, the power to supplement the securities statutes by rules. This grant is both general and specific. For example, section 19(a) of the Securities Act provides a general grant of rule-making power: "The Commission shall have authority from time to time to make . . . such rules and regulations[11] as may be necessary to carry out the provisions of this title. . . ." Section 2(a)(15) provides a specific grant:

> The term "accredited investor" shall mean—
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> (i) [a person meeting criteria specified]; or
>
> (ii) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.

Notice that, with respect to the definition of an accredited investor, Congress in section 2(a)(15) both makes its own law, in

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11. In Commission usage, regulations are compendiums of rules or "items" covering a particular topic or purpose. For example, Regulation D is a series of rules relating to three exemptions from the Securities Act's registration requirements, and Regulation S-K is the general repository of disclosure requirements under the Securities Act and the Exchange Act. Regulation S-K's components are called items, with item 102, for example, relating to disclosures concerning a company's properties.

subsection (i), and gives the Commission guidance for rule-making, in subsection (ii). In other situations, Congress has chosen simply to turn everything over to the Commission. Section 14(a) of the Exchange Act provides a good example: "It shall be unlawful for any person . . . , in contravention of such rules and regulations as the Commission may prescribe . . . , to solicit . . . any proxy . . . in respect of any security . . . registered pursuant to section 12 of this title."

Congress has given the Commission's rules under Exchange Act section 14(a) the force of law, by use of the phrase, "It shall be unlawful. . . ." That is the basic way of giving rules the force of law in the Exchange Act, since section 32(a), as amended by the Sarbanes-Oxley Act of 2002, provides:

> Any person who willfully violates any provision of this title, . . . or any rule or regulation thereunder *the violation of which is made unlawful or the observance of which is required under the terms of this title*, . . . shall upon conviction be fined not more than $5,000,000, or imprisoned not more than 20 years, or both, except that when such person is a person other than a natural person, a fine not exceeding $25,000,000 may be imposed. . . . [Emphasis added.]

Rules are also given the force of law in section 24 of the Securities Act:

> Any person who willfully violates any of the provisions of this title, or the rules and regulations promulgated by the Commission under authority thereof . . . , shall upon conviction be fined not more than $10,000 or imprisoned not more than five years, or both.

In administering the securities statutes, the Commission issues a large number of rules, along with many pronouncements that are not rules, at least in the usual sense of the term. Some of these pronouncements have the force of law. For example, Securities Act registration statement forms are given the force of law by Securities Act Rules 130 and 401(a), the latter of which says "a registration statement . . . shall conform to the applicable . . . forms" and the former of which provides that the term "rules and regulations," as used in certain sections of the Securities Act, includes the registration statement forms.

The bulk of the Commission's pronouncements, which usually take the form of a release, do not have the force of law. Under the Securities Act the Commission has issued more than 8,500 releases, in excess of 52,000 under the Exchange Act. In many of these releases, the Commission promulgated a rule or made an announcement with respect to a rule, a registration statement form, or some other matter. In others, however, the Commission, or a division of the Commission, announced a policy or an interpretation of a statute or rule. Although these policies and interpretations do not have the force of law, as a practical matter they are often given almost that effect by a securities lawyer. A litigator can expect a court to pay substantial deference to the Commission's interpretations and policies, and so he or she must consider them not far below the rules in the real-world hierarchy of securities regulation. The lawyer working as a planner, which describes securities lawyers most of the time, typically moves Commission policies and interpretations even closer to rules in the lawyer's own hierarchy. First, the planner wishes to take no avoidable chance of running afoul of the law. Second, congruence with the Commission's policies and interpretations is often the best way efficiently to accomplish a client's transaction.

Also of substantial importance to the securities lawyer are the interpretive letters and so-called no-action letters that are issued, upon request, by the staff of a division of the Commission. In certain instances, the Commission's staff interprets a provision of law for an interested person. In other cases, the no-action letter procedure is used. The process of issuing a no-action letter begins when an interested person, or more usually his or her lawyer, writes a letter outlining a proposed transaction.[12] If the staff is amenable, it responds by indicating that if the transaction is entered into, the staff will not recommend enforcement action to the Commission. Until late 1970 no-action letters were not made public, constituting in a sense a private body of "law" known only to a small group of securities experts. All letters issued since

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12. Securities Act Rel. Nos. 6,269 (Dec. 12, 1980), 6,253 (Oct. 28, 1980), and 5,127 (Jan. 25, 1971) outline the procedures to be followed in requesting an interpretive or no-action letter. Requests to the Division of Corporation Finance may be sent by email to cfletters@sec.gov.

then are published, except for cases in which confidential treatment is sought and approved.[13]

In 1997, the Division of Corporation Finance began issuing Staff legal bulletins, which the director of the division described as "super no-action letters." These bulletins are on various subjects, with the first bulletin covering requests for the confidential treatment of information, filed with the Commission, that otherwise would be required to be disclosed to the public.

Lawyers sometimes call the Chief Counsel's office in the Division of Corporation Finance, or a staff member in the division, for an informal interpretation of some aspect of securities law. When calling the Chief Counsel's office, a lawyer leaves a voicemail message asking for a return telephone call and briefly stating merely the subject matter involved in the question he or she wants to discuss. A staff person listens to these messages and makes brief notes, which are passed to the staff members who handle questions relating to particular subjects. The return call usually comes within a day or two. A lawyer needs to do the necessary research and analysis before calling the Commission, so the question can be well honed and the lawyer's own position stated articulately and persuasively. And, in any case, Commission staff members will not spend scarce time trying to teach a lawyer the basics of securities law involved in a question. Helpfully, the Commission has published a manual of telephone interpretations (available at www.sec.gov/interps/telephone.shtml) given by the Division of Corporation Finance, and this manual may answer a lawyer's question.

Whether a securities lawyer relies on his or her own analysis of an issue, asks for a no-action letter, or calls the Commission for an informal interpretation depends on many factors and requires a good deal of judgment. Sometimes there is no easy answer as to what should be done.

In mid 2004, the Commission made the staff's comment letters with respect to filed documents, and the responses to these letters

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13. SEC Organization; Conduct and Ethics; and Information and Requests Rule 81. The rule is effective for requests submitted on or after December 1, 1970, and covers publication of requests and responses, and requests for confidential treatment.

by issuer's counsel, available on the Commission's website.[14] These letters provide extremely helpful information about the current issues being focused on by the staff. This provides drafters some of the best available guidance about how to draft a filing that avoids staff comments on these issues. Availability of these documents begins with those issued or filed after August 1, 2004, though they will not be made available until forty-five days after the staff has completed its review of a filing.

Court decisions, of course, are as important in interpreting securities statutes and rules as they are in other areas. Coverage by case law is, however, far from uniform among the various securities statutes. Some provisions have come under continual judicial scrutiny, while others have received virtually no attention from the courts. In addition to giving the Commission the power to make rules, Congress has also given the Commission the power to sit in a quasijudicial capacity and adjudicate with respect to the statutes it administers. The adjudication process starts with a hearing before an administrative law judge, whose decision is appealable to the Commissioners.[15] The Commissioners' decisions look very much like those of courts and serve the same interpretive—and, in a real-world sense, law-making—function. Decisions of the Commission may be appealed to a U.S. Court of Appeals.[16]

Adding the Constitution at the top, and remembering the interpretive function of courts and the Commission in its quasijudicial capacity, one finds then the following hierarchy:

Constitution

Securities statutes

Rules and other pronouncements given the force of law

Policy and interpretive releases

Staff legal bulletins

Interpretive and no-action letters

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14. SEC Press Rel. No. 2004-89 (June 24, 2004). Thought the decision was made in 2004, it was not effected until almost a year later, due to practical problems.
15. The entire process is the subject of extensive rulemaking, particularly in the Commission's *Rules of Practice* and its *Rules Relating to Investigations.*
16. *E.g.*, Securities Act § 9(a).

Manual of telephone interpretations

Telephone interpretations

Staff comments on filed documents[17]

There is one other item that must be considered—what securities lawyers sometimes call "lore." Much of the knowledge it takes to deal with the Commission, and otherwise practice in the field, is not the subject of an official pronouncement. If, for example, a lawyer were to prepare and file a Securities Act registration statement following only the statute, rules, and registration statement form, the Commission would likely reject it on the basis that it is so far afield that the staff does not know how to deal with it. This book will try to help with lore.

Lore aside, where does one find the various statutes, rules, forms, releases, and no-action and interpretive letters? There are at least two ways to break down the publications containing these materials: (1) official and unofficial,[18] and (2) governmental and private. There are official and unofficial government publications, but all private publications are unofficial.[19] One should refer to the official publications when needed, but unofficial publications, and especially private ones, are generally more useful.

§ 1:4 Government Publications

Ask the average lawyer where to find the most authoritative text of the federal securities statutes, and you likely will be told United States Code, or perhaps even United States Code Annotated. In reality the first of these publications is quite far removed from being the most authoritative, and the second is published by a private company and has no authority at all. The most authoritative official text of federal statutes actually is found in the bills that contain the original statutes and amendments as passed by

17. The hierarchy of much of this list is not completely set. For example, for the person to whom an interpretive or no-action letter is addressed, its place is higher on the list than releases of general applicability. Also, securities experts differ in their views about the hierarchy of some of the latter items.

18. "Official" is used in the sense of there being a legal recognition, to some degree or other, of the authoritativeness of the publication.

19. This is true for federal statutes generally, not just for those relating to securities, with one exception of only historical interest. *See* 1 U.S.C. § 113.

Congress. Once such a bill is deposited in the public archives, with proper signatures attesting to its adoption as a law, it is virtually unimpeachable, at least when no defect appears on its face.[20] For example, one need not worry about whether a defect, such as lack of a quorum, existed in a bill's passage because courts do not hear evidence on such an issue. Recent original bills are maintained by the Office of the Federal Register and are available for public inspection in Washington.[21] Older original bills are kept in the national archives,[22] and at least microfilm copies are available to researchers.[23] But, obviously, checking the text of original bills is impractical except in highly unusual circumstances.

The next most authoritative sources of federal statutes are Statutes at Large, which are "legal evidence" of laws,[24] and slip laws,[25] which are "competent evidence" of laws.[26] There is no apparent difference between "legal" and "competent" evidence,[27] and so finding a material divergence between these two sources might be an occasion for checking the original bill. Since each Statutes at Large volume contains only the text of bills passed during a particular congressional session, it is cumbersome to trace statutory language through a multitude of volumes. In addition, Statutes at Large is not up-to-date, and so another source is needed as a supplement. Theoretically, slip laws can be used for this purpose, but that is not a practical solution.

The securities statutes are codified in title 15 of United States Code. Some titles of the Code have been enacted into what is called "positive law," making them legal evidence of the laws they contain.[28]

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20. Field v. Clark, 143 U.S. 649, 672–73 (1892).
21. *See* 1 C.F.R. §§ 2.5(a), 3.2(a).
22. *See* 1 U.S.C. § 106a.
23. 36 C.F.R. § 1254.1(b).
24. 1 U.S.C. § 112.
25. Slip laws are pamphlet editions of laws published, relatively soon after adoption, under the authority of the Archivist of the United States. *See* 1 U.S.C. § 113. Each pamphlet contains the text of one bill.
26. 1 U.S.C. § 113.
27. The legislative history of a 1966 amendment to the law that is codified in 1 U.S.C. § 113, by which slip laws were added to the coverage of the law, indicates that the terms were considered synonymous. Act of July 8, 1966, Pub. L. No. 89-497, 80 Stat. 271; S. REP. NO. 89-1310 (1966), *reprinted in* 1966 U.S.C.C.A.N. 2473, 2475.
28. 1 U.S.C. § 204(a). *See* note to 1 U.S.C. § 204(a) for a list of titles enacted as positive law.

Title 15 has not been so enacted, and therefore it is merely prima facie evidence of the law.[29] Courts have made it clear that if a section of the Code that is not enacted into positive law is in conflict with Statutes at Large, the latter governs.[30] And, whether language conflicts or not, the text of the original Act sometimes must be consulted in construing statutory language. The Supreme Court has held that a provision in the Code must be read in the context of the entire Act in which it originates,[31] and on occasion one can be misled by reading only the Code.[32] Some text is changed systematically to enable statutes to fit into the Code. For example, the Securities Act begins, "This act may be cited . . . ," but the Code reads, "This subchapter may be cited. . . ." The greatest difference is in the area of numbering. The Securities Act, for instance, appears as title 15, beginning with section 77a, with section 77a corresponding to section 1 of the Act, section 77b with section 2, and so on. United States Code, like Statutes at Large, is difficult to update through government sources.

The Commission publishes the text of the securities statutes. On its website (www.sec.gov), one can now click on the name of a securities statute and be taken to PDF versions of each of the various securities statutes.

It is difficult to determine the most authoritative official text of rules. Since all rules are required to be published in the *Federal Register*, this is a good starting point.[33] Before publication, an original of the document to be published must be delivered to the Office of the Federal Register.[34] Publication then creates a rebuttable presumption that the published version is a "true

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29. 1 U.S.C. § 204(a).
30. *See, e.g.*, United States v. Welden, 377 U.S. 95, 98–99 n.4 (1964). For an interesting example involving a taxpayer who won his case against the government on this basis, see Royer's, Inc. v. United States, 265 F.2d 615, 618 (3d Cir. 1959). Even when Congress has enacted a United States Code title as positive law, the Code does not take precedence over Statutes at Large. *See Welden*, 377 U.S. at 98–99 n.4.
31. *Welden*, 377 U.S. at 98–99 n.4.
32. For example, 1 U.S.C. § 113 begins: "The edition of the laws and treaties of the United States, published by Little and Brown, . . . shall be competent evidence. . . ." Unless one looks to the original statute, it is not at all apparent that the edition in question is a specific edition published not later than 1846.
33. 5 U.S.C. § 552(a); 44 U.S.C. § 1505(a). *See also* 17 C.F.R. § 202.6.
34. 44 U.S.C. § 1503.

copy of the original."[35] The original is retained in the national archives,[36] and at least a microfilm copy is available for inspection.[37] In the case of documents, such as presidential proclamations, that are themselves the original source of text, the original in the national archives can be taken as an original source. The situation is different, however, in the case of Commission rules, because the document delivered to the Office of the Federal Register is a release that merely purports to contain the text of a rule that previously has been passed. What, then, is the most authoritative source of a Commission rule? It is hard to say. One can argue that the real text is what the Commissioners agreed to, even if that is never correctly memorialized.[38]

In any event, the best practically available government sources of Commission rules are the *Federal Register*, published daily, and the annually published codification known as the Code of Federal Regulations. Similar to the case of the *Federal Register*, publication of a rule in C.F.R. creates prima facie evidence of the text of the rule.[39] The law relating to publication requirements gives reasonable protection when a rule is not published in the *Federal Register* as required or is published there inaccurately. Basically, unless one has "actual and timely notice" of a rule, one may not be "adversely affected" by it unless it has been published in the *Federal Register*.[40] The easiest way to find the current text of a rule through government sources is to start with C.F.R. and then

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35. 44 U.S.C. § 1507.
36. 44 U.S.C. § 1503.
37. 36 C.F.R. § 1254.1(b). A duplicate original, or a certified copy, of recently filed documents is also available for inspection at the Office of the Federal Register. 44 U.S.C. § 1503; 1 C.F.R. § 3.2(a).
38. *But see* Securities Act § 19(a), which requires some publication before a rule is effective. That provision may equate to "no publication—no rule."
39. 44 U.S.C. § 1510(e). The section also uses the term "prima facie" to describe the status of *Federal Register* material that amends material in the Code of Federal Regulations.
40. 5 U.S.C. § 552(a). *But see* 44 U.S.C. § 1507. A problem arises when a rule is correctly published in the *Federal Register*, but is not published, or is published inaccurately, in the Code of Federal Regulations. As a practical matter, the rule, or the correct text thereof, could be hard to find. Some help may be available in this situation because of the fact that the Code of Federal Regulations is technically a special or supplemental edition of the *Federal Register*. 44 U.S.C. § 1510(a).

update through the *Federal Register* to find changes since the C.F.R. revision date. To perform this update, it is necessary first to check the latest List of C.F.R. Sections Affected. That list is published monthly, in pamphlet form, and it includes page number references to *Federal Register* material affecting rules. To be up to date, it is necessary to use the Readers Aids section of the latest issue of the *Federal Register*, and of the last issue of any prior month not covered in the latest List of C.F.R. Sections Affected. Each Readers Aids section contains a cumulative list of C.F.R. sections affected during the month, again with page number references to the *Federal Register*.

The Code of Federal Regulations is divided into numbered titles, parts, and sections. The rules under the securities statutes are found in title 17, beginning at part 200. In C.F.R., rules are not referred to as rules, but as sections of the Code. For example, Securities Act Rule 144 appears as 17 C.F.R. § 230.144. Not only is this the C.F.R. form for rules, but Commission action with respect to rules is often phrased in terms of C.F.R. For example, in a release amending Rule 144, the Commission might begin: "17 C.F.R. § 230.144 is amended to read as follows. . . ." When discussing rules, however, securities lawyers and the Commission's staff invariably use rule numbers, specifying the governing statute when there is any question.

In 1973, the Commission began publishing the SEC Docket on a weekly basis. That publication contains all of the Commission's releases published since that date. In 1981, Commerce Clearing House, Inc. took over publication. The SEC Docket is a helpful, though unofficial, source of rules.

The SEC Docket is, of course, a good source of releases generally, not just those containing rules. The *Federal Register* is, however, the most authoritative, practically available government source of all releases. The law relating to publication of rules also mandates *Federal Register* publication of policy and interpretive releases. More important, it provides to individuals the same protections in the case of faulty publication or nonpublication of those releases as it provides for rules.[41] If the date of a release is known, the release can be found quite easily by checking the table of contents of *Federal Register* issues near the release

41. 5 U.S.C. § 552(a).

date. If only the release number is known, it can take some rummaging in *Federal Register* issues to find the approximate dates when the Commission could have issued the release.

The more important regulations under the securities laws, along with forms, are available at the Commission's website (www.sec.gov). They are a bit hard to find, as they are in a section called "About the SEC." Once there, one can click on the "Rules" opposite the name of the principal securities statute and now be directed to the Electronic Code of Federal Regulations. For those wanting daily information directly from the Commission, a helpful service is the SEC News Digest, published daily on the Commission's website. Select "News Digest" under "News & Public Statements" to find this tool, which provides a daily summary of significant Commission activity, proposed and final rules, and lists of companies that have filed Securities Act registration statements and Exchange Act current reports on Form 8-K.

Copies of interpretive and no-action letters are available at the public reference room of the Commission, and the SEC website (www.sec.gov) gives access to important letters that are relatively recent. The website is a good place to start a search because the site has letters listed by subject matter. The whole body of no-action and interpretive letters is not, however, available in a useful form except from a private source. Decisions of the SEC sitting in its quasijudicial capacity are announced in releases, which can be found in the same way as any other releases. Selected decisions eventually are reported in Securities and Exchange Commission Decisions and Reports. It can, however, take some years for a decision to appear there. Staff legal bulletins and the Division of Corporation Finance's manual of telephone interpretations (along with recent news releases, selected rules and interpretive releases, staff comment letters on filed documents and issuers' responses to those comments, and other material of interest to securities lawyers) are published on the Commission's website, www.sec.gov.

§ 1:5 Private Publications

The most widely used private hard-copy source of federal securities law materials is Commerce Clearing House, Inc.'s *Federal Securities Law Reporter.* That publication is a seven-volume, loose-leaf service, updated weekly, containing the *Statutes at Large* text of the statutes and a complete and current set of the

rules and forms. It also includes a complete list of all releases, along with copies of selected releases and selected no-action and interpretive letters. As part of the service, a subscriber also receives copies of court and Commission securities cases. The CCH service is also available on CD-ROM and on the LexisNexis computer service.

For an annotated version of *United States Code*, the *United States Code Annotated*, published by West Publishing Company, or *United States Code Service*, published by Lexis Publishing, can be consulted. To update these sources more currently than the pocket parts and other supplements, West's *U.S. Code Congressional and Administrative News* is helpful, as is *Shepard's United States Citations.* Most or all of these resources are available online.

The *Securities Lawyer's Deskbook*, which is published online by the University of Cincinnati College of Law (www.law.uc.edu/ccl), contains the securities statutes and their rules, regulations, and forms. The current text of the statutes and the rules and regulations is maintained by the college, while access to the forms is by hyperlink to the Commission's website. The *Deskbook* has a particularly helpful search function. Findlaw.com also provides links to many securities law materials, such as those found in the U.S. Code and the Code of Federal Regulations, along with the text of court cases, though one has to use great care since materials like statutes and rules are not current. The site tells a user how to update these materials, though the process can be tedious, and one can miss the posted cautions about the currency of the materials.

The most-used service for keeping current with securities law developments is *Securities Regulation & Law Report*, which is published weekly by the Bureau of National Affairs, Inc. and is available both in hard copy and online from BNA. This publication is also available on the LexisNexis computer service. It contains selected rules, forms, releases, and cases. The publisher also gives its own summary of a wide range of securities law developments. BNA also has available online *Securities Law Daily*, which is essentially a daily version of the summary portion of *Securities Regulation & Law Report.*

It is virtually impossible to do complete research in policy and interpretative releases and no-action and interpretative letters without the LexisNexis or Westlaw computer service or West's

CD-ROM Federal Securities Library with online updates. Each source contains all interpretive and no-action letters that have been released to the public, along with selected policy and interpretative releases. Each also contains statutes, rules, and decisions by courts and the Commission, along with other helpful material.

§ 1:6 State Securities Law

By the time Congress passed the Securities Act, most states had been in the business of securities regulation for many years. That regulation remained in place after the passage of the New Deal securities statutes, and the states have continued to be active in the area. There is great divergence among the various state regulatory schemes, but it is not unusual for a state to exercise jurisdiction in many of the major areas covered by the Securities Act and the Exchange Act. As with the Securities Act, the typical state statute requires that securities be registered before sale, unless preempted by federal law or an exemption is available. Preemption became particularly important with the passage of the National Securities Markets Improvement Act of 1996, which amended Securities Act section 18. These amendments designated a number of securities "covered securities" and provided that covered securities are exempt from state regulation, with minor exceptions. For general purposes, the most important covered securities are (or someday will be), in rough terms, securities of publicly held companies, securities that are offered or sold to "qualified purchasers" as defined by the Commission, and securities offered or sold under a rule issued under Securities Act section 4(2). The trouble with the exemption for offers and sales to qualified purchasers, which could be very helpful, is that the Commission has never passed a rule defining the term. In August 2007, the Commission proposed amendments to Regulation D that include a new Rule 507 exempting from the registration provisions of the Securities Act sales to "large accredited investors" who are deemed "qualified purchasers."[42]

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42. Securities Act Rel. No. 8,828 (Aug. 3, 2007). Regulation D is discussed in section 6:5. Rule 506 under Regulation D provides an exemption under section 4(2), which makes securities offered or sold in a Rule 506 transaction covered securities. This aspect of covered securities is mentioned above in this paragraph.

State law also regulates brokers and dealers to some extent, overlapping here with the Exchange Act. The typical state statute also prohibits various kinds of fraud, which is proscribed by both the Securities Act and the Exchange Act. The liability provisions in state securities laws have great importance.

Like the more specialized of the federal statutes, state securities laws are more easily understood when they are approached by someone who knows the federal scheme. Partially for that reason, this book will touch on state securities regulation only to a very limited extent. It is important to remember, however, that state law may be involved in any particular aspect of the securities business and in any kind of securities transaction. In addition, one should realize that state securities administrators often have substantially more discretion than their federal counterparts, especially under the merit regulation scheme discussed at the beginning of this chapter.[43]

A good example of the sometimes immense power of officials under state securities laws began in 2002. The Attorney General of New York brought enforcement actions against ten securities firms headquartered in that state, charging conflicts of interest relating to their research analysts. Under the New York securities statute, the attorney general would have been able, if he proved the charges, to prevent the securities firms from doing business in New York. The firms settled for $1.4 billion, plus structural reforms within the firms and enhanced disclosures to investors. Following his success in that matter, the New York Attorney General has become involved in a number of other securities scandals. For example, he engineered several large settlements (the largest being some $675 million) with companies alleged to have engaged in illegal market timing of mutual fund transactions.

Picking up on the actions in New York, a number of other states have become involved in investigations and enforcement actions relating to securities fraud, in situations they previously had left mainly to the Commission. Some of the settlements involving abusive market timing practices by mutual funds were the joint efforts of the New York Attorney General and other state

43. *See* section 1:2.2, *supra.*

regulators. This trend continues with investigations into various practices emanating from the subprime mortgage crisis that began in 2007.

§ 1:7 Special Position of Securities Lawyers

The environment in which securities lawyers practice is quite different from that of most other lawyers. That difference is probably the result of two distinguishing characteristics of securities law practice. First, it is usually a securities lawyer who decides whether a particular transaction can proceed or, because of legal problems, must be canceled. As a matter of common practice, for example, it is often true that, unless a lawyer attests to the legality of a transaction by the delivery of an opinion, the parties to the transaction will not agree to proceed. Second, a securities lawyer typically does not merely advise clients on how to accomplish a transaction, but rather he or she usually is an active participant in the transaction.

The first of those characteristics, coupled with the knowledge of the Commission that its own enforcement resources are wholly insufficient to police a significant fraction of securities transactions, has caused the Commission to advocate that a lawyer has a special responsibility to protect the public when working in the securities area. For example, the Commission has argued that when a securities lawyer has reason to believe that a client's actions will violate the securities laws, the lawyer has a duty to inform the Commission. Proponents of expanded responsibility for securities lawyers sometimes liken the position of the securities lawyer to that of the certified public accountant, who long ago was held to have an overriding responsibility to the public, rather than merely to his or her clients.[44]

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44. In this regard it is helpful to note that, in Exchange Act § 10A, auditors are given heavy responsibilities with respect to the detection and reporting of illegal acts. Included in these responsibilities are the requirements to see that information the auditor has uncovered about illegal acts (i) gets into the hands of the board of directors or its audit committee and (ii) is, under specified circumstances, reported to the Commission by the board or, if the board fails to do so, by the auditors. These basic requirements predate the Sarbanes-Oxley Act of 2002, and that Act adds substantially to auditors' requirements and limitations when dealing with publicly held companies.

The second of these characteristics—active involvement by lawyers in securities transactions—sometimes insures that when the legality of a completed transaction is questioned, one or more securities lawyers will find themselves in the middle of the controversy, rather than somewhat comfortably on the sidelines. It is probably when contemplating that possibility that a securities lawyer most often looks with envy on colleagues who merely advise clients, rather than help them effect transactions.

There are two cases that point up especially well the distinguishing characteristics of securities law practice and the results that can flow from these characteristics. The first is *SEC v. National Student Marketing Corp.*[45] National Student Marketing Corp. and Interstate National Corp. had agreed to merge. At the closing of the transaction, officers of the corporations and their lawyers discussed information, provided by NSMC's accountants, concerning problems with some of the financial statements of NSMC that Interstate had provided its shareholders in connection with their vote to approve the merger. As a condition to the closing, the law firm representing each party was to deliver an opinion covering various points, including "that all steps taken to consummate the merger had been validly taken and that [its client] had incurred no violation of any federal or state statute or regulation to the knowledge of counsel."[46] The law firms involved were two of the largest and most respected in the country: White & Case of New York for NSMC and Lord, Bissell & Brook of Chicago for Interstate.

If lawyers for either side had refused to deliver their opinion, Interstate almost certainly would not have proceeded with the closing. A solution to any legal question arising because of the financial statements was to give new statements to the Interstate shareholders and have them vote again on the merger. There was a problem with that alternative, however. The merger agreement contained an upset date by which if the merger was not consummated NSMC ceased to be bound, and it was impossible for the Interstate shareholders to vote before that date. Interstate's management was afraid that if it missed the upset date, NSMC

45. SEC v. Nat'l Student Mktg. Corp., 457 F. Supp. 682 (D.D.C. 1978).

46. Complaint in *National Student Marketing*, dated February 3, 1972, at 48, *reprinted in* LARRY D. SODERQUIST, SECURITIES REGULATION: A PROBLEM APPROACH 822–23 (1982).

might refuse to merge or might force a renegotiation of the merger's terms. That fear seemed well placed because the price of NSMC's stock, which NSMC was to give Interstate's shareholders, had risen substantially since the parties had finalized the merger agreement.

The law firms delivered their opinions, and the merger closed in October 1969. The price of NSMC's stock continued to rise for a time, reaching its high in mid December. Then, in the words of the court, ". . . in early 1970, after several newspaper and magazine articles appeared questioning NSMC's financial health, the value of the stock decreased drastically. Several private lawsuits were filed and the SEC initiated a wide-ranging investigation."[47]

That investigation culminated in a complaint by the Commission, filed in federal district court, that alleged securities fraud against multiple parties, including NSMC, Interstate, White & Case and one of its partners, and Lord, Bissell & Brook and two of its partners. The heart of the Commission's complaint against the law firms and the individual partners was this provision:

> As part of the fraudulent scheme [the law firms and their named lawyers] failed to refuse to issue their opinions . . . and failed to insist that the financial statements be revised and shareholders be resolicited, and failing that, to cease representing their respective clients and, under the circumstances, notify the plaintiff Commission concerning the misleading nature of the nine month financial statements. . . .[48]

Protracted litigation followed. Early in this process counsel for White & Case filed a memorandum arguing its case. The following is an excerpt:

> The basic question presented by the principal claim in the amended complaint against White & Case is: Did White & Case have an obligation in the face of a determination by the representatives of Interstate that it was in their interest to proceed with the closing:
>
> (a) to prevent the closing from taking place;
>
> (b) to withdraw from representation of the client; and
>
> (c) to notify the SEC?

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47. *Nat'l Student Mktg. Corp.*, 457 F. Supp. at 699.
48. Complaint, *supra* note 46.

> . . . It is our view that White & Case did not have either a right or duty to take the steps mentioned; that White & Case acted with propriety throughout the closing; and that the steps suggested by the SEC . . . would have violated their responsibility to their client and might have subjected their client to liability. . . .
>
> Plainly, there were good reasons why as a business matter Interstate should proceed and great difficulties as a business matter in justifying to their investors a decision not to proceed.[49]
>
> But in any event White & Case believed this was a business decision for Interstate with which NSMC and its counsel had no right to interfere and every obligation to allow the merger to be consummated if that was Interstate's choice.[50]

Five years later, White & Case and its partner reached a settlement with the Commission. Without admitting or denying the allegations in the complaint, the partner consented to the entry of an injunction against violations of specified sections of the securities laws and also agreed that, for 180 days, he would not practice before the Commission or advise clients with respect to matters involving securities registered under the federal securities laws. Also without admitting or denying the Commission's allegations, White & Case agreed to adopt certain internal procedures in connection with its practice of securities law.[51]

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49. The president of Interstate advised the SEC in testimony taken before the complaint was filed that he took this decision "in the interest of the shareholders," that "the shareholders would have been harmed far more than helped if the merger had not been completed," [and] that if the merger had been called off the Interstate stock would "plummet the next day."

    Counsel for Interstate testified before the SEC that if Interstate did not proceed and its shares declined as expected, "we felt we would have a tremendous number of irate shareholders suing Interstate management for failing to go through with the deal." [Footnote in original.]

50. Memorandum in *National Student Marketing*, filed April 12, 1972, by Arnold & Porter, *reprinted in* LARRY D. SODERQUIST, SECURITIES REGULATION 637–38 (3d ed. 1994).

51. SEC v. Nat'l Student Mktg. Corp., [1977–1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,027.

By the time the *National Student Marketing* case was tried, only four defendants were left: the former president of Interstate; Lord, Bissell & Brook; and two of the law firm's partners, one of whom had been also a director of Interstate. The district judge found that the former president of Interstate and the lawyer-director, when acting as a director of Interstate, had violated antifraud provisions of the federal securities laws. He also found that Lord, Bissell & Brook and its two partners had aided and abetted those violations. The one small bright spot for the law firm and its partners, coming after more than six years of litigation, was the judge's refusal to enjoin further violations because he was not convinced that an injunction was required to prevent further violations.

The other case that points up especially well the distinguishing characteristics of securities law practice, and the results flowing from them, is *In re Carter*,[52] which was a proceeding before the Commission sitting in its quasijudicial capacity. The Commission brought the action under then Rule 2(e) (now Rule 102) of its Rules of Practice to determine whether two partners of Brown, Wood, Ivey, Mitchell & Petty, a well-known and respected New York law firm, should be suspended or barred from practicing before the Commission because of alleged unethical or improper professional conduct.

An administrative law judge found that the lawyers had willfully aided and abetted a client's violations of various provisions of the federal securities laws. The judge also concluded that both of the partners should temporarily be suspended from practicing before the Commission. In its decision on appeal, the Commission reversed the administrative law judge, finding that the lawyers "did not intend to assist the violations by their inaction or silence," but rather, "seemed to be at a loss for how to deal with a difficult client."[53]

Nevertheless, the Commission believed that the lawyers' conduct raised questions concerning the obligations of securities lawyers, and therefore it announced the interpretation of unethical or improper professional conduct it would apply in the future:

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52. Exchange Act Rel. No. 17,597 (Feb. 28, 1981).
53. *Id.*

> The Commission is of the view that a lawyer engages in "unethical or improper professional conduct" under the following circumstances: When a lawyer with significant responsibilities in the effectuation of a company's compliance with the disclosure requirements of the federal securities laws becomes aware that his client is engaged in a substantial and continuing failure to satisfy those disclosure requirements, his continued participation violates professional standards unless he takes prompt steps to end the client's noncompliance.[54]

Although the required prompt action could be resignation, that was not the action the Commission favored. In its view, "[p]remature resignation serves neither the end of an effective lawyer-client relationship nor, in most cases, the effective administration of the securities laws. The lawyer's continued interaction with his client will ordinarily hold the greatest promise of corrective action."[55]

In both *National Student Marketing* and *In re Carter*, lawyers were accused of aiding and abetting violations of Exchange Act section 10(b). In *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*,[56] the Supreme Court determined that a private plaintiff cannot maintain an aiding and abetting action under that section. Under the Court's reasoning, which was based primarily on its interpretation of congressional intent, it was unclear whether the Commission had authority to bring actions for aiding-and-abetting violations of section 10(b). Exchange Act section 20, as amended by the Private Securities Litigation Reform Act of 1995, now provides that the Commission has authority to bring actions for aiding and abetting the violation of any section of the Exchange Act or of any of its rules or regulations. (A general statute[57] has long created aiding-and-abetting liability for all federal criminal offenses, and a violation of the securities laws can be a criminal offense.) In private actions, one should expect professionals, such as lawyers and accountants, to be named as primary violators of section 10(b), rather than

54. *Id.*
55. *Id.*
56. Cent. Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).
57. 18 U.S.C. § 2.

aiders and abettors, whenever the facts arguably would support such a claim.[58]

Section 602 of the Sarbanes-Oxley Act of 2002, passed as a result of corporate scandals involving securities fraud, codifies (with minor changes) the main part of Rule 102(e) as a new section 4C of the Exchange Act. This new section relates to improper or unethical professional conduct, and other related problems, in the context of all federal securities laws. More importantly, section 307 of Sarbanes-Oxley required the Commission to pass rules that set minimum standards of professional conduct for securities lawyers representing issuers (which, under that Act's definition, essentially means Exchange Act reporting companies[59] and companies that have filed a Securities Act registration statement). In January 2003, the Commission issued these rules in a compendium entitled "Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of an Issuer."[60] The rules are complex and go beyond the section 307 mandate. Basically, they lay reporting obligations on both in-house and outside counsel in the case of material violations of the securities laws or fiduciary duties, or similar violations.

Rule 3 requires lawyers to report evidence of a material violation[61] by an issuer or by an officer, director, employee, or agent of an issuer. In most cases, the lawyer would report such a violation to the issuer's chief legal officer or to that officer and the chief executive officer. The chief legal officer then has the obligation to cause an inquiry into the allegation and to report back to the lawyer who made the report of a possible violation. If the chief legal officer finds no violation, his or her response to the

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58. Courts disagree on what it takes for a professional to be liable as a primary violator. *See, e.g.*, Ziemba v. Cascade Int'l, Inc., 256 F.3d 1194 (11th Cir. 2001); Wright v. Ernst & Young LLP, 152 F.3d 169 (2d Cir. 1998); *In re* Software Toolworks, Inc., Sec. Litig., 50 F.3d 615 (9th Cir. 1995).

59. See section 9:3 for a discussion of how companies become Exchange Act reporting companies.

60. *See* Exchange Act Rel. No. 47,276 (Jan. 29, 2003).

61. "Evidence of a material violation" is defined in Rule 2(e) of the Standards of Professional Conduct. It "means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur."

reporting lawyer must state the basis for the finding. If the chief legal officer finds a violation, he or she must advise the reporting attorney of his or her findings and the action he or she took relating to the violation. As an alternative to causing an inquiry into an allegation from a reporting attorney, the chief legal officer may refer the attorney's report to a qualified legal compliance committee of the board (these committees are discussed below).

If the reporting lawyer receives an appropriate response within a reasonable time, his or her obligations usually are complete. If the reporting lawyer does not receive an appropriate response within a reasonable time, he or she must report the evidence of a material violation to the audit committee, to another committee of independent directors, or to the full board of directors if the board has no committee consisting only of independent directors. Alternatively, the report may be made to a "qualified legal compliance committee" of independent directors, if the board has established such a committee. (The "qualified legal compliance committee" does not have to be a separate committee, but may be a board committee, such as the audit committee, that meets the Commission's requirements, which are set out in definitional form in Rule 2(k), and that is named as such.) If the reporting lawyer does not believe that the issuer has made an appropriate response, then his or her responsibility does not stop at receiving the report mentioned at the beginning of this paragraph. In such a situation, the lawyer must explain the reasons for his or her belief to the chief legal officer and the chief executive officer, and to directors to whom the lawyer may have reported the evidence of a material violation.

Rule 3 provides reporting lawyers with an alternative to reporting evidence of material violations to the chief legal officer or to the chief legal officer and the chief executive officer. A lawyer may bypass these officers and report his or her evidence directly to a qualified legal compliance committee and, in that case, need not receive or access any report from such a committee.

Rules 4 and 5 establish the responsibilities of subordinate lawyers and those who supervise them. Rule 6 details the manner in which the Commission will prosecute violations by lawyers. In this respect, it should be noted that, under Rule 6, lawyers who violate the Standards of Professional Conduct may be sanctioned by the Commission as if they had violated one of the federal

securities laws. Rule 7 provides that nothing in the Standards of Professional Conduct creates a private right of action and that the Commission has exclusive authority to enforce compliance.

While the Commission was drafting these new rules, there was speculation that it might revisit *In re Carter* and fold in the standards of conduct set out there, changed as the Commission may have desired. This did not happen. In its proposed Standards of Professional Conduct, however, the Commission proposed that lawyers be required to make a "noisy withdrawal" when issuers failed to take appropriate actions with respect to a lawyer's report. This withdrawal would have included disaffirming to the Commission any past tainted submissions. In response to massive opposition from lawyers, the Commission allowed additional time for comments on this provision. In addition, the Commission proposed an alternative to "noisy withdrawal," allowing the same sixty-day comment period. Under this alternative, the issuer and not the lawyer would have had the responsibility to report the lawyer's withdrawal or failure to receive an appropriate response to his or his report of evidence of material violation. An issuer would have been required to make the disclosure on a Form 8-K current report under the Exchange Act.[62]

At its annual meeting in August 2003, the American Bar Association issued pronouncements on the responsibilities of securities lawyers, with the ABA being against noisy withdrawal. A number of states also entered the fray, taking positions both for and against noisy withdrawal. SEC rulemaking in this area now seems remote. Lawyers should review their own state rules, however, because some states (a minority) have provisions for mandatary "noisy withdrawal" in situations that would include securities fraud by a client (public or private).

Litigation arising out of the Enron and other corporate scandals continues to make its way through the courts. One example is *In re Enron Corp. Securities, Derivative & ERISA Litigation.*[63] In the opinion in this case, which is 158 pages long,[64] the court dealt with, among many other things, the alleged involvement of two

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62. Exchange Act Rel. No. 47,282 (Jan. 29, 2003).
63. *In re* Enron Corp. Sec., Derivative & ERISA Litig., 235 F. Supp. 2d 549 (S.D. Tex. 2002).
64. The list of lawyers representing the parties is, by itself, over three double-columned pages.

law firms in a massive fraud. The question before the court was whether the complaint properly stated claims against the firms as primary violators of Rule 10b-5. With respect to Vinson & Elkins L.L.P., the court found that the lead plaintiff had met its burden of stating the claim, saying in part that, allegedly,

> Vinson & Elkins . . . chose, not once, but frequently, to make statements to the public about Enron's business and financial situation. . . . Moreover in light of its alleged voluntary, essential, material, and deep involvement as a primary violator in the ongoing [fraudulent] scheme, Vinson & Elkins was not merely a drafter, but essentially a co-author of the documents it created for public consumption concealing its own and other participants' actions.[65]

With respect to Kirkland & Ellis, however, the court found that the lead plaintiff had not met its burden of stating a claim that the firm was a primary violator of Rule 10b-5, saying in part:

> The Court agrees with Kirkland & Ellis that Lead Plaintiff has only alleged that Kirkland & Ellis represented some of the illicit Enron-controlled, non-public [special purpose entities] and partnerships that Enron, but not Kirkland & Ellis, used for transactions (devices or contrivances) to hide its debt and record sham profits, disguising its true financial condition, and performed legal services on their and Enron's behalf. . . . Any documents that it drafted were for private transactions between Enron and the [special purpose entities] and the partnerships and were not included in or drafted for any public disclosure or share holder solicitation. Any opinion letters that the firm wrote are not alleged to have reached the plaintiffs nor been drafted for the benefit of the plaintiffs. It was not Enron's counsel for . . . its SEC filings.[66]

In connection with the related Enron bankruptcy litigation, on November 24, 2003, the examiner, Neal Batson, filed a report concluding that Enron has viable malpractice claims against Vinson & Elkins and Andrews Kurth LLP, a Houston law firm,

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65. *In re Enron Corp.*, 235 F. Supp. 2d at 705. This matter must now be reconsidered in light of the *Stoneridge* decision, discussed at footnote 70, *infra*, and in section 12:12.

66. 235 F. Supp. 2d at 705–06.

and that both firms may also be liable for aiding and abetting breaches of fiduciary duty by Enron officers. He also concluded that Enron's former general counsel, James Derrick, and other in-house lawyers may have committed malpractice in their work for Enron.[67]

More than a decade after *Central Bank*, the courts remained divided about the potential liability of "secondary actors" (for example, lawyers) under the federal securities laws. One issue was whether the shareholders of a company can sue the company's vendors, business partners, accountants, banks, or lawyers for participating in a "scheme" to issue materially misleading statements to shareholders. The Fifth (in the Enron case) and Eighth Circuit Courts of Appeals[68] had said "no," and the Ninth Circuit[69] had said "sometimes." That issue was recently settled by the U.S. Supreme Court in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*[70] The question in *Stoneridge* was whether a company that engages in a sham transaction with a primary actor, knowing that the primary actor will use the transaction to fraudulently inflate revenues, can be a primary actor itself, even if it does not make misstatements of its own. It was similar to the question posed in the Enron class action that was decertified by the Fifth Circuit and is now on its way up to the Supreme Court.[71] In *Stoneridge*, the Supreme Court ruled that a party with no duty to disclose who does not make or have attributed to it any material misstatement is not liable under a theory of "scheme liability" in private 10b-5 litigation. Although secondary actors remain subject to Commission enforcement actions and to potential criminal liability, *Stoneridge* effectively eliminates 10b-5 liability for non-speaking secondary actors who have no duty to disclose information. *Stoneridge* and the predecessor cases are discussed in greater detail in chapter 12.

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67. *In re* Enron Corp., 367 B.R. 373 (Bankr. S.D.N.Y. 2007).
68. Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc., 482 F.3d 372 (5th Cir. 2007); Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc. (*In re* Charter Commc'ns, Inc. Sec. Litig.), 443 F.3d 987 (8th Cir. 2006), *rev'd*, 128 S. Ct. 761 (2008).
69. Simpson v. AOL Time Warner, Inc., 452 F.3d 1040, 1048 (9th Cir. 2006).
70. Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 128 S. Ct. 761 (2008).
71. *See* note 68, *supra.*

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REGULATORY FRAMEWORK OF SECURITIES ACT REGISTRATION

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Chapter 3

Regulatory Framework of Securities Act Registration

§ 3:1 Introduction

§ 3:1.1 *Statutory Framework*

Consideration of the regulatory framework of registration must begin with the Securities Act, and because of the way the Act is structured, it is essential to begin by considering section 5. In doing so, it is most helpful to examine the various subsections of section 5, not in the order in which they appear, but rather as they relate to the three time periods in an offering:

(1) the period before a registration statement is filed (the prefiling period),

(2) the period after filing but before the registration statement becomes effective (the waiting period), and

(3) the period after effectiveness (the posteffective period).

The following table shows the basic applicability of the various subsections:[1]

PREFILING	WAITING	POSTEFFECTIVE
§ 5(a), (c)	§ 5(a), (b)(1)	§ 5(b)

The following sections of this chapter examine the regulatory framework of each of those periods, beginning, when appropriate, with the relevant provisions of section 5. Whenever statutory sections are discussed in this and later chapters, it will be helpful to refer to the sections themselves. Some of those sections are set out in the text and others may be found in the appendix.

In 2005, in what was termed "securities offering reform," the Commission adopted or amended a number of rules that substantially affected the material covered in this chapter.[2] These rule changes gave issuers and underwriters more freedom to release information during the course of a registered offering than had previously been the case. The 2005 securities offering reform continued the Commission's efforts towards integrating the

1. The applicability of sections 5(b)(2) and 5(c) to a period or periods not shown here will be referred to below. *See* note 34, *infra*, with respect to section 5(b)(2) and section 3:2, *infra*, with respect to section 5(c).
2. Securities Act Rel. No. 8,591 (July 19, 2005).

disclosure processes under the Securities Act and Exchange Act, a process that began in 1977.

In addition to understanding the basic statutory and regulatory framework, the 2005 rules required issuers and their lawyers to also consider various categories of issuers (for example, "well-known seasoned issuers") created by the Commission. The 2005 rule changes already have resulted in significant changes in the way many issuers conduct and communicate with respect to registered securities offerings and eliminated unnecessary and outmoded restrictions on the capital raising process.

Note that when securities are offered and sold in connection with certain business combinations, such as mergers and tender offers, the Commission's rules permit somewhat more and different communications with security holders and the securities markets than are discussed here.[3] These other rules will easily be understood by anyone who has a good grasp of the material in this chapter. The 2005 securities offering reform rules likewise do not apply to registered investment companies, and they do not address private placements and other exempt offerings. In addition, they generally do not apply to blank check companies, shell companies, and blind pool offerings.

§ 3:1.2 Categories of Issuers

The statutory framework now is overlayed by five categories of issuers that one must understand. Different categories of issuers have the availability of different communication opportunities and registration options. They likewise are bound by different requirements and restrictions.

The five categories of issuers are:

- *Well-Known Seasoned Issuers* (WKSIs, often pronounced "wick-seas") are "seasoned issuers" (see below) that either (1) have at least $700 million in market value of common equity held by nonaffiliates or (2) have issued at least $1 billion in principal amount of nonconvertible securities (excluding common equity) in primary registered offerings for cash in the prior three years (excluding exchange offers).

3. *See* Securities Act Rules 135, 145, 162, 165, 166, 425, and 432.

The definition of WKSI excludes blank check companies, shell companies, issuers of penny stock, issuers involved in bankruptcy proceedings, and issuers which have violated the antifraud provisions of the federal securities laws. These "ineligible issuers" (as they are called in Rule 405) may not avail themselves of the benefits offered to WKSIs. WKSIs are the issuers that benefit the most from the streamlined registration process and greater latitude in communicating with market participants now allowed. The definition of a WKSI includes issuers of a sufficient size and established reporting history that are followed and scrutinized by sophisticated investors, analysts, and the media.[4]

- *Seasoned Issuers* are Exchange Act reporting companies that are eligible to register primary offerings of securities on Form S-3 or F-3.[5]
- *Unseasoned Issuers* are Exchange Act reporting companies that are not eligible to register primary offerings of securities on Form S-3 or F-3.
- *Nonreporting Issuers* are issuers that are not required to file periodic reports under the Exchange Act and include those issuers that file such reports "voluntarily," such as pursuant to a loan agreement or indenture.
- *Ineligible Issuers* include the issuers referred to in the definition of WKSI above as well as reporting companies that are (with limited exceptions) not current in their Exchange Act reports. Ineligible issuers do not benefit from automatic shelf registration (described in section 4:3.3[C], *infra*) and are limited in their ability to utilize a "free writing prospectus" (described in section 3:3.3, *infra*).

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4. On January 26, 2009, the Commission issued staff interpretations, in question-and-answer format, regarding timing of determination of WKSI status and its effect on certain filings.
5. In Securities Act Rel. No. 33-8878 (Dec. 19, 2007), the Commission expanded the eligibility criteria for use of Form S-3.

§ 3:2 Prefiling Period

§ 3:2.1 Statutory Scheme

The provisions of section 5 applicable to the prefiling period are sections 5(a) and (c). They provide:

> Prohibitions Relating to Interstate Commerce and the Mails
>
> Section 5.(a) 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 such security through the use or medium of any prospectus or otherwise; or
>
> (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.
>
> * * *
>
> (c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

It is best to begin an analysis with section 5(c), since it relates to offers and is applicable in its entirety to the prefiling period (except for provisions on registration statements that are the subject of a refusal order, stop order, public proceeding, or examination, which are rare occurrences that are discussed in chapter 4). Section 5(a), on the other hand, deals with sales (which chronologically follow offers) and is applicable to the waiting period as well as the prefiling period.

The most helpful first step in understanding section 5(c) is the culling of language that does not aid comprehension. For example,

"directly or indirectly" adds very little to understanding, and "through the use or medium of any prospectus or otherwise" adds nothing. The clause relating to "means or instruments of transportation or communication in interstate commerce or of the mails" is a bit trickier. It is a practical impossibility to complete the usual securities offering without using one of the named "jurisdictional means." Of course, it is possible that a particular act, such as the making of a specific offer, might be done without use of those means. The concept of jurisdictional means, however, is broad. Any use of the telephone by the offeror almost certainly satisfies the requirement,[6] and it can be met in much more abstruse ways. For example, when the president of an issuer by chance encounters a friend at the country club and offers to sell the friend securities, the president probably has not used any jurisdictional means. But if the friend telephones for more information, a court probably would find that jurisdictional means had been used to "offer" the securities, because the offeror reasonably could have foreseen the use of the telephone by the offeree.[7] Lawyers litigating securities cases may sometimes find "no jurisdictional" means arguments helpful. Others will find such arguments too dangerous to rely on, and they can virtually ignore the jurisdictional means language of section 5. That is what generally will be done in this book. After culling the above language, and setting aside language relating to refusal orders, stop orders, public proceedings, and examinations, one is left in section 5(c) with this: "It shall be unlawful for any person . . . to offer to sell or offer to buy . . . any security, unless a registration statement has been filed as to such security. . . ."

All that remains, then, for understanding section 5(c) is an understanding of what its various words and phrases mean. That is not so simple as it may seem. An examination of the definitions, contained in section 2 of the Act, shows that some of those words and phrases have special meanings. After a reading of definitions, one is ready to consider rules, releases, cases, and so on in an attempt more fully to understand those terms.

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6. *See, e.g.*, Kerbs v. Fall River Indus., Inc., 502 F.2d 731, 737–38 (10th Cir. 1974); Lennerth v. Mendenhall, 234 F. Supp. 59, 63 (N.D. Ohio 1964).

7. *See, e.g.*, United States v. Wolfson, 405 F.2d 779, 783–84 (2d Cir. 1968) (discussing the reasonably foreseen use of the mails).

After considering offers under section 5(c), one should turn to section 5(a). Taken to its essentials, section 5(a)(1) prohibits the sale of securities unless a registration statement has become effective (that is, at the end of the waiting period). The major problem in that area is determining what constitutes a sale. A look at section 2(a)(3) shows that the word has special meanings, which are discussed below.[8] Section 5(a)(2) contains a rather straightforward prohibition against transmitting unregistered securities through the mail, or by means of interstate commerce, for purposes of sale or delivery after sale.[9] That provision is an important enforcement tool of the Commission, but one that relates to problems a securities lawyer rarely encounters while working as a planner.

Reading the basic portions of sections 5(c) and 5(a)(1) together, the rule for the prefiling period is: no offers, no sales. Whether an activity constitutes a sale may be an issue in the prefiling period, but that issue is typically of more concern in the waiting period. For that reason, the discussion of sales appears in the context of the waiting period. Offers present the main problem of the prefiling period, and they are discussed here.

§ 3:2.2 *What Is an Offer?*

[A] Section 2(a)(3)

The starting point for understanding the concept of an offer under the Securities Act is the definition contained in section 2(a)(3), which in its basic part provides: "The term 'offer to sell,' 'offer for sale,' or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." The provision does not purport to be a complete definition, because it speaks only in terms of what an offer "shall include." Presumably the drafters intended to take the common-law definition of offer as a beginning and modify it.[10] The modification

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8. *See* sections 3:3.2 and 5:3, *infra*.
9. Some of the more interesting nuances of this section are discussed below as they apply to section 5(b)(2), a closely analogous provision. *See* section 3:4.3, *infra*.
10. The *Restatement* defines an offer as "the manifestation of willingness to enter into a bargain, so made as to justify another person in understanding that his assent to that bargain is invited and will conclude it." RESTATEMENT (SECOND) OF CONTRACTS § 24 (1979).

immediately apparent is that the solicitation of an offer to buy is considered an offer to sell. As a result, it is not possible to avoid the "no offer to sell" prohibition of section 5(c) by phrasing an offer in terms of a solicitation of an offer to buy.

The language of section 2(a)(3) may have been meant to modify the common-law definition of "offer" in a more significant way. It can be argued that the intent of the phraseology "shall include *every* attempt or offer to dispose of" (emphasis added) was to push the perimeters of the ordinary definition outward, so as to encompass activities that otherwise would not constitute offers. The full intent of the drafters is not clear, but a desire for expansiveness is not unlikely. In any case, the Commission has read the definition broadly, particularly in terms of prefiling activities that, while falling far short of common-law offers, condition the market for the securities to be sold.

[B] Conditioning the Market

The concept of conditioning the market first was articulated by the Commission in Securities Act Release No. 3,844.[11] After referring to the definition of "offer" in section 2(a)(3), the Commission stated without analysis that, in the prefiling period, it is not legally possible to begin a public offering *or* "initiate a public sales campaign." The use of the connector "or" causes confusion. A public sales campaign is only unlawful when it involves an offer as defined in the Act. When it does, the campaign should be encompassed in the term "public offering." Presumably, the Commission used that latter term in the more restrictive sense of a formal offering, but it is difficult to be sure. What is clear in the release, and in later pronouncements on the subject, is that the Commission has not been precise or analytical in fitting its ideas into the statutory scheme.

In Release No. 3,844, the Commission emphasized that:

> [T]he publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in the

11. Securities Act Rel. No. 3,844 (Oct. 8, 1957).

> securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.[12]

The Commission chose to explain itself through the use of examples. One example concerns promoters and prospective underwriters of a mining company in the development stage who "arranged for a series of press releases describing the activities of the company, its proposed program of development of its properties, estimates of ore reserves and plans for a processing plant."[13] Those activities were determined to have violated section 5. A more subtle example, also involving a mining venture, concerned the distribution by a prospective underwriter of a brochure that "described in glowing generalities the future possibilities for use of the mineral [to be explored for] and the profit potential to investors"[14] in the industry. Neither the venture nor any security was mentioned, but the brochure did bear the underwriter's name. The Commission said the activities were the beginning of a sales campaign and that it violated section 5.

A year after Release No. 3,844, events occurred that gave the Commission the chance to put greater force behind its expansive concept of what constitutes an offer. It did so in *In re Carl M. Loeb, Rhoades & Co.*,[15] a disciplinary proceeding against two securities firms registered under the Exchange Act. The problems began when the co-managing underwriters put out press releases concerning the issuer, a real estate development company, before a registration statement was filed. The releases described the property involved, related the company's development plans in general terms, outlined the proposed securities offering, and mentioned the names of the two managing underwriters. Although the releases did not directly offer to sell any securities, the Commission concluded that publicity of that type and in that

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12. Securities Act Rel. No. 3,844 (Oct. 8, 1957). *See also* Securities Act Rel. No. 7,879 (Aug. 8, 2000), in which the Commission found a "stock give away" on the Internet to be conditioning the market for a planned future public offering. The term "offer" is used throughout this book as a shorthand for all its various permutations (*e.g.*, "offer to sell" and "offer for sale") included in section 2(a)(3).
13. Securities Act Rel. No. 3,844.
14. *Id.*
15. *In re* Carl M. Loeb, Rhoades & Co., 38 S.E.C. at 843 (1959).

situation "must be presumed to set in motion or to be a part of the distribution process and therefore to involve an offer to sell or a solicitation of an offer to buy . . . securities."[16] Focusing on the more extensive of the releases and the resultant publicity, the Commission found that "such release and publicity was of a character calculated, by arousing and stimulating investor and dealer interest in [the] securities . . . , to set in motion the processes of distribution."[17]

After *Loeb, Rhoades*, securities lawyers have counseled caution in the release of any publicity about the issuer or its industry that might fall under Release No. 3,844 or *Loeb, Rhoades*. However, since issuers usually depend on publicity to sell their products and services, it is impractical to suggest that all publicity be stopped. In fact, the Commission has long recognized that publicly held companies should keep their security holders informed about company affairs,[18] and in the years since *Loeb, Rhoades* there has been an increasing recognition of the obligation of such companies to do so. Those conflicting duties have led to the fear that publicity may get a company in trouble under the Securities Act, and the lack of it may result in violations of the Exchange Act.

In response to that tension, the Commission issued Securities Act Release No. 5,009.[19] That release contained little help to issuers beyond indicating that the tension they felt may be more apparent than real. It was of more help to broker-dealers. The release briefly discussed the Commission's ideas concerning the publicity activities of broker-dealers, and in that respect, at least, it has continued usefulness. The tension felt by issuers did not abate, however, and subsequently the Commission issued a more helpful release on the subject, Securities Act Release No. 5,180.[20]

There are two basic themes in that release. The first theme, which deals with publicity, is that while a publicly held company may not legally initiate publicity that is for the purpose of

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16. *Id.* at 851.
17. *Id.*
18. The Commission recognized but did not discuss this in *Loeb, Rhoades* because the company involved in that decision was privately held. Securities Act Rel. No. 3,844 contains no useful analysis on this issue, although it does include helpful examples involving publicity by publicly held companies.
19. Securities Act Rel. No. 5,009 (Oct. 7, 1969).
20. Securities Act Rel. No. 5,180 (Aug. 16, 1971).

facilitating the sale of securities, a "business as usual" general publicity effort probably does not run afoul of section 5(c). The second theme relates to the kinds of information publicly held companies may provide when inquiries are directed to them by shareholders, securities analysts, the press, and others. Here the Commission emphasized that although factual information should be provided, responses involving predictions, forecasts, projections, and opinions concerning value are not acceptable. Although the Commission refrained from giving a list of what can and cannot be done by a publicly held company during the prefiling and later periods of an offering, it declared that a company should:

1. Continue to advertise products and services.
2. Continue to send out customary quarterly, annual, and other periodic reports to stockholders.
3. Continue to publish proxy statements and send out dividend notices.
4. Continue to make announcements to the press with respect to factual business and financial developments; that is, receipt of a contract, settlement of a strike, opening of a plant, or similar events of interest to the community in which the business operates.
5. Answer unsolicited telephone inquiries from stockholders, financial analysts, the press, and others concerning factual information.
6. Observe an "open door" policy in responding to unsolicited inquiries concerning factual matters from securities analysts, financial analysts, security holders, and participants in the communications field who have a legitimate interest in the corporation's affairs.
7. Continue to hold stockholder meetings as scheduled and to answer stockholders' inquiries at stockholder meetings relating to factual matters.

Although the release helps the publicly held company to some extent, it does little to aid the first-time issuer.[21] The first item on

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21. These concerns were further addressed by Rules 168 and 169, adopted as part of the 2005 securities offering reform. *See* section 3:2.2[C], *infra*.

the list provides some help, since the continued advertising of products and services seems equally applicable to public and private companies. But even there, the issues may be complex. For example, a new advertising campaign might raise questions, especially when it is presented in media that seem calculated to reach investors rather than merely customers.

The releases just discussed were written before the advent of the Internet. Now, the Commission's staff scrutinizes an issuer's website carefully to see if it conditions the market for an upcoming offering. In doing this, the staff takes a common sense view of the question, based on the experience of viewing many websites. At least as soon as an offering seems likely, a company and its lawyers should examine the company's website to see how it will strike the staff and others once a registration statement has been filed—and also how it would strike them after the offering if buyers of the securities have lost money. Appropriate changes should be made, preferably at the suggestion of a lawyer with good judgment on how the site is likely to be viewed by the staff and other lawyers. During the infancy of the Internet, problems arose for companies that previously had not had a website but wanted to launch one in anticipation of a public offering. Such websites often came under heightened scrutiny from the Commission. Although this situation is less likely to occur today, lawyers nevertheless should advise clients that any significant increase in a company's online presence prior to an offering should be undertaken only with caution. In reviewing websites, hyperlinks must be considered carefully. The Commission has indicated, in what probably should be taken as understatement, that hyperlinking information that meets the broad definition of "offer," "raises a strong inference that the hyperlinked information is attributable to the issuer for the purposes of a Section 5 analysis."[22]

In re Goldman Sachs & Co.[23] offers a twenty-first-century example of a securities firm in trouble with the Commission for

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22. Securities Act Rel. No. 7,856 (Apr. 28, 2000). See this release for guidance not only on websites, but on the use of electronic media by issuers generally. *See also* Exchange Act Rel. No. 34-58288 (Aug. 1, 2008) in which the Commission has provided additional guidance on the use of company websites and solicited comment on the use of technology in providing information to investors.

23. *In re* Goldman Sachs & Co., Securities Act Rel. No. 8,434 (July 1, 2004).

conditioning the market. Before the registration statement was filed for a Chinese company called PetroChina, information about the offering became public, but not through Goldman Sachs. There arose a public perception that proceeds of the offering might be used in the Sudan, which would violate U.S. sanctions. A senior representative of Goldman Sachs made statements to various national media in order to correct this public perception. The Commission found that Goldman Sachs had in these statements violated section 5(c) because the "statements could reasonably have had the effect of arousing investors' interest in PetroChina's securities." For these violations, and violations of section 5(b)(1) during the waiting period, the Commission imposed a civil penalty of $2 million.

The need for large measures of judgment is unavoidable when making decisions on questions relating to publicity. In exercising that judgment, a lawyer needs to focus on the real reason for a particular action. If the action is designed to help sell securities, the inquiry is ended—the act cannot be done. But the opposite is not true, because an inquiry cannot end with a determination that the real reason for an advertising campaign is product sales or another acceptable goal. The securities lawyer must remember that questions of that nature are often examined, long after the fact, in the context of a lawsuit. In the typical case, the transaction involved in the suit is a failure in financial terms,[24] and a court may not perceive the equities to be on the side of the issuer. In dealing with questions concerning the real reason for publicity, the most important issue may be what an advocate can make reality appear to be to a fact finder already negatively disposed. As we shall see in the next section, the Commission addressed a number of these concerns in the 2005 securities offering reform release.

[C] General Exceptions

There now are a number of generally applicable exceptions to the definition of "offer." The first is found in section 2(a)(3) itself:

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24. Purchasers will not sue, of course, if the securities they have purchased have increased in value. Almost as important, they are not likely to complain to the Commission either. A large percentage of Commission investigations begin with a letter or telephone call from a disgruntled security holder.

> The terms defined in this paragraph and the term "offer to buy" as used in subsection (c) of section 5 shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer).

It is important to note that, so far as securities firms go, the exception is limited to underwriters, and therefore does not cover dealers. During the prefiling period, then, the company can find a managing underwriter, or a prospective managing underwriter can find a company interested in doing a public offering, and the managing underwriter can work with other securities firms to gauge their interest in joining the underwriting syndicate.[25] However, the managing underwriter cannot begin to assemble the dealer group, even tentatively.

Another generally applicable exception is contained in Securities Act Rule 135, which begins:

> For purposes of section 5 of the Act only, an issuer or a selling security holder (and any person acting on behalf of either of them) that publishes through any medium a notice of a proposed offering to be registered under the Act will not be deemed to offer its securities for sale through that notice if . . . [t]he notice includes a statement to the effect that it does not constitute an offer of any securities for sale . . . and . . . [t]he notice otherwise includes no more than the following information. . . .

The information that may be included is very basic, and does not go much beyond the type, amount, and basic terms of the securities to be offered, the anticipated timing of the offering, and a brief statement of the manner and purpose of the offering, without naming the underwriters. In specialized situations,

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25. As discussed below in section 3:3.2, "What Is a Sale?", issuers and underwriters could go further and finalize their arrangements at any time. They rarely if ever wish to, however, prior to the very end of the waiting period.

including rights offerings and offerings to employees, more (but still very basic) information may be included.[26]

As a matter of practice, it rarely is wise to put out a Rule 135 notice in the case of a privately held company that is going public because the notice is likely to generate inquiries, the answers to which may violate section 5(c). A Rule 135 notice may make good sense in a publicly held company, however, as part of the continuing disclosure to investors and security holders about the issuer's plans. These companies are used to dealing with the laws relating to disclosure and are much less likely than non-publicly held companies to respond to inquiries in a way that constitutes a section 5(c) violation.

Other exemptions are found in Rules 163, 163A, 168, and 169, adopted in 2005. The first two simply are exemptions from section 5(c). The latter two rules do two things. First, they provide that if the communication meets the rule's requirements, it will not be an "offer" *for section 5(c) purposes* (in other words, it is an "offer," just not a *prohibited* offer). Second, communications covered by the rules are deemed not to be a "prospectus" under section 2(a)(10). Accordingly, the communications (assuming they meet the requirements of the rules) likewise will not violate the section 5(b)(1)[27] waiting period's prohibitions on "prospectuses." Because these rules address the same issues on conditioning the market as were addressed by Release 5,180, discussed above, they are discussed here[28] in connection with the prefiling period; however, one should not forget their effect during the waiting period. Each of these four rules is examined below.

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26. Notice how far the Commission has gone in this instance in using the rulemaking power given it in section 19(a) of the Securities Act. The relevant grant of power is to make rules defining "accounting, technical and trade terms" used in the Act. In that connection, one should notice that Congress has already defined "offer for sale" in section 2(a)(3). Such aggressive use by the Commission of its rulemaking power is not unusual.

27. *See* section 3:3, *infra*.

28. Note that Rules 138 and 139 dealing with research reports operate in a similar manner as do Rules 168 and 169. That is, they exclude certain communications from the definition of "prospectus" and while those communications may be "offers," they are deemed not to be offers for purposes of section 5(c). Accordingly, communications meeting the requirements of these rules are permitted in the prefiling period as well. The rules are discussed in section 3:3.3[F], *infra*.

Rules 168 and 169 both state prominently that they are not available for any communication that, although in technical compliance with the rule, is part of a "plan or scheme to evade" the requirements of section 5 of the Securities Act. Both Rule 168 and Rule 169 are nonexclusive safe harbors; in other words, reliance on either rule does not create a presumption that any communication that falls outside the safe harbors is a prohibited "offer" or otherwise subject to section 5. Thus, reliance on one of the rules does not affect the availability of any other exemption or exclusion under the Securities Act, and attempted compliance with one of the safe harbors does not act as an exclusive election. For example, one would not be precluded from relying on earlier interpretive guidance such as Release 5,180, discussed above.

Rule 168 makes available for reporting issuers (which does not include "voluntary filers"), as well as asset-backed issuers and certain nonreporting foreign private issuers, a safe harbor from the gun-jumping provisions for continued publication or dissemination of "regularly released or disseminated" factual business information *and* "forward-looking" information. Such information must be communicated "by or on behalf of" the issuer.

For purposes of Rule 168, "factual business information" is defined as

- factual information about the issuer, its business or financial developments, or other aspects of its business;
- advertisements of, or other information about, the issuer's products or services; and
- dividend notices.

Rule 168 also defines "forward-looking" information as a list of items, including earnings or revenue projections. The safe harbor covers either historical or forward-looking information that is contained in an issuer's Exchange Act reports. The safe harbor covers only the use of such information and not its content, which is governed by other rules.

Rule 168 is not available to cover any information about the registered offering itself, or information that is released or disseminated as part of the offering activities. The Commission declined to define "offering-related," and instead left it to each issuer to determine, based upon the particular facts and

circumstances, whether or not a communication contains information about the registered offering or is being used as part of the offering activities.

Rule 169 creates a safe harbor from the gun-jumping provisions for regularly released factual business information that, unlike Rule 168, is available to all eligible issuers, including nonreporting issuers. It differs from Rule 168 in the following respects:

- It covers regularly released ordinary course factual business information intended for use only by persons other than in their capacity as investors or potential investors, such as customers and suppliers (thus, for example, dividend notices are excluded from the safe harbor);
- It does not cover forward-looking information; and
- The same issuer employees or agents who historically have been responsible for providing the information for intended use by customers and suppliers must be the persons who communicate information provided in reliance on this safe harbor.

Under both Rules 168 and 169, information will be considered released or disseminated "by or on behalf of" an issuer if the issuer or an agent or a representative of the issuer, other than an offering participant who is an underwriter or dealer, authorizes or approves the release or dissemination of the communication before it is made. Information will be considered "regularly released or disseminated" if the issuer has previously released or disseminated the same type of information in the ordinary course of its business, and the release or dissemination is "consistent in material respects" in "timing, manner and form" with the issuer's similar past release or dissemination of such information.

Rule 163A provides all issuers a nonexclusive bright-line time period, ending thirty days prior to filing a registration statement, during which, subject to limitations, their communications will not risk violating the gun-jumping provisions. Rule 163A, unlike Rules 168 and 169, does not relate to the definition of "prospectus." It provides only that if the communication meets the rule's requirements, it will not be an "offer" *for section 5(c) purposes* (in other words, it is an "offer," just not a *prohibited* offer). Accordingly, Rule 163A applies only in the prefiling period. The

Rule 163A safe harbor, however, is not available for communications made in connection with offerings by blank check or shell companies, or penny stock issuers. The rule also excludes communications regarding business combination transactions, because they are regulated separately under Regulation M-A.

Rule 163A reflects the Commission's belief that the thirty-day time period is adequate to ensure that communications made prior to that period will not condition the market for a securities offering. The Rule 163A safe harbor is subject to the following conditions:

- A communication made in reliance on the Rule must be made "by or on behalf of the issuer" (as defined in Rules 168 and 169) and cannot reference a securities offering that is or will be the subject of a registration statement; and
- The issuer must take reasonable steps within its control to prevent further distribution or publication of the communication during the thirty-day period immediately before the filing of its registration statement.

The Commission did not specify what constitutes "reasonable steps within the issuer's control" for purposes of Rule 163A. It did indicate that, with respect to information posted on an issuer's website, it does not expect that an issuer will necessarily remove the information from the website and, provided that the information is appropriately dated,[29] otherwise identified as historical material, and not referred to as part of the offering activities, the Commission will not object to an issuer maintaining the information on the website. The Commission also indicated that, while it does not expect an issuer to be able to control the republication or accessing of previously published press coverage, it expects issuers to be able to control their own involvement in any subsequent redistribution or publication. In the Commission's example, an issuer or its representative that gives an interview to the press prior to the thirty-day period could not rely on Rule 163A if the interview was published during the thirty-day period. Accordingly, this puts a burden on the issuer to take whatever steps are needed to preclude the publication of an article during

29. *See* section 3:3.3[E], *infra*.

the thirty-day period, presumably including obtaining an agreement to that effect with the publisher.[30]

Rule 163 permits WKSIs to engage in unrestricted oral and written offers before a registration statement is filed without violating the gun-jumping provisions. These communications are still considered "offers" and any written offer will be a "prospectus." A written offer made "by or on behalf of" (see discussion of Rules 168 and 169 above) a WKSI, however, under the Rule 163 exemption would be a "free writing prospectus"[31] and must be filed promptly by the issuer when and if the issuer files its registration statement. It must also include a legend, the text of which is provided in the rule. The Commission noted in its discussion of Rule 163 that, in view of the automatic shelf registration process now available to WKSIs,[32] it expects that WKSIs usually will have a registration statement on file that they can use for registered offerings, and that, consequently, it will be unusual for WKSIs to make offers prior to the filing of a registration statement. The Commission indicated that it provided this exemption from the prohibition on prefiling offers as part of its overall program of liberalized communications for WKSIs.

Table 3-1 at the end of this chapter summarizes the types of communications that issuers are permitted to make before and after filing a registration statement with the Commission.

[D] Special Situations

Section 2(a)(3) contains two provisions relating to special situations. The first provision serves as an example of the drafters' skill at anticipating possible loopholes:

> Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value.

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30. Alternatively, a company could choose to deal with such a communication as a "free writing prospectus." *See* sections 3:3.3[A] and 3:3.3[C], *infra*.
31. *See* section 3:3.3[C], *infra*.
32. *See* section 4:3.3[C], *infra*.

Actually, that exception is not necessary because neither the Commission nor a court was likely to accept any other interpretation.

The other exception provides:

> The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security.

This exception usually applies to a convertible security or an option (often called a warrant). Examples are preferred stock convertible into common stock, and a warrant to purchase additional common stock that is sold along with common stock. Under the provision, the underlying security does not have to be registered originally when the conversion or exercise cannot occur immediately, but rather can only take place at some point in the future. Although section 2(a)(3) does not specifically address the issue, at the time the conversion or exercise can occur, an offer exists, and the filing of a registration statement, or the availability of a registration exemption, is required. Logic leads to that conclusion because the no offer exception speaks only to the time of original issue or transfer, and the requirement of later registration is dealt with in the legislative history.[33]

A number of other Securities Act rules contain exceptions either to the operation of section 5(c) or to the definition of "offer" that relate to special situations. Those include situations involving general advertising concerning investment companies (Rule 135a), the use of certain materials concerning options trading (Rule 135b), and publication by securities firms of specified information relating to certain companies with publicly held securities (Rules 138 and 139).

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33. H.R. REP. NO. 73-85, at 11 (1933).

§ 3:3 Waiting Period

§ 3:3.1 Statutory Scheme

During the waiting period, section 5(a) continues to apply, prohibiting all sales and all transportation, by the mails or in interstate commerce, of securities for sale or delivery after sale, and section 5(b)(1)[34] becomes applicable also. It provides:

> (b) It shall be unlawful for any person, directly or indirectly—
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> (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10. . . .

When the language concerning interstate commerce and the mails is ignored, the section provides that it is unlawful to use any prospectus unless it satisfies the requirements of section 10. The definition of "prospectus" is found in section 2(a)(10), which reads:

> The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except. . . .

Stripped of its detail, section 2(a)(10) defines a prospectus as a written offer or a confirmation of sale (setting aside the exceptions and the concepts of radio or television offers). Exception (a) in section 2(a)(10) relates to the posteffective period and is not considered here. Exception (b) is a typical administrative law provision. It sets out the law regarding which communications are not deemed a prospectus, and then gives the Commission power to supplement it:

> (b) a notice, circular, advertisement, letter, or communication in respect of a security shall not be deemed to be a

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34. Section 5(b)(2) also applies as a technical matter, but the chances are slim that the situation it contemplates would occur during the waiting period. It is really a posteffective-period provision, and it will be discussed in that connection.

> 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, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

To supplement that provision, the Commission adopted Rule 134,[35] which was amended in 2005 when the Commission also enacted a number of rules that further address, among other things, the definition of a "prospectus." Three of those rules (Rules 163, 168, and 169) also provide an exemption to section 5(c) during the prefiling period and are discussed above.[36] Rules 164 and 433 deal with "free writing prospectuses,"[37] electronic road shows,[38] and websites.[39] Others (Rules 137, 138, and 139) deal with research reports.[40]

Section 10 of the Securities Act, entitled "Information Required in Prospectus," is too long to reproduce here, but it should be examined at this point. Section 10(a) provides that a prospectus "shall contain the information contained in the registration statement," with some exceptions. That requirement may lead to two misconceptions. First, it may seem that a registration statement is filed and a prospectus subsequently is drafted based on the filed document. Actually, a prospectus is drafted for inclusion in a registration statement. Practicality dictates this, and this is what is contemplated by the Commission's registration statement forms and rules.[41] The Commission requires the prospectus to contain most of the registration statement disclosure. The nonprospectus disclosures make up a small percentage of the total registration statement. Second, the statute's language may make it appear that any prospectus included as part of a registration statement

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35. *See* section 3:3.3[B], "Exceptions," *infra*.
36. *See* section 3:2.2[C], *supra*.
37. *See* section 3:3.3[C], *infra*.
38. *See* section 3:3.3[D], *infra*.
39. *See* section 3:3.3[E], *infra*.
40. *See* section 3:3.3[F], *infra*.
41. These requirements are discussed in the next chapter.

necessarily must satisfy the requirements of section 10(a), whether or not the registration statement actually contains the information it is supposed to contain. That is not the case. Although the exact requirements of the section are somewhat unclear,[42] at least it can be said that a prospectus does not comply with section 10(a) when it contains blanks where required information is to be added by amendment.[43]

It may be possible for the prospectus as originally filed to comply with the requirements of section 10(a). Usually, however, certain required information is unknown at the time of filing. For example, the underwriting syndicate is seldom established at that time, and the names of the underwriters must usually be added by an amendment just before the registration statement becomes effective. The price of the securities to be offered is also typically left blank originally, along with miscellaneous other information. In the usual case, then, a section 10(a) prospectus is not available in the waiting period. A prospectus that meets the requirements of section 10(b) is available. That section gives the Commission authority to permit the use of a prospectus, for the purpose of section 5(b)(1), that omits or summarizes information required by section 10(a). The Commission has exercised that authority in Rules 430, 431, and 433. The first of those rules allows the use, during the waiting period, of a "preliminary prospectus" containing omissions.[44] The second covers "summary prospectuses" and

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42. *See* section 3:4.2, "Section 5(b) and Defective Prospectuses," *infra*.

43. The unclear drafting of section 10(a) may be attributable to the fact that, prior to 1954 amendments, the Securities Act prohibited all offers prior to effectiveness. The original drafters of the section therefore would not have had reason to contemplate the use of a prospectus prior to the time the registration statement was effective and the prospectus complete and in its final form. *But see* note 44, *infra*, and accompanying text.

44. Some controversy exists about whether Rule 430 was promulgated under section 10(a) rather than 10(b). *See* 1 LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 477–78, 480 n.216 (3d ed. 1989). Sections 10(a)(4) and 10(d) would seem to give the Commission authority to adopt a preliminary prospectus rule under section 10(a) rather than section 10(b) if it wished. When it adopted Rule 430 (originally Rule 433), the Commission did not specify which part of section 10 the rule was under. *See* Securities Act Rel. No. 3,519 (Oct. 9, 1954). The language of Rule 430 seems to indicate, however, that it was not adopted under section 10(a), since it speaks in terms of a preliminary prospectus containing substantially the information required . . . to be included in a prospectus meeting the requirements of section 10(a).

allows their use in certain circumstances.[45] The third covers the "free writing prospectus" added in 2005.[46]

In their essentials, then, sections 2(a)(10) and 5(b)(1) provide that, during the waiting period, no offer, in writing or by radio or television, may be made except by a section 10 prospectus or a communication meeting the requirements of exception (b) to section 2(a)(10).[47] Additionally, those sections prohibit confirmations of sale. During the waiting period, the prohibition on oral offers, included in section 5(c)'s general prefiling period prohibition of offers, is lifted.[48] As discussed above, section 5(a) continues to apply during the waiting period, prohibiting all sales and all transportation, by the mails or in interstate commerce, of securities for the purpose of sale or delivery after sale.

§ 3:3.2 What Is a Sale?

The definition of "sale" contained in section 2(a)(3) does not purport to be complete. Its basic provision is: "The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value." Similar to its treatment of offers, the Securities Act takes the common-law meaning of the

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If the Rule 430 preliminary prospectus were itself a section 10(a) prospectus, the Commission would here have the preliminary prospectus chasing its own tail. Also, it is unlikely that the Commission would wish a preliminary prospectus to satisfy the prospectus delivery requirement of section 5(b)(2), and that would be the case if Rule 430 were a rule under section 10(a). (Section 5(b)(2) is discussed below in connection with the posteffective period.)

45. Summary prospectuses are not common. Note that most open-end mutual funds have another option. Under Securities Act Rule 498, they may provide disclosure in what is called a "profile."

46. Unlike "summary prospectuses," there has been widespread use of the free writing prospectuses after December 1, 2005.

47. Several rules supplement exception (b) to section 2(a)(10). Rule 134a creates an additional exception to the definition of "prospectus" in very specialized circumstances. Rules 163, 168, and 169, which also provide an exemption to section 5(c) during the prefiling period, are discussed above. *See* section 3:2.2[C], *supra*. Rules 134, 134a, 137, 138, 139, and 164 are discussed below. *See* section 3:3.3[B]–[F], *infra*.

48. The prohibition on oral offers continues, however, if the registration statement is the subject of a refusal or stop order, or a public proceeding or examination. Those exceptions are discussed in the next chapter. *See* section 4:3.3, "Refusal Orders, Stop Orders, and Withdrawal of Registration Statements," *infra*.

term "sale" as its base and then expands it.[49] The most striking thing about section 2(a)(3) is its inclusion of contracts of sale within the ambit of "sale." That inclusion is a drafters' technique that allows provisions such as section 5(a) to be written a little more cleanly, but at a price, for by that technique the drafters laid a little trap. In the waiting period, certain offers may be made. The trick is that when an offer is accepted and a contract is created, section 5(a)(1) has been violated because a sale has occurred. As a practical matter, then, ordinary offers should not be made in the waiting period, but rather offerors should condition their offers in such a way that they cannot be accepted until the registration statement is effective. Partly for that reason, during the waiting period, securities firms make conditional offers and collect responses called "indications of interest," with the hope of turning those indications of interest into sales shortly after effectiveness.

As with offers, the Commission reads the section 2(a)(3) definition of "sale" liberally,[50] leading to an expansive application of an already expanded concept. By including in the definition not only contracts of sale, but "*every* . . . disposition of a security . . . for value" (emphasis added), the drafters of section 2(a)(3) provided the Commission a reasonable basis for that reading. An example of the Commission's expansive reading is found in *In re Franklin, Meyer & Barnett*.[51] In that case, during the waiting period salesmen in a securities firm performed two acts that might be considered as consummating sales. First, they accepted checks sent by customers in payment for offered shares. Except for one instance, there was no indication that those checks were sent at the behest of, or even with the prior agreement of, the salesmen. The checks were deposited in the customers' accounts with the firm, and there was no finding that funds were taken out of those accounts prior to effectiveness. Second, the salesmen sold other securities for customers and held the proceeds for application

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49. Some aspects of the concept of "sale" are discussed here. The discussion continues in chapter 5. A major portion of that chapter deals with special situations involving the question of whether a transaction includes a sale.

50. In Securities Act Rel. No. 3,844 (Oct. 8, 1957), the Commission stated this explicitly. *See also* Securities Act Rel. No. 7,879 (Aug. 8, 2000), in which the Commission found that a giveaway of stock on the Internet was a sale of the stock.

51. *In re* Franklin, Meyer & Barnett, 37 S.E.C. at 47 (1956).

against the purchase price of the offered shares. In most cases, those sales of other securities were at the suggestion of the salesmen. In each instance, the Commission found that the salesmen had made sales during the waiting period. It gave no helpful analysis, other than to say that the salesmen "accepted orders"[52] prior to the effective date.

In contrast to that expansiveness is the exception in section 2(a)(3), introduced in connection with the prefiling period,[53] that relates to "preliminary negotiations or agreements" between an issuer and underwriters, or among underwriters. That exception provides that all the terms in section 2(a)(3), including "sale," do not include those negotiations or agreements. On its face, the exception is ambiguous because it cannot be determined from the words themselves whether "preliminary" modifies only "negotiations" or whether it also modifies "agreements." If the latter were the case, neither the agreement among underwriters nor the underwriting agreement could be entered into during the waiting period, since those are not "preliminary" agreements. Everyone—including the Commission—wants the underwriting arrangements finalized prior to effectiveness. Perhaps because of that, a problem has never existed with interpretation: "preliminary" modifies "negotiations" only.[54] It is then unclear how negotiations are so limited. It seems that there is no limitation, because the parties must finalize negotiations before they can sign agreements. It may be argued that by adding the word "preliminary," the drafters attempted to make clearer the distinction between negotiations and agreements: Negotiations are preliminary to agreements, and agreements are not part of negotiations.

§ 3:3.3 What Is a Prospectus?

Under the language of section 2(a)(10), without the exceptions, any written offer, offer by radio or television, or confirmation of sale is a prospectus. (In this book, radio or television offers are considered special varieties of written offers and so are not always specifically mentioned.) An understanding of the concept of

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52. *Id.* at 51.
53. *See* section 3:2.2[C], "General Exceptions," *supra*.
54. This interpretation seems also to have been the clear intent of Congress. H.R. REP. NO. 73-85, at 12 (1933) ("Underwriting agreements can . . . be entered into prior to the time of the filing of the registration statement.").

"offer" provides a foundation for understanding what makes up a prospectus, because a determination of what constitutes an offer is much more complex than a determination of whether something is written or transmitted by radio or television. One difficult part of the task, therefore, has been accomplished in the discussion of the prefiling period.[55] What remains is to discuss the "written or by radio or television" aspects of prospectuses, to cover the exceptions to the definition of the term prospectus, and to discuss the possible application of a 1995 Supreme Court case.

Before doing that, however, it now is instructive to review the definitions of "written communication" and "graphic communication" that were added to Rule 405 in 2005. That rule now defines all methods of communication other than oral communications as "written communications" for purposes of the Securities Act. "Written communication," in turn, is any communication that is written or printed, a radio or television broadcast (regardless of the means of transmission of the broadcast), or a "graphic communication." The term "graphic communication" covers all forms of electronic media, including, but not limited to, audiotapes, videotapes, facsimiles, CD-ROM, email, websites, substantially similar messages widely distributed (rather than individually distributed) on telephone answering or voice mail systems, computers, computer networks, and other forms of computer data compilation. Excluded from the definition of "graphic communication," however, is a communication that, at the time of the communication, originates live, in real time, to a live audience and does not originate in recorded form or otherwise as a graphic communication, although it is transmitted through graphic means. Accordingly, a live, real-time road show transmitted to a live audience (but *not* a subsequent replay of that show) is not a "graphic communication."

In connection with the waiting period issue of what constitutes a prospectus *Gustafson v. Alloyd Co.*,[56] which is discussed in chapter 8, needs to be considered. This case dealt with litigation under Securities Act section 12(a)(2), which provides a civil remedy in the case of offers or sales "by means of a prospectus or oral communication" that contains a materially false or

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55. *See* section 3:2.2, "What Is an Offer?", *supra*.
56. Gustafson v. Alloyd Co., 513 U.S. 561 (1995).

misleading statement. In reaching its decision that a "prospectus" existed only in the context of a registered offering, the Court indicated that the definition of the term in section 2(a)(10) "refers to documents of wide dissemination." The Court also indicated that it could not "accept the conclusion that [the term 'prospectus'] means one thing in one section of the Act and something quite different in another." Although these statements, along with other broad language in the opinion, were merely dicta in respect of matters outside the holding of the case, it has resulted in one effect: the practical elimination of any private remedy under the Securities Act for fraud in a nonpublic transacton. Partly because, as discussed in chapter 8, the decision was based on an exceedingly flawed understanding of the Securities Act, one might have expected that ultimately it would have been overturned or that, in any case, it would not be applied to the conception of what constitutes a prospectus in a registered offering. Otherwise, some of the discussion in this chapter of what constitutes a prospectus could change in ways that are difficult fully to predict. Accordingly, a lawyer operating as a planner would be exceedingly unwise to change his or her advice to clients about what can and cannot be done during the course of a Securities Act registration, based on the assumption that *Gustafson* will provide added flexibility.

[A] Indirect Offers

Garden-variety written offers are spotted easily enough. It is indirect offers that cause a problem. Written publicity concerning the issuer or its industry that conditions the market for a security is the most common example of an indirect offer. The discussion of publicity in connection with the prefiling period is equally applicable here.[57] For instance, the examples discussed above from Release No. 3,844, and the facts of *Loeb, Rhoades*, involved press releases and a brochure. Along these lines, *Goldman Sachs* involved statements to the media that resulted in articles about

57. *See* section 3:2.2[B], "Conditioning the Market," *supra*. See also section 3:2.2[C], "General Exceptions," for a discussion of Rules 168 and 169, which also provide an exemption to section 5(c) during the prefiling period. These rules, which address dissemination of types of regularly released historical and forward-looking information that also is excluded from the definition of "prospectus," are directly applicable here.

an offering. Those publicity items were in writing or resulted in a writing and, therefore, constituted prospectuses because they made offers.[58] Release No. 3,844 directly speaks to that point in connection with a discussion of the waiting period and gives a waiting period example involving the distribution of a report concerning an issuer prepared by a third party.[59]

The "written or by radio or television" aspects of publicity can be more subtle than the examples discussed above. Take, for instance, an oral announcement by the president of an issuer at a press conference that, if in writing, would constitute a prospectus under the section 2(a)(10) definition. There is probably little doubt that, when a reporter incorporates the announcement in an article, the president has made an offer that is "written." Analytically, it can be said that the president caused the writing, and that that is enough to make the offer one that is by means of a prospectus. Clearly, the statute does not speak in terms of who the scrivener is. Harder questions are presented by responses to press inquiries. Upon analysis, however, it becomes clear that the hardest questions relate to whether a particular statement involves an offer, rather than to whether the offer was "written or by radio or television." But that is not to say, for example, that a newspaper article including a puffing answer to a reporter's unsolicited question about a company's product would be as likely to constitute a section 5 problem as would prepared statements at a called press conference. The newspaper article would be less dangerous, but primarily because a court would not be as likely to decide that the answer involved an offer, written or otherwise.

Now, under Rules 164 and 433,[60] media publications or broadcasts about a registered offering that constitute an offer, whether communicated orally or in writing, may constitute a "free writing prospectus" and have to satisfy the applicable free writing prospectus conditions at the time of publication or broadcast if the issuer or an offering participant prepares, pays for, or gives consideration for the publication or broadcast. In the case of a

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58. *See* section 3:3.3, "What Is a Prospectus?," *supra*.
59. See section 3:3.3[F], *infra*, for a discussion of the rules on research reports added as a part of the 2005 securities offering reform.
60. See section 3:3.3[C], *infra*, for a discussion of "free writing prospectuses."

nonreporting issuer or a reporting unseasoned issuer, a statutory prospectus will have to precede or accompany the communication. A seasoned issuer that is not a WKSI and related offering participants will have to have a statutory prospectus on file with the Commission.

These rules, however, relax the free writing prospectus conditions if the issuer or offering participant does not pay for or prepare the publication or broadcast and is unaffiliated with the persons in the media who disseminated the information. If the free writing prospectus is prepared and published or broadcast by persons in the news media who are not affiliated with and not paid by the issuer or offering participant, a statutory prospectus is not required to precede or accompany the communication. For example, if a member of the press who is invited to a road show writes an article containing information from the road show, the article is a free writing prospectus that is subject to the rules, unless the road show is readily accessible to an unrestricted audience. Any such free writing prospectus is required to be filed with the Commission by the issuer or offering participant involved within four business days after the issuer or offering participant becomes aware of its publication or broadcast. The filing obligation may be met by filing

(1) the media publication,

(2) all of the information provided to the media in lieu of the publication, or

(3) a transcript of the interview or similar materials that the issuer or other offering participant provided to the media.

A media publication does not need to be filed if the substance of the written communication has previously been filed with the Commission. Finally, the issuer or offering participant is permitted to file information the issuer reasonably believes is necessary or appropriate to correct information included in a media publication.

Written publicity is not, of course, the only way indirect written offers can be made. *In re Franklin, Meyer & Barnett*, discussed above,[61] offers an interesting example. During the waiting period,

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61. *In re* Franklin, Meyer & Barnett, 37 S.E.C. at 47 (1956), discussed above in section 3:3.2, "What Is a Sale?"

a securities salesman sent a customer a preliminary prospectus that satisfied the requirements of section 10(b). That prospectus was allowed under section 5(b)(1). The salesman also enclosed his business card, on which he wrote, "Phone me as soon as possible as my allotment is almost complete on this issue." The Commission found that the business card solicited an offer to buy and was therefore a prospectus. That conclusion seems clear enough. A different situation would be presented if the salesman had called the customer and, finding him not in, had left the above message, which was reduced to writing. One way to approach that situation is to begin with the above analysis relating to press inquiries. Would the idea of "causing" a writing be extended to encompass the salesman's acts? It is hard to say. Considering the flexibility inherent in the concepts discussed above, it might depend on how badly the Commission or a court wanted to expand the concept.[62]

When an issue involves the Internet, the Commission has tried hard to facilitate the reasonable use of this new technology. In a no-action letter predating the 2005 securities offering reform relating to *Net Roadshow, Inc.*,[63] for example, the staff of the Division of Corporation Finance indicated its willingness to have road shows (company and underwriter presentations relating to an offering, done during the waiting period) transmitted over the Internet, under specified conditions, without the transmissions being considered prospectuses under Securities Act section 2(a)(10).[64]

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62. Factual permutations would make an affirmative answer to the question more or less likely. For example, it would be important to know if the salesman specifically asked that the message be put in writing or that it not be. Agency concepts should help the salesman in an argument along these lines: (1) that in the one situation the press is the agent of the issuer, whereas in the other whoever answered the customer's telephone is the customer's agent, not the salesman's; (2) that the oral statement to the agent was the equivalent of an oral statement to the customer directly; and (3) that the note-taking by the agent was therefore analytically indistinguishable from note-taking by the customer.

63. Net Roadshow, Inc., SEC No-Action Letter (July 30, 1997). *But see* note 64, *infra*.

64. In connection with the definitions and rules regarding electronic road shows adopted as a part of the 2005 securities offering reform initiative, the prior electronic road show no-action letters were withdrawn effective December 1, 2005. *See* Securities Act Rel. No. 8,591, at 129 (July 19, 2005). *See* section 3:3.3[D], *infra*.

[B] Exceptions

Exception (b) to section 2(a)(10), which is quoted above,[65] allows certain written offers in the waiting period by deeming them not to be prospectuses. In supplementation of that provision, and perhaps partially as an exercise of the power given it in section 19(a) to make rules relating to definitions,[66] the Commission adopted Rule 134. That rule was intended to provide an "identifying statement" that could be used to locate persons that might be interested in receiving a prospectus. Any type of communication that is written or by radio or television can meet the requirements of Rule 134. Press releases and letters are typical examples. Also common, although used more in the posteffective than in the waiting period, is the so-called tombstone advertisement, which gets its name from its stylized format. Those are found most often in the financial section of newspapers, such as the *Wall Street Journal*.

Prior to 2005, Rule 134 provided a limited safe harbor from the gun-jumping provisions for certain public notices about an offering made after an issuer had filed a registration statement. The 2005 amendments to Rule 134 expanded the information about the issuer and the registered offering permitted in the notice and reduced the scope of information required to be included in the notice. Specifically, Rule 134 now permits expanded levels of disclosure pertaining to

- The issuer and its business, including where to contact the issuer;
- The terms of the securities being offered;
- The offering itself, including underwriter information, more details about the mechanics of and procedures for transactions in connection with the offering process, the anticipated schedule of the offering, and a description of marketing events;
- Procedures for account opening and submitting indications of interest and conditional offers to buy the offered securities;

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65. *See* section 3:3.1, "Statutory Scheme," *supra*.
66. *See* Securities Act Rel. No. 3,568 (Aug. 29, 1955) (statement of authority).

- Directed share plans and other participation in offerings by officers, directors, and employees; and
- Credit ratings reasonably expected to be assigned to the offered security.

There previously had been some uncertainty about the ability of issuers to rely on Rule 134 to communicate information about a proposed offering if the initial filed registration statement did not include a bona fide price range for the securities to be offered. The Division of Corporation Finance had warned that Rule 134 would not be available to those issuers because without a bona fide price range, the initial registration statement would not include a "statutory prospectus." The 2005 amendments to Rule 134 changed that previous position and allows issuers who have filed an initial registration statement that includes an "otherwise" statutory prospectus to rely on Rule 134 notwithstanding the fact that the prospectus does not contain a bona fide price range. Rule 134 also provides that an active hyperlink to a statutory prospectus in an electronic Rule 134 notice will satisfy the requirement that the prospectus accompany or precede that notice.

In addition to Rule 134, the Commission has adopted Rule 134a, which is a highly specialized rule providing that certain written material relating to standardized options, as defined in Exchange Act Rule 9b-1, is not deemed a prospectus. Unlike Rule 134, which takes exception (b) to section 2(a)(10) as its starting point, Rule 134a's real foundation is the Commission's general rule-making power found in section 19(a).

The applicability of Rule 135, discussed in connection with the prefiling period, is uncertain in the waiting period. Rule 135 provides that certain notices by "an issuer or a selling security holder (and any person acting on behalf of either of them) that publishes through any medium a notice of a proposed offering to be registered under the Act will not be deemed to offer its securities for sale through that notice if [certain requirements are met]." Its thrust clearly is toward the prefiling period. Everything supports that conclusion, including the rule's focus on offers, rather than on prospectuses as in Rules 134 and 134a, and statements by the Commission in the original adopting release.[67]

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67. Securities Act Rel. No. 3,568 (Aug. 29, 1955).

None of that means, however, that Rule 135 could not apply during the waiting period. The important phrases in the rule to consider are "proposed offering" and "to be registered." In the usual situation, securities firms begin a public offering immediately after a registration statement is filed. In that situation, Rule 135 clearly could not continue to be used, because the offering is no longer "proposed." However, an offering sometimes is delayed until later, for example until the registration statement becomes effective. (Note, however, that there is a theory that the offering begins either on the filing of the registration statement or on its being made public by the Commission, which occurs almost immediately.) The phrase "to be registered" is more problematic. In a technical sense, securities are still "to be registered" during the waiting period, since they are not "registered" until the registration statement is effective. But the term may be used in a somewhat looser sense, similar to the phrase "to be the subject of a registration statement." Usually, of course, it does not matter whether Rule 135 applies during the waiting period, because of the availability of Rule 134. But the question may be important to the occasional issuer that has published a notice meeting the information requirements of Rule 135 but not those of Rule 134.[68]

[C] Free Writing Prospectuses

Rules 164 and 433 permit issuers and other offering participants to make written offers in the form of a "free writing prospectus," which is deemed a section 10(b) prospectus that complies with section 5(b)(1) during the waiting period. In the case of WKSIs, a free writing prospectus also is excluded from the operation of section 5(c) because WKSIs can use free writing prospectuses in the prefiling period. As with many so-called safe harbors, it is nonexclusive and also is not available for any communication that, while in technical compliance with the rules, is part of a "plan or scheme to evade" the requirements of section 5 of the Securities Act.

"Free writing prospectus" is defined as a written communication that constitutes an offer to sell or a solicitation of an offer to buy securities that are the subject of a registration statement (or, in

68. Most often, this would occur when someone, during the waiting period, has used as a model a Rule 135 notice from a previous transaction.

the case of a WKSI, that are or will be the subject of a registration statement), and is not otherwise a prospectus satisfying the requirements of section 10 of the Securities Act. It specifically does *not* include notices or communications covered by Rules 134, 135, 168, or 169, discussed above, research reports covered by the safe harbors discussed below or the business combination rules.

Ineligible issuers in many cases may not use a free writing propectus. Certain ineligible issuers, however, may use a free writing prospectus that consists only of a description of the offering or the securities to be offered. Blank check, shell, and penny stock companies, however, may not utilize a free writing prospectus. The prospectus delivery and availability conditions vary depending on the type of issuer involved and the type of person using the free writing prospectus. In securities offerings by seasoned issuers and WKSIs, the issuers and other offering participants may use a free writing prospectus after the filing of a registration statement containing a statutory prospectus (a base prospectus in the case of shelf registrations). Seasoned issuers and WKSIs are not required to deliver the most recent statutory prospectus in order to use a free writing prospectus. Instead, the user must notify the recipient, through a required legend,[69] of the filing of the registration statement and the URL for the Commission's website, where the recipient can access or hyperlink to the preliminary (or base) prospectus.

As mentioned, a WKSI may use a free writing prospectus to make an offer prior to the filing of a registration statement, provided that the free writing prospectus is filed promptly by the WKSI when and if the WKSI files its registration statement. A nonreporting issuer, including in an IPO, or an unseasoned issuer may use a free writing prospectus only after a registration

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69. The legend is specified by the rule and provides that it must contain a toll-free telephone number, and may contain an email address, through which the statutory prospectus may be requested. Other than the specified legend, there is no other information required in the free writing prospectus; however, the information in the free writing prospectus must not *conflict* with the information in the registration statement, including Exchange Act reports incorporated by reference into the registration statement. Legends or disclaimers of responsibility or liability that are impermissible in a statutory prospectus or registration statement are also impermissible in free writing prospectuses.

statement is filed, and then the use by an issuer or other offering participant generally is conditioned on the free writing prospectus being accompanied or preceded by the latest statutory prospectus (which is the final if the registration statement has been declared effective). Because in these cases the most recent statutory prospectus must be *actually provided* to anyone who might receive a free writing prospectus, the use of broadly disseminated free writing prospectuses in registered offerings by these types of issuers and offering participants in these offerings may not be feasible unless they are in electronic form and contain a hyperlink to the statutory prospectus.[70]

The Rule also specifies when free writing prospectuses must be filed with the Commission. Electronic road shows that are written communications are specifically exempt from the filing requirements in certain circumstances (discussed below). Finally, issuers and offering participants must retain any free writing prospectuses that have not been filed (as noted, in certain cases they are not required to be filed) with the Commission for three years from the date of the initial offering of securities.

[D] Electronic Road Shows

Electronic road shows historically were regarded by the Commission as written offers and therefore generally not permitted prior to filing of a registration statement and its effectiveness. Since 1997, the Commission has permitted electronic road shows prior to effectiveness under limited circumstances pursuant to a series of no-action letters.[71] In 2005, as a part of securities offering reform, the Commission took the opportunity to clarify the treatment of electronic road shows.

The analysis begins with whether the communication is "written" (for example, "graphic"). A live, real-time road show to a live

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70. The condition that the statutory prospectus accompany or precede the free writing prospectus does not require that it be provided through the same means, so long as it is provided at the required time. Also, simply referring to its availability will not satisfy this condition.

71. *See* text accompanying note 63, *supra*. The 2005 rule changes permit the use of electronic road shows without many of the conditions the Commission previously had required in the no-action letters. The no-action letters with respect to registered public offerings were withdrawn as of December 1, 2005, the effective date of Rule 433.

audience, even if transmitted graphically, is an oral rather than a graphic communication and, therefore, not a written communication or a free writing prospectus. Also, materials (such as slides or other visual aids) that are provided or transmitted simultaneously as part of the live road show generally are excluded from the definition of a written communication. Electronic road shows that do not originate live, in real-time to a live audience and are graphically transmitted are considered written communications and are therefore free writing prospectuses. Accordingly, they are permissible only if they satisfy the conditions applicable to free writing prospectuses, subject to the qualifications in the following paragraph.

If a road show is a free writing prospectus, Rule 433's filing conditions generally do not apply, with one exception: In the case of an initial public offering of equity and/or securities convertible into equity, the filing conditions will apply to an electronic road show that is a free writing prospectus unless the issuer makes at least one version of a "bona fide electronic road show"[72] with respect to such offering readily available without any restriction to any potential investor at or prior to the time the issuer makes another version available.

[E] Websites

The offering rules now provide that an offer of securities contained on an issuer's website or on a third-party website hyperlinked from the issuer's website is considered a written offer of the securities made by the issuer. Unless exempt, that will be a free writing prospectus of the issuer. Historical information that is not an offer will not become an offer if accessed at a later time,

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72. "Bona fide electronic road show" is defined as a "road show that is a written communication transmitted by graphic means that contains a presentation by one or more officers of an issuer or other persons in an issuer's management and, if the issuer is using or conducting more than one road show that is a written communication, includes discussion of the same general areas of information regarding the issuer, such management, and the securities being offered as such other issuer road show or road shows for the same offering that are written communications." A bona fide electronic road show need not provide an opportunity for questions and answers or other interaction, even if other versions of the electronic road show do provide such opportunities. Securities Act Rel. No. 8,591 (July 19, 2005).

unless it is updated or used or referred to (by hyperlink or otherwise) in connection with an offering. There is a safe harbor for website material: Historical information will not be considered a current offer of the issuer's securities and, therefore, not be a free writing prospectus, if that historical information is separately identified as such, and located in a separate section of the issuer's website containing historical information. The use of historical information will be deemed a current offer if it is incorporated by reference or otherwise included in a prospectus for, or otherwise used or referred to in connection with, the offering.[73]

[F] Research Reports

Acknowledging the benefits of research reports to potential investors, Rules 137, 138, and 139 set forth the circumstances under which a broker or dealer may publish a research report[74] contemporaneously with a registered offering without violating the gun-jumping rules. Rule 137 provides generally that a broker or dealer who is not a participant in a registered offering but who publishes or distributes research on any issuer (including non-reporting issuers, except for blank check companies, shell companies and penny stock issuers) in the regular course of business, without receiving any consideration in exchange, is not considered to be engaged in the distribution of the issuer's securities and, therefore, not an underwriter in the offering. Rule 138 generally allows a broker or dealer to publish research on the issuer's common stock or debt or preferred stock convertible into common stock if the issuer proposes to offer nonconvertible debt or nonconvertible, nonparticipating preferred stock, and vice versa, if the broker or dealer publishes the report in the ordinary course of its business and the issuer is a reporting issuer that is current in its periodic Exchange Act reports; however, the exemption does not apply to blank check companies, shell companies, and issuers of

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73. *See also* Exchange Act Rel. No. 34-58288 (Aug. 1, 2008) in which the Commission has provided additional guidance on the use of company websites in the disclosure process.

74. Rule 405 defines "research report" as "a written communication . . . that includes information, opinions or recommendations with respect to securities of an issuer or an analysis of a security of an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision."

penny stock. Rule 139 generally permits a broker or dealer participating in a registered offering of securities of a seasoned issuer or certain nonreporting foreign private issuers to publish research reports concerning the issuer or its securities if the research is published with reasonable regularity in the usual course of the broker or dealer's business. Rule 139 also provides an exemption for industry reports covering any reporting issuer (seasoned or unseasoned) if the broker or dealer observes the restrictions relating to the nature of the publication and the opinions or recommendations required to be given in such report.

Other conditions to these exemptions are set forth in the relevant rule. These are beyond the scope of our discussion; however, they should be reviewed. If one becomes involved in any situation in which research appears during the course of a registered offering, it must be examined to determine the connection, if any, to the issuer and circumstances of the issuance of the report to ensure that an exemption is available.

§ 3:3.4 Preliminary Prospectus Delivery Requirements

The Commission has perceived a shortcoming in section 5 of the Securities Act, which allows, but does not require, that preliminary prospectuses be distributed during the waiting period. It views that as a shortcoming because securities firms direct much of their sales effort at customers during that period. Since the Commission cannot rewrite section 5, it has corrected that shortcoming by two roundabout means. First, the Commission has indicated in Rules 460 and 461, read together with Securities Act Release No. 4,968,[75] that it will not "accelerate" the effective date of a registration statement unless certain distributions of preliminary prospectuses have been made. Acceleration is discussed more fully in the next chapter, but for present purposes it is necessary to appreciate the importance of acceleration in most offerings. Section 8 of the Securities Act provides that a registration statement becomes effective twenty days after filing, or after the filing of any amendment. It also provides that a registration statement may become effective on "such earlier date as the Commission may determine" or, in securities parlance, that its

75. Securities Act Rel. No. 4,968 (Apr. 24, 1969).

effective date may be "accelerated." The problem for issuers is that a registration statement rarely can be complete at the time it is filed. Certain information, such as the name of each underwriter in the syndicate, usually cannot be supplied until just prior to effectiveness. Thus, acceleration typically is required as a practical matter.

The second means by which the Commission forces the distribution of preliminary prospectuses is even more roundabout than the first. Exchange Act section 15(c)(2) prohibits securities firms from engaging "in any fraudulent, deceptive, or manipulative act or practice" and gives the Commission power to determine what acts and practices fit within that prohibition. In Exchange Act Rule 15c2-8, the Commission requires underwriters and dealers to take reasonable steps to furnish copies of the preliminary prospectus to any person who makes a written request for a copy. It also requires underwriters and dealers to furnish copies of the preliminary prospectus to their sales personnel, and the managing underwriter to provide the underwriters and dealers with sufficient quantities of the prospectus to meet their delivery requirements. Further, in the case of offerings by issuers that are not subject to the reporting requirements of the Exchange Act (which includes almost all first-time registrants), the rule requires underwriters and dealers to "deliver a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale at least 48 hours prior to the sending of such confirmation." The teeth behind those requirements is the Commission's determination, in Rule 15c2-8, that a failure to make those deliveries constitutes a deceptive act or practice under Exchange Act section 15(c)(2).

Issuers can incur duplicate printing and mailing costs if they have to deliver more than one version of a preliminary prospectus. This so-called "recirculation" is necessary if the first preliminary prospectus that is delivered to prospective buyers is changed in material ways by a preliminary prospectus that is contained in a subsequent amendment to the registration statement. In order to avoid recirculation, the underwriters frequently do not distribute a prospectus to the public until at least one round of comments on the registration statement is received from the Commission and an amendment is filed containing a revised prospectus that the company, the underwriters, and their respective attorneys believe

is sufficiently responsive to those comments. If this procedure is followed, the filing of the registration statement is called a "quiet filing." (One should note that the decision whether or not to recirculate takes much judgment and often is made in conjunction with the Commission's staff.)

In response to the evolving use of the Internet in business communications, the Commission has issued a number of releases addressing electronic delivery of prospectuses. The most important is Securities Act Release No. 7,856,[76] which provides that electronic delivery is permissible if the recipient gives informed consent, and that such consent can be given telephonically if a record is kept of the call. This release also gives guidance as to what other electronic material will be considered part of a prospectus, what material will be considered delivered concurrently, and what the issuer's responsibility is for the content of its website and hyperlinked materials. In addition, the release sets out basic principles to be observed in conducting an offering entirely online. In a helpful move, the Depository Trust Company (which, among other things, serves as a clearinghouse for settlement of securities trades and safekeeps securities for securities firms and others) has, with the approval of the Commission,[77] established a Prospectus Repository System. Prospectuses that are put into this system by underwriters can be accessed by their customers, thus completing prospectus delivery, so long as the customer has the proper password and agrees to certain conditions.

§ 3:4 Posteffective Period

§ 3:4.1 Statutory Scheme

Section 5(b)(1), discussed in connection with the waiting period, continues to apply during the posteffective period. That section proscribes the use of any prospectus, unless it satisfies the requirements of section 10. During the waiting period, section 10(b) allows the use of preliminary, summary and free writing prospectuses. Summary prospectuses and free writing prospectuses may also be used after effectiveness, in certain circumstances.[78]

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76. Securities Act Rel. No. 7,856 (Apr. 28, 2000).
77. Exchange Act Rel. No. 47,410 (Feb. 26, 2003).
78. *See* Securities Act Rules 431 and 433.

Otherwise, in the posteffective period the only prospectus that satisfies the requirements of section 10 is the "final prospectus" called for by section 10(a). Usually, the only prospectus that complies with the requirements of that section is the prospectus that is included in the registration statement just before it becomes effective (the registration statement having in most cases been amended shortly before effectiveness to make final changes and to include information, such as the names of all the underwriters, that was left blank in the preliminary prospectus).[79] Sometimes, however, information is omitted from the prospectus filed as part of the registration statement and a final (and complete) prospectus filed subsequent to the registration statement being declared effective.[80]

Also, during the posteffective period a new exception is applicable to the definition of "prospectus." That is exception (a) in section 2(a)(10), which provides that a communication is not deemed a prospectus when it is accompanied or preceded by a prospectus that meets the requirements of section 10(a). The term used to describe communications allowed by that exception is "free writing" (not to be confused with a "free writing prospectus" discussed above).

After effectiveness, section 5(b)(2) comes into play.[81] It provides:

> (b) It shall be unlawful for any person, directly or indirectly—
>
> . . .
>
> (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

This section is relatively straightforward, although as indicated in the following sections in the chapter, not to the extent it might

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79. See section 3:4.1, "Statutory Scheme," *supra*, for a discussion of section 10(a).

80. *See* Securities Act Rules 430A, 430B, and 424.

81. As indicated in note 34, *supra*, this section is applicable during the waiting period as a technical matter.

at first seem. As a practical matter, the section provides that a security may not be delivered to a buyer unless the buyer simultaneously receives, or has received, a copy of the final prospectus.

During the posteffective period, oral offers may be made, since section 5(c) does not apply during that period (except in the case of a registration statement that is the subject of a stop order or of a public proceeding instituted before the effective date). Written offers may be made by means of the final prospectus, as contemplated by section 5(b)(1). They may also be made by a free writing prospectus or by free writing, when accompanied or preceded by a final prospectus, as provided in section 2(a)(10). Offers may continue to be made under exception (b) to section 2(a)(10) and under Rules 134 and 134a. Sales may be made, since the prohibition on sales contained in section 5(a)(1) no longer applies. Under sections 5(a)(2) and 5(b)(2), securities may be delivered to buyers as long as the securities are accompanied or preceded by a final prospectus. Finally, under section 2(a)(10), confirmations of sale may be sent to buyers when a final prospectus is delivered along with the confirmation, or when a final prospectus has preceded it.[82]

In 2005, the requirement that a final prospectus "accompany or precede" various communications in the posteffective period was addressed by adopting an "access equals delivery" model for meeting the prospectus delivery requirements of section 5(b). Rule 172 deems section 5(b) prospectus delivery requirements (for confirmations, notices of allocation, and delivery of the securities) to have been met if the final prospectus has previously been filed with the Commission or if the issuer makes a good-faith and reasonable effort to file the final prospectus within the timeframe required by Rule 424.

Rule 173 requires that for each transaction involving a sale by an issuer or underwriter to a purchaser or a sale in which the final

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82. Getting to this conclusion is a two-step process. Section 2(a)(10) first includes confirmations of sale in the definition of "prospectus" and then provides, in exception (a), that no communication (other than a preliminary prospectus) sent during the posteffective period will be deemed to be a prospectus if it is accompanied or preceded by a final prospectus.

prospectus delivery requirements apply, each underwriter, broker, or dealer participating in the offering shall provide to each purchaser purchasing from it, not later than two business days after the completion of the sale, a copy of the final prospectus or, in lieu of the final prospectus, a notice providing that the sale was made pursuant to a registration statement.

The 2005 changes to the prospectus delivery rules benefit not only issuers and underwriters. Rules 153 and 174 now effectively eliminate the aftermarket prospectus delivery obligations of brokers and dealers as well.

§ 3:4.2 Section 5(b) and Defective Prospectuses

As indicated above, during the posteffective period, section 5(b)(1) allows the use of a prospectus that meets the requirements of section 10, and section 5(b)(2) requires that a section 10(a) prospectus accompany or precede the delivery of a security. Except for summary and free writing prospectuses, which can be used under section 5(b)(1) and Rules 431 or 433, every prospectus used in the posteffective period must be a final rather than a preliminary prospectus to meet the requirements of section 10(a). So much is clear. But what if a final prospectus is defective because it is materially false or misleading? Does such a defect prevent the prospectus from meeting the requirements of section 10(a)?

The place to start to answer that question is section 10(a) itself, which provides that "a prospectus . . . shall contain the information contained in the registration statement. . . ." On its face, that language seems to require only that the prospectus track the registration statement, defective or otherwise, although as the prior discussion of section 10(a) has indicated, to comply with that section the prospectus must at least be complete.[83] The language of the section itself, then, provides no help in answering questions concerning materially false or misleading prospectuses.

The Commission and the Second Circuit have provided their answer in *SEC v. Manor Nursing Ctrs., Inc.*[84] In that case, developments subsequent to the effective date of a registration statement and final prospectus made the information in the prospectus materially false and misleading. The Commission

83. *See supra* section 3:4.1, "Statutory Scheme."
84. SEC v. Manor Nursing Ctrs., Inc., 458 F.2d 1082 (2d Cir. 1972).

alleged that the continued use of the prospectus constituted a section 5(b)(2)[85] violation, and the Second Circuit agreed:

> We hold that implicit in the statutory provision that the prospectus contain certain information is the requirement that such information be true and correct. A prospectus does not meet the requirements of § 10(a), therefore, if information required to be disclosed is materially false or misleading.[86]

Although the First Circuit has followed *Manor Nursing*,[87] it has done so without analysis. And the Fifth Circuit has criticized the case strongly. In *SEC v. Southwest Coal & Energy Co.*,[88] the court was faced with a situation in which *Manor Nursing* was relevant by analogy. In rejecting the Second Circuit's thesis, the Fifth Circuit focused its analysis not on section 10(a), but on the violence *Manor Nursing* does to other sections of the Securities Act. False or misleading statements in a prospectus are the subject of specific antifraud provisions, and in those provisions Congress provided for defenses available in certain circumstances. By finding that a false or misleading prospectus violates section 5(b)(2), the Second Circuit pushed aside the tailor-made antifraud provisions, rendering them, in the words of the Fifth Circuit, "essentially superfluous as remedial mechanisms" and obliterating the defenses they provide.[89]

§ 3:4.3 Final Prospectus Delivery Requirements

As indicated in the discussion relating to the waiting period, section 5 does not require that preliminary prospectuses be delivered. Section 5(b)(2), however, does require that a final

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85. It is unclear why the Commission did not also allege a violation of section 5(b)(1), since it seems that if one subsection of section 5(b) were violated, the other would have been also. This may be important, because if section 5(b)(1) can be violated in the posteffective period by using a defective final prospectus, it is not much of a leap to the idea that it can be violated in the waiting period by the use of a defective preliminary prospectus.
86. *Manor Nursing Ctrs.*, 458 F.2d at 1098. Regrettably, the court did not give any helpful analysis to defend its reading of section 10(a).
87. A.J. White & Co. v. SEC, 556 F.2d 619, 622 (1st Cir. 1977).
88. SEC v. Sw. Coal & Energy Co., 624 F.2d 1312, 1318 (5th Cir. 1980).
89. *Id.* at 1319.

prospectus be delivered along with the security purchased, unless the security has been preceded by a copy of that prospectus (assuming the use of jurisdictional means).[90] That requirement is not so clear as it may seem. The first problem is with the concept of "security." The term is defined in section 2(a)(1):

> When used in this title, unless the context otherwise requires—
>
> (1) the term "security" means any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

This definition provides only the starting point for an understanding of what constitutes a security for the purposes of the Securities Act, and much of chapter 5 is spent on that question. An important issue to focus on here is the difference between a security and a certificate representing a security. In the case of stock, for example, a security obviously exists apart from any stock certificate, and, ignoring for now the last clause of section 2(a)(1), the certificate only purports to be an evidence of ownership of the security represented. At least in the usual conception, however, some other securities seem only to exist in paper form, with the security and its representation appearing to be coextensive. Bonds offer a good example, for there is no certificate purporting to

90. See section 3:2, "Prefiling Period," *supra*, for a discussion of the jurisdictional means requirement.

represent a bond. Rather, the piece of paper called a bond is thought of as the bond.

Section 2(a)(1) adds to the confusion by sometimes mentioning the term "certificate" in connection with a particular security and sometimes not. But for general purposes, again ignoring its last clause, the intent of section 2(a)(1) is clear enough—the drafters are referring to the property interest that is a security and not to an evidence of the interest—and the occasional use in section 2(a)(1) of the term "certificate" should not be taken to mean otherwise. What the drafters meant by "voting-trust certificate," for example, is probably an interest in a voting trust.

In the sense discussed above, no common stock is ever carried through the mails or in interstate commerce, since common stock is not tangible, but rather is a legal conception of ownership. Does that mean that certificates representing common stock can be delivered freely without being accompanied or preceded by a final prospectus? The answer is clearly no, and that conclusion may be reached in at least two ways, each involving the definition of "security" in section 2(a)(1). First, the last clause of that definition, "or any certificate of interest or participation in [or] temporary or interim certificate for . . . any of the foregoing," may be read to provide that stock certificates are themselves "securities." That is not, however, entirely clear from the language. It is questionable whether an ordinary stock certificate should be considered a "certificate of interest or participation in" common stock, since in the same clause the drafters referred to any "temporary or interim certificate for" any security. It can be argued that the "certificate of interest or participation in" formulation is designed to cover certificates evidencing some unusual and less than complete ownership interest in a security and, further, that if the drafters had intended to include ordinary certificates for common stock in the last clause of the definition, they would have done so by adding them to the provision relating to "temporary or interim" certificates. That could have been done either by including the word "permanent" along with "temporary" and "interim" or by taking out all modifiers and simply saying "certificate" for any security.

Second, it is possible to conclude that the delivery of a stock certificate triggers the final prospectus delivery requirement by focusing on the language that appears at the beginning of the

section 2 definitions—"When used in this title, unless the context otherwise requires. . . ." Since it is impossible physically to deliver common stock itself, it can be argued that the context of the term "security" in section 5(b)(2) requires that the term be read to encompass not only common stock, but a certificate representing the stock.

Adding to the confusion concerning section 5(b)(2) is the fact that, under current business practice, a large percentage of security purchasers never take possession of the security purchased or any formal certificate representing the security. For convenience, and to avoid safekeeping problems, they prefer not to take physical delivery. In addition, purchasers do not typically take title to securities in their own name. The securities firm with which they have an account, or a party working with the firm, usually holds title for them. In that case, the securities firm or other agent is the record owner and the purchaser is the beneficial owner.

In light of those business practices, there are seemingly unresolved questions concerning the requirements of section 5(b)(2) and their satisfaction. It seems clear that delivery of the security to an agent of the purchaser is the equivalent of delivery directly to the purchaser, and that the section 5(b)(2) prospectus delivery requirement is thereby triggered. But that reasoning may lead to the nonsensical, although perhaps legally valid, conclusion that section 5(b)(2) may be satisfied by sending the agent a copy of the final prospectus. Another issue is whether, or at what point, delivery of the security, by jurisdictional means or otherwise, takes place when the securities firm that has sold the security retains record ownership in its name and simply makes an entry on its books showing that it has transferred beneficial ownership to the purchaser. The practical way around those and any other section 5(b)(2) problems is to deliver a final prospectus before any of the acts that might be considered to constitute delivery of a security are done. Since early prospectus delivery makes good business sense, in general and for reasons discussed below, avoiding problems under section 5(b)(2) in that way entails little real cost.

Section 5(b)(2) aside, there are at least two reasons why final prospectuses must be delivered to purchasers. First, for business and other reasons, underwriters and dealers deliver to each customer a written confirmation of sale, typically as soon as a customer

has agreed to buy. However, under section 2(a)(10), which defines "prospectus," a written confirmation is itself a prospectus unless, as provided in exception (a) to section 2(a)(10), the confirmation is accompanied or preceded by a final prospectus. And, of course, if the required prospectus delivery is not made and the confirmation is itself a prospectus, it is an illegal one since it does not meet the requirements of section 10. Business practice essentially requires that that confirmation be delivered, but Rule 10b-10 under the Exchange Act requires it, in virtually all cases, in any event. Second, Exchange Act Rule 15c2-8, which was discussed in connection with the waiting period,[91] establishes much the same requirement for limited distributions of final prospectuses that it establishes for preliminary prospectuses. Basically, they are to be furnished to sales personnel, and to other persons on written request.[92]

Many of the purchasers in a public offering retain their securities for a substantial period, but others sell them in the trading markets shortly after their purchase. Under section 4(3) of the Securities Act, which generally exempts from the Act's registration requirements transactions by dealers[93] operating in the trading markets, and Rules 153 and 174, which provide details concerning dealers' prospectus delivery requirements, dealers generally are subject to the final prospectus delivery requirements of section 5 when (and only when) they sell securities that have been registered within the previous forty or ninety days. That is true regardless of how many times the securities have changed hands in the trading markets. (The forty-day period applies when the issuer of the securities has previously registered other securities under the Securities Act. Rule 174 shortens the period to twenty-five days in the case of securities that are listed on a securities exchange or are authorized to trade on the Nasdaq Stock Market, and this rule generally does away with the section 4(3) prospectus delivery requirement in the case of securities issued by companies that were subject to the reporting requirements of the

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91. *See supra* section 3:3, "Waiting Period."
92. See section 3:4.1, *supra*, for a discussion of Rules 153 and 174 and the "access equals delivery" concept of final prospectus delivery adopted in 2005.
93. Here "dealer" refers to the technical definition of dealer in section 2(a)(12) of the Securities Act, basically a person who engages in the business of trading in securities.

Exchange Act prior to the filing of the registration statement to which the prospectus relates, and in certain other cases.) Moreover, as previously mentioned, Rules 153 and 174, which allow brokers and dealers to rely upon the filing of a final prospectus as "access equals delivery," now effectively eliminate the aftermarket prospectus delivery obligations of brokers and dealers.

Section 4(3) makes applicable to certain trading transactions by dealers requirements that are generally applicable only in the case of a sale in a registered offering. One rationale for the requirements of section 4(3) is that, for a limited period after a registration statement becomes effective, underwriters and dealers may be offering for sale both securities that are part of the underwriting and securities that were purchased by customers in the underwriting and then repurchased by underwriters and dealers. In that situation, it is fortuitous whether a purchaser buys in the original offering or in the trading market. One can maintain that the right of a customer to obtain a prospectus should not depend on that fortuity, especially since much of the aftermarket interest in the securities during that period is typically created by underwriters and dealers in connection with the original offering. Another rationale for the section 4(3) prospectus delivery requirements is based on the conception that the distribution of securities by the underwriters and dealers is not complete until the securities have come to rest in the hands of persons who intend to keep them as an investment for at least some period. Under that conception, the forty- or ninety-day period after commencement of the offering is viewed as a rough approximation of the period of distribution. Once that reasoning is accepted, it is logical that the dealers' exemption from the prospectus delivery requirement is not made available during the distribution period.

When events occur after the effectiveness of a registration statement that make the final prospectus materially false or misleading, or when prior defects are discovered after effectiveness, the prospectus must be corrected.[94] That correction can be performed in one of two ways. First, an issuer may file a posteffective amendment to the registration statement containing

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94. See *supra* section 3:4.2, "Section 5(b) and Defective Prospectuses," for an introduction to the idea of why this is so.

the correction, which correction may be contained in either an amended final prospectus or a supplement to the final prospectus. (In industry usage, an amended prospectus is one that has been rewritten to reflect changes, while a supplemented prospectus is one to which a sticker incorporating changes has been added to the cover page.) Second, Rule 424(b) allows an issuer to amend or supplement the final prospectus without filing a posteffective amendment, as long as the new form of prospectus is filed with the Commission before it is used. Traditionally, issuers handle relatively discrete corrections by the Rule 424(b) mechanism and more extensive corrections through the filing of a posteffective amendment.

Table 3-1 SUMMARY OF COMMUNICATION RULES[1]

PREFILING PERIOD
Securities Act §§ 5(a) and 5(c)
Basic rule: No "offers" or "sales"

Rule	Allows	Applicable to
135	Limited notices	All issuers
163	Any communication by or on behalf of an issuer that is a WKSI[2] (Note: In view of the breadth of the communication allowed under Rule 163, WKSIs generally will not be required to rely upon any other communication rule that is available.)	WKSIs *only*
163/405	Free writing prospectus	WKSIs *only*
163A	Certain communications by or on behalf of an issuer more than thirty days before filing	All communications other than those relating to business communications subject to Rules 165 or 166, in connection with S-8 offerings (other than WKSIs) and communications by blank check, shell, or penny stock companies
168	Regularly released factual and forward-looking information	Reporting issuers, certain FPI, and certain asset-backed issuers
169	Regularly released factual information (excluding dividend notices)	Nonreporting issuers
Rel. No. 33-5180	Certain regularly released business information	All issuers

1. This table shows the primary rules governing communications during the three major periods of the offering process. Although there are other rules that cover more specialized communications during the offering process—*e.g.*, Rule 134a (Options Material) and the rules regarding communications in connection with business combination transactions—those listed here are the primary ones with which an issuer (other than an investment company) will have to contend.
2. See discussion of WKSIs, seasoned issuers, and nonreporting issuers in section 3:1.2, *supra*.

WAITING PERIOD
Securities Act §§ 5(a) and 5(b)(1)
Basic Rule: No "sales"; verbal offers permitted;
no written offers other than by means of a preliminary prospectus

Rule	Allows	Applicable to
134	Limited notices	All issuers
164	Free writing prospectus (Note: For unseasoned and nonreporting issuers, the free writing prospectus must be accompanied or preceded by statutory prospectus;[3] also, no FWP through media if paid for by issuer or offering participant.)	All issuers other than blank check, shell, and penny stock companies; also limitations on use by other ineligible issuers
168, 169, and Rel. No. 33-5180	Certain regularly released information (same as during the prefiling period)[4]	Same as during the prefiling period

3. Note that in an IPO, a FWP may be used only if the filed prospectus contains a price range.
4. Although Rules 168 and 169 would appear to apply only during the prefiling period, as they provide exemptions from section 5(c), the rules, by their terms, refer to a security "which is the subject of an offering pursuant to a registration statement that the issuer proposes to file, or has filed, or that is effective. . . ." This is because section 5(c), in certain circumstances (*e.g.*, stop order; section 8 proceeding), can apply in the waiting and posteffective periods.

POSTEFFECTIVE PERIOD
Securities Act § 5(b)
Basic rule: Any written communication must be accompanied or preceded by "final" prospectus

Rule/ Provision	Allows	Applicable to
Section 2(a)(10)	Free writing (*not* a "free writing prospectus")—carve out from the statutory definition of "prospectus"	All issuers
134	Limited notices	All issuers
153	"Access equals delivery" of final prospectus	All issuers other than blank check, shell, and penny stock companies; also limitations on use by other ineligible issuers
164	Free writing prospectus (Note: for unseasoned and nonreporting issuers, the free writing prospectus must be accompanied or preceded by statutory prospectus; also, no FWP through media if paid for by issuer or offering participant.)	All issuers
168, 169, and Rel. No. 33-5180	Certain regularly released information (same as during the prefiling period)[5]	Same as during the prefiling period

5. Although Rules 168 and 169 would appear to apply only during the prefiling period, as they provide exemptions from section 5(c), the rules, by their terms, refer to a security "which is the subject of an offering pursuant to a registration statement that the issuer proposes to file, or has filed, or that is effective. . . ." This is because section 5(c), in certain circumstances (*e.g.*, stop order; section 8 proceeding), can apply in the waiting and posteffective periods.