April 25, 1995

MEMORANDUM FOR MEMBERS OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES

What follows is our perspective on why issuers seek alternatives to registered public offerings. In summary, issuers take into account certainty of the timing of market access, market pricing, liability for offering materials, and the cost of preparing a registration statement, including complying with the rigorous accounting requirements applicable in public offerings.

To the extent there are perceived regulatory impediments to registration which affect the timing of an offering, we suggest certain changes to the existing system that can be implemented without amendment to the Securities Act of 1933, as amended (the "1933 Act"). Implementation of these changes would not eliminate access to the off-shore or private markets, and we discuss our views as to whether such choices should remain. We then consider a model of company registration that would in all likelihood require legislative action, and discuss certain issues which must be resolved before going forward. Many of these issues were debated when the ALI Code was under consideration.

Background

The 1933 Act principally regulates distributions of securities to the public by companies and control persons. It requires that a registration statement be filed with the SEC, and that a prospectus (which is part of the registration statement) be delivered to investors with a confirmation of sale. There is certainty built into the 1933 Act. The 1933 Act states that, except as otherwise determined by the Commission, a registration statement becomes effective automatically twenty days after filing. However, in practice that cannot happen. The filing must include the price at which the shares will be sold to the public. Since underwriters are unwilling to take an underwriting risk of 20 days before they can confirm sales to investors, the price would have to be omitted in the initial filing. However, an amendment including the price starts the 20 day period running again. While the 20 day period can be accelerated, the Commission must be satisfied that certain standards are met. To make these determinations within the pressure of a 20 day period proved difficult. Thus, the practice evolved that the initial filing includes a legend which in effect consents to an indefinite delay of the date the registration statement would otherwise become effective[1] until the staff acts to accelerate the time period. This permits the staff to review and comment on the filing. Once all comments are responded to, an amendment is filed without the legend and including the price[2], the underwriters sign the underwriting agreement, and the staff accelerates the twenty day period and declares the registration statement effective. At that point, sales may be confirmed to investors. The underwriting risk is reduced to the five day business period between confirmation and settlement.[3]

The development of the delaying amendment was an imaginative response to the structure of the 1933 Act that permitted the staff to institute a review process while at the same time recognizing underwriting constraints, although it does create uncertainty as to timing of an offering, because it is not possible to tell how long the staff will take to review the filing and issue comments. While the initial paper described in general the review process, and while probably less than 10% of registration statements are reviewed, review is always a possibility. Moreover, the staff, rightfully so, will not commit in advance as to whether a filing will be reviewed or how long the process will take. It will also not disclose the criteria it employs to select filings for review. And if there is a particular concern about a new area of

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1 The cover page of a registration statement contains the following legend:

> The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933 or until the Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

2 Rule 430A now permits the registration statement to be declared effective without the price in certain cases.

3 With the implementation of T-3, that period may be reduced.

disclosure - for example derivatives - and an issuer has substantial activity in the area of concern, the likelihood of review increases.

Shelf-Registration

Shelf-registration has gone a long way to eliminating uncertainty as to review for eligible issuers. Its core idea is to permit seasoned companies with an active following in the market to register securities they expect to sell in the next two years in advance of any particular sale; the registration statement is declared effective by the staff, sometimes after a full review. Securities are subsequently sold off the shelf by means of prospectus supplements. Since the registration statement is effective, there is no need for any SEC action.

Shelf-registration was made possible by the concept of incorporation by reference, which in turn was made possible once the disclosure requirements under the Securities Exchange Act of 1934 (the "Exchange Act") were made identical to the requirements under the 1933 Act. The registration statement includes the information mandated by the 1933 Act by incorporating the information from reports filed under the Exchange Act, and is kept current by incorporating by reference subsequent periodic reports filed after the effective date of the registration statement. Shelf-registration has also permitted the staff more control over its review process of the 1933 Act and Exchange Act filings. Prior to its implementation, review was driven by issuers' decisions about offerings. Now the staff can allocate more time to Exchange Act reports, which can be reviewed irrespective of an offering.

Shelf-registration has been used most extensively for debt securities and has led to substantial savings for issuers. However, before the adoption of unallocated shelf-registration statements, few companies filed shelf-registration statements related to equity securities because of a fear that the market overhang reflected by the number of securities registered would depress the price of the outstanding securities.

Recently, the Commission expanded the number of companies eligible to use shelf-registration techniques and tried to mitigate the perceived overhang effect with respect to equity by not requiring that a specified number of shares to be issued be identified, and permitting a generic description of the types of equity that might be issued. Notwithstanding the adoption of unallocated shelf-registration, there are, as we heard at our first meeting, a number of companies that are still unwilling to signal the market in advance that they might consider an equity issue of any kind.

Even with shelf-registration, there may also be impediments to particular takedowns. For example, the disclosure requirements with respect to probable material acquisitions and dispositions can delay access to the market even if an effective shelf-registration statement is in place. There are also other instances in which automatic takedowns are not possible.

Continued Uncertainty

Thus, uncertainty as to the timing of access to the market continues to exist for (i) any company conducting an initial public offering, (ii) any company not eligible for shelf-registration either because (A) its float is less than $75 million, (B) it has not filed reports under the Exchange Act for a twelve month period or (C) it has not been timely in its Exchange Act filings during the prior twelve months, (iii) any company eligible to file a shelf-registration statement that either has not filed one or filed one that does not cover the security to be distributed, (iv) any company for which a material acquisition or disposition is probable (in which event certain financial and business information must be included), (v) any company whose financial statements have become stale[4] and (vi) any company making an exchange offer (securities must be issued for cash in a takedown from a shelf-registration statement).

Private Placements and Off-Shore Offerings

Access to the private markets under the exemption afforded by Section 4(2) of the 1933 Act or to off-shore markets under the safe harbor provided by Regulation S is not subject to regulatory uncertainty as to timing. Moreover, public companies can use their publicly filed documents to their advantage in supplying disclosure to investors in private placements or off-shore distributions. Such access is of course subject to market conditions, and in the case of private placements, the securities issued are subject to resale restrictions which affect liquidity.

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4 This problem was a problem primarily for foreign issuers and has been substantially alleviated by recent rule changes.

Liability considerations with respect to the information furnished to investors or the participants involved may also affect the decision to go to other than the public market. For example, companies are exceedingly reluctant to supply forward looking information in the context of a public offering. The litigation risks are perceived to be too great and the duty to update is uncertain in scope. If such information is essential to sell the deal, a private offering may be preferred because the risk of class action litigation from institutional investors is perceived to be less than in a public offering. In addition, there are different liability standards applicable to private offerings and fewer participants may be held responsible. Prior to the Gustafson decision by the Supreme Court last month, it was thought that liability for documents used in public offerings was governed both by Sections 11 and 12(2) of the 1933 Act and Rule 10b-5 under the Exchange Act, and that liability for documents used in private placements was governed by Section 12(2) and Rule 10b-5.

Section 11 imposes an absolute liability standard on the company for any material statements and omissions in the prospectus and a negligence standard on all directors, certain officers, the underwriters and other experts involved in the offering who are considered gatekeepers. In contrast, liability under Section 12(2) and Rule 10b-5 attaches only to the seller of the securities, and in the case of Section 12(2) is a negligence standard, not an absolute liability standard. The Rule 10b-5 standard is discussed below.

In Gustafson, the Supreme Court held that Section 12(2) of the 1933 Act does not apply to private placements under Section 4(2). Thus, no express liability provision of the 1933 Act is applicable to information furnished in a private placement. Such liability must be determined under the more stringent requirements of Rule 10b-5 - that is, the plaintiff must show that it relied upon the material misstatement or omission and that the seller was at least reckless in its statements or its decision to omit information. Gustafson's holding was a complete surprise to the bar, which had always been of the view that Section 12(2) applied to private offerings, although there was debate as to its applicability to secondary market transactions. Before the Gustafson case, a decision to access the private market for liability reasons resulted, in the bar's view, in a limited reduction in exposure for the company and none for the underwriters as sellers of securities in an underwritten private placement. There was a substantial reduction in liability exposure for the directors. And because the negligence standards in Sections 11 and 12, while phrased differently, were thought to be equivalent, the due diligence techniques used in public offerings were generally followed in private placements, and in particular in Rule 144A offerings.

Following the Supreme Court's decision, there is a much clearer liability advantage under federal law for going to the private market, especially with documents prepared and filed under the Exchange Act. The advantage with respect to the off-shore market is unchanged, since it was always governed by Rule 10b-5. Thus, even if regulatory uncertainty is mitigated, these liability advantages may more than offset advantages of more certain access to the public market, especially if the liquidity of securities sold in the market for restricted securities is increased, as suggested by Professor Coffee's proposal.

Because of the structure of the 1933 Act, companies will continue to have the choice between the public, private and off-shore markets. Professor Coffee rightly urges us to allow the private market to function vigorously, and not to worry if substantial overlap or competition develops with the public market. There was no discussion at our first meeting about the off-shore market. From a policy point of view, however, one must consider the impact of the Gustafson decision. In private transactions that are underwritten under Rule 144A, no one may be liable under U.S. federal securities law for a misleading prospectus even if the issuer and the gatekeepers are negligent.[5] Moreover, to the extent that research reports can now be much more freely distributed in the private market without fear of liability following the Gustafson case, there may be concern about information being made available to the institutional private market with the company's cooperation that is not made available at the same time to the public market.

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5 State law provides remedies for negligence, but such remedies are not thought to be as effective as federal remedies which may be enforced in federal courts. All U.S. states (other than New York) have statutes that allow investors to rescind transactions or recover damages when securities are sold by means of materially misleading offering documents. In approximately 35 states, including a number of states with a significant institutional investor base, the standard of actionable conduct is comparable to the reasonable care standard of Section 12(2).

Costs of Registration

Although it is difficult to quantify, it is thought that legal and accounting fees are not likely to be as high in transactions in the private market when compared to non-shelf offerings in the public market. This is especially true for foreign issuers, where the costs of reconciling their financial statements to U.S. generally accepting accounting principles can substantially outweigh the benefits of a private versus a public offering.

Additionally, one can shape the nature and extent of disclosure to suit the targeted investor. In many placements, for example to insurance companies, no prospectus is necessary and limited information is furnished about the company. There are, however, extensive terms and conditions included in the documentation, including representations and warranties. In contrast, the prospectus in a public offering must include the mandated disclosure irrespective of its relevance to any particular investor. This flexibility can result in significant costs savings.

Possible Changes

From the perspective of investor protection, the Commission may well conclude that it should encourage easier access by issuers to the public market through reducing the uncertainty as to timing. We do not believe there is authority under the 1933 Act to permit every registration statement to go effective upon filing or within a designated period of less than 20 days. However, there are several suggestions the Committee might consider.

First, with respect to equity securities, issuers eligible for Form S-3[6] or F-3 could either include

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[6] The eligibility requirements for a Form S-3 issuer are as follows:

> An issuer that has been subject to the periodic reporting requirements of the 1934 Act for at least 12 months and has timely filed all required reports in the last 12 months may register equity securities on Form S-3 if its voting stock held by non-affiliates has an aggregate market value ("float") equivalent to at least $75 million and if it has not defaulted

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equity securities on an unallocated shelf registration statement, or file a registration statement which would go effective automatically on a date specified in the filing, the functional equivalent of a shelf-takedown. There are examples of routine registration statements which are currently permitted to go effective automatically. Consideration should be given to whether there should be a minimum period of time between filing and effectiveness, depending on the size of the transaction, so the market is adequately informed of the proposed offering.[7] Currently, Rule 415 does not permit shelf-registration of voting stock in excess of 10% of the market value of the company's outstanding securities held by non-affiliates (calculated as of a date within 60 days of filing).

Consideration should also be given to changing the rules for acquisition and disposition disclosure applicable to offerings of securities for cash pursuant to Forms S-3 and F-3. There are currently two problems with this disclosure. First, the timing of its release. Second, its necessity for companies acquired in situations in which those companies may not have prepared financial statements meeting SEC requirements.

As to timing, the current rules require disclosure in advance of the transaction. Disclosure is necessary if the transaction is probable and material, and yet the required information may not be readily available at that time. To address the timing issue, one might instead impose the requirements of the Exchange Act. Under the Exchange Act, information need not be filed generally until 15 days after the transaction is consummated. In addition, if the necessary financial statements are not available at that time, they can be filed as soon as practicable but no later than 60 days after the date the Form 8-K must be filed. Distributions thus would be possible before that information is filed on Form 8-K, provided perhaps that some summary information be included about the transaction in the prospectus. To address the content issue, if the information is not available for businesses acquired, issuers should be

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[6](...continued)
on certain payments.

They are similar to the ones for Form F-3.

[7] If it does not go effective on the date filed, provision must be made to have the price included just before it goes effective to reflect the realities of underwriting risk.

permitted flexibility to provide whatever information they deem appropriate. Management has presumably investigated the company acquired upon behalf of the shareholders and has been able to reach agreement on value based on the information available to it, and the issuer must satisfy itself that there are no material omissions in its prospectus when it makes an offering.

Exchange offers also cause regulatory uncertainty. They cannot be made from a shelf-registration statement, and information about the target must be included in SEC format even if the target is <u>not</u> material to the acquiring company. It is for this reason that off-shore acquisitions by U.S. companies are almost always conducted under Regulation S. A review of the requirements to introduce flexibility is needed.

Regulatory uncertainty would still exist for initial filers and those companies not eligible to use Form S-3 or F-3 (since only those issuers are eligible to file shelf-registration statements for primary offerings). With respect to the former, the discussion at our first meeting indicated that the process of going public was often beneficial for the companies involved, in terms of disclosure, controls and governance. Moreover, it seems that the SEC should oversee any first time issuer to the market in its role as a gatekeeper. Finally, it seems impossible by rule or even practice to have the same schedule for every filer - <u>i.e.</u> that the process will take no longer that 30 days. Thus, there will always be some uncertainty and the choice will continue to be between the public, private and off-shore markets. We do not believe that an acceptable solution to uncertainty is to abandon the review and comment process. Such oversight is essential to the integrity of the disclosure system.

With respect to companies not eligible to use Form S-3 or F-3, it is difficult to see how much further one could expand the requirements - after all, the rationale for eligibility is the following in the market by securities analysts who are continuously keeping the market informed, and a float of $75 among non-affiliates is already a low threshold. A possibility might be to permit companies with less than the current float requirement to have access to Form S-3 for debt, and if they have commitments from three analysts to write about the company for a prescribed period of time and to distribute their reports widely, for equity.

<u>Foreign Issuers</u>

Currently, foreign private issuers coming to the United States have a choice between the public market and the Rule 144A market. If they decide to go to the public market, they generally must supply the same information as U.S. issuers, since the Commission's regulatory model is one of national treatment. While financial statements may be prepared in accordance with local accounting principles, they must be audited in accordance with U.S. generally accepted auditing standards, and must be reconciled to U.S. generally accepted accounting principles. The cost of complying with this requirement, as well as uncertainty as to timing of the SEC review process, often result in foreign issuers preferring the private to the public market. If we decide to recommend increased liquidity of shares sold in private transactions, and in light of the Gustafson decision, the Committee may wish to consider allowing foreign companies otherwise eligible to use Form F-3 to come to the public market complying with all the current requirements except reconciling to U.S. GAAP. Following an initial offering, most foreign issuers would soon be eligible to file shelf-registration statements. We note that the recent SEC report on Rule 144A noted that the fastest increase in its use was by foreign issuers.

Forward Looking Information

In addition to regulatory uncertainty about the timing of an offer, one must deal with the uncertainty surrounding the release of forward looking information to investors. The Commission could be criticized for streamlining the registration process without at the same time dealing with the issue of information communicated to investors but not included in the prospectus, or for that matter, in Exchange Act filings. While the Commission is considering the issue of forward looking information in other proceedings, we think it is important that (i) issuers be encouraged but on a voluntary basis to include forward looking information in the registration statement and (ii) it be made clear that companies do not have a duty to update that information. The structure of the 1933 Act and its rules are based on the primacy of the registration statement and the prospectus to which liability attaches. To the extent that forward looking information is communicated orally to certain investors or indirectly through research reports and not included in the prospectus, then the goals of the 1933 Act are undermined. However, to drive that information into the prospectus, one must satisfy directors and issuers that their exposure to liability is remote if they act in good faith.

A less attractive alternative would be to permit increased use of analysts' reports in offerings provided they are widely circulated to all investors and the company limited its involvement to reviewing factual statements. The analysts' views continue to be extremely important, and the consequences of the Gustafson opinion may be increased use of research reports in private offerings.

Off-Shore Offerings

Issuers have access to markets off-shore as well as to the domestic private market. Liability considerations will no longer affect the decision as to which of these markets to choose as a result of the Gustafson case. With respect to debt offerings, U.S. issuers will select the market in which interest rates are more attractive. Off-shore issues of equity securities by U.S. companies are probably driven by certainty as to the timing of access to the market. However, there are significant policy issues when the only trading market for those securities is the United States. First, the securities are not restricted, that is, subject to the holding period requirements of Rule 144. Thus, resales into the United States in ordinary secondary market transactions are possible through U.S. dealers 40 days after the commencement of the offering. And because securities issued off-shore are often issued at a discount to reflect the fact they are not for a forty day period fungible with the outstanding securities of that class, the risk of flow-back is increased, and a certainty if investors have tried to capture the discount by shorting the underlying stock.

As discussed below, if one adopts a company registration system, one should be indifferent as to where securities of any class are distributed or how they are distributed. However, if one continues with the current system, one has to determine whether the likelihood of flowback should raise a concern. Attached is an article discussing the issues. To the extent that regulatory uncertainty as to timing of access to the market is reduced, there seems less reason to permit off-shore distributions likely to flow back immediately, in part because of the potential for circumvention of the rules applicable to domestic offerings. Thus, while off-shore offerings should be permitted, steps might be taken to ensure that the securities have come to rest in the hands of investors. It should be noted that most U.S. companies issuing equity in a global offering when the only trading market is the United States register the entire offering.

As a consequence, the securities may be freely traded across borders at any time.

Company Registration

The paper distributed in connection with our first meeting did not address in detail how a company registration system would operate. The 1933 Act requires that securities be registered each time they are distributed to the public, and that a prospectus be delivered to each purchaser together with a confirmation of sale. By contrast, a company registration system would be modeled on Section 12(g) of the Exchange Act. Companies of a certain size and with certain security holdings would be required to file such annual, periodic and special reports as the Commission required. Once registered with the Commission, the company could distribute securities in the ordinary course of its business without preparing a prospectus containing previously disclosed information about the company or its financial condition. Under the existing system a prospectus must be prepared each time with that information, but because it can be incorporated by reference from Exchange Act reports by seasoned issuers, the requirement is not onerous for issuers eligible to use shelf-registration.

There are several issues that must be addressed to implement company registration. First, what should the liability standards be with respect to information filed with the SEC and to whom should they apply? There are currently four approaches in the 1933 Act and the Exchange Act - Section 11 of the 1933 Act (applicable to the company, each director, certain officers, the underwriters, accountants and other experts), Section 12(2) of the 1933 Act, applicable to any seller, Section 18 of the Exchange Act, applicable to the issuer with respect to any document filed pursuant to the requirements of the 1933 Act, and Section 10 of the Exchange Act and Rule 10b-5 adopted thereunder, applicable to any statement or omission by any person which affects the purchase or sale of a security. While the combination of the integrated disclosure system and shelf-registration is a form of company registration, it takes effect in the context of a distribution of securities to the public, with the result that Sections 11 and 12(2) apply to all filed documents. There is existing case law with respect to these Sections. By contrast, litigation under Section 18 of the Exchange Act is almost non-existent because of what the plaintiff must show. Thus, most challenges to disclosures under the Exchange Act or to the market by way of press release are under Rule 10b-5. The Committee should discuss what the appropriate liability standards should be. This issue was not resolved by the ALI Code.

Second, how often should the information be updated? Currently, updating is periodic, unless a company is purchasing or selling to the public its own securities, in which event all material non-public information not contained in previous filings must be disclosed before the purchase or sale occurs. In a company registration system, should a distribution or repurchase be the only time updating is necessary in between interim filings? By contrast, companies listed on the New York Stock Exchange are required to "release quickly to the public any news or information which might reasonably be expected to materially affect the market for its securities". If a company is involved in significant activities such as merger and acquisitions negotiations, material information need not be publicly disclosed if it has not been disclosed to anyone other than corporate insiders and their advisers and if it remains confidential. Further, a company is expected to respond to rumors or unusual market activity by making an appropriate announcement: if the "rumors are in fact false or inaccurate, they should be promptly denied or clarified", and if the rumors are true or there are corporate developments, an immediate candid public statement should be made. In circumstances in which the immediate release policy is not implicated[8] or "where disclosure would endanger the company's goals or provide information helpful to a competitor", the company may decide when to disclose information after weighing "the fairness to both present and potential stockholders who at any given moment may be considering buying the company's stock".[9]

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8 Information for immediate release includes annual and interim earnings, dividend announcements, mergers, acquisitions, tender offers, stock splits, major management changes, and any substantive items of unusual or non-recurrent nature.

9 The NASD requires companies whose securities are quoted on NASDAQ to make prompt disclosure to the public of material information "that would reasonably be expected to affect the value of its securities or influence investors' decisions", except in unusual circumstances in which it is possible to maintain confidentiality and immediate public disclosure would prejudice the ability of the company to pursue its corporate objectives.

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However, only the exchanges and the NASD, as the case may be, can enforce the immediate release policy, through delisting of securities. No civil liability attaches from failure to comply with listing conditions and, to our knowledge, no company has been delisted recently for failing to comply with this requirement. Trading has, however, been suspended in situations in which there are active rumors about the company which it refuses to confirm or deny.

Should the Committee consider recommending a rule reflecting the approach of the New York Stock Exchange? If so, should private investors have a right to sue if they allege it was not complied with? Under what circumstances should any statements about new developments be updated? Because of the concern about a duty to update, companies are reluctant to announce prospective developments until the arrangements are firm, notwithstanding the conditions imposed by the exchanges to listing.[10] Could that rule also be used with respect to

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The American Stock Exchange has similar provisions for prompt disclosure and an exception for when immediate disclosure would prejudice the ability of the company to pursue its corporate objectives or when the facts are changing and "a more appropriate time for disclosure is imminent".

[10] Although the court decisions are not uniform and the distinctions between the duty to correct and the duty to update are often muddled, courts have indicated that a company may have a duty to update statements which, although accurate when made, become materially misleading due to subsequent events. There is no simple rule for distinguishing initially accurate statements that should be updated and those that need not be. To the extent it is possible to discern the direction in which the courts may be moving with respect to a duty to update material information that has been publicly disclosed, it is with respect to forward looking statements on which investors might expect to continue relying -- not necessarily projections or forecasts, but statements concerning, for example, negotiations regarding strategic alliances or products in development. A duty to update, even if limited to certain forward looking statements, would create an affirmative duty to disclose material information apart from that

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new issues of securities? Or should some form of document be delivered in connection with a significant distribution of securities?

Other issues must be considered. What should the threshold levels be to require company registration? The current standard under the Exchange Act? Higher thresholds? Would companies not yet eligible have access only to the private markets? Or would registered offerings still be feasible? Should the same disclosure be required of all issuers, irrespective of size or country of incorporation? Or should issuers be classified?

Finally, how frequently should issuers be required to file interim reports? Foreign issuers are only required to report annually, while domestic issuers must report quarterly. There has been criticism of the frequency with which U.S. companies are required to report. Most foreign exchanges have a semi-annual requirement which might be considered.

Conclusion

We believe that significant improvements can be made to the regulatory process without legislation amending the current statutes. However, company registration is likely to require appropriate modification. We hope this paper will assist the Committee deliberations.

Edward F. Greene
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[10](...continued)
required by the SEC's rules, stock exchange rules or in circumstances in which the issuer is trading in its securities or has a duty to correct a prior statement which was inaccurate or misleading when made.