

## CHAPTER I.

### INTRODUCTION, SCOPE AND SUMMARY

- A. Introduction
- B. Scope of the Report
- C. Summary of the Report
  - 1. Chapter II – Background for a Re-examination of Disclosure Policy
  - 2. Chapter III – The Form and Content of '33 Act Prospectuses
  - 3. Chapter IV – The Dissemination of '33 Act Prospectuses
  - 4. Chapter V – The “Gun-Jumping” Problem
  - 5. Chapter VI – Secondary Distributions and Brokers’ Transactions
  - 6. Chapter VII – Business Combinations
  - 7. Chapter VIII – Small Offerings Exempt under Section 3(b) of the '33 Act
  - 8. Chapter IV – The Breakthrough in Dissemination of '34 Act Reports

9. Chapter X – '34 Act Registration and Reporting
10. Chapter XI – Annual Reports to Shareholders and Proxy Statements
11. Chapter XII – Administration and Enforcement of '34 Act Reporting Requirements

## CHAPTER I.

## INTRODUCTION, SCOPE AND SUMMARY

A. Introduction

In November, 1967, the Commission announced the formation of a small, internal study group “to examine the operation of the disclosure provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and Commission rules and regulations thereunder.”<sup>1/</sup>

This report is the product of that assignment.

The '33 and '34 Acts were the first in time of the six federal securities statutes (not counting portions of Chapter X of the Bankruptcy Act) administered today by the Commission. Together, these two Acts provide a disclosure system broadly applicable to American business enterprise. Various proposals for changing features of that system have been made, both from inside and outside the Commission. It has been the task of the study group (the “Study”) to sift these proposals, to appraise the Commission’s existing rules and policies with a critical eye, and to recommend a course of action to the Commission.

The Study wishes to acknowledge with deep appreciation the assistance provided to it by numerous groups and individuals concerned with or affected by the work of the Commission. Many

---

<sup>1/</sup> Securities Act Release No. 4885 (November 29, 1967).

persons, at considerable inconvenience and expense, traveled to Washington (some on two or more occasions) to meet with the Study for extended discussion. On several occasions, help was requested with difficult and time-consuming statistical projects. It was invariably forthcoming. Concrete suggestions were asked for and received. No agency of government could possibly have expected any finer cooperation from the private sector. Listed below are representative organizations which provided the Study with invaluable help. Regrettably, it is impossible to list the names of all of the individuals and private firms who contributed in equal measure, although in a non-representative capacity, to the Study's work.

The American Bar Association, Committee on Securities Regulation (Banking and Business Law Section)

The American Institute of Certified Public Accountants

The American Society of Corporate Secretaries

The American Stock Exchange

The Association of the Bar of the City of New York, Committee on Securities Regulation

The Financial Analysts Federation

The Financial Executives Institute

The Investment Bankers Association

The North American Securities Administrators

The National Association of Securities Dealers, Inc.

The New York Stock Exchange.

This report is essentially a technical memorandum. It makes no attempt to treat its subject matter in scholarly detail. Many items of historical or collateral interest (such as the history of the development of Forms 10, 10-K, 9-K and 8-K) which were examined in supporting memoranda during the course of the Study, have been omitted from this report. Arguments in favor of and against the Study's recommendations have been condensed. Citations to cases, books and articles dealing with matters discussed in the report have been sparingly used.

If the Study had confined itself to matters of broad policy, this report could have been completed many months earlier. Two factors influenced the Study to reject this approach and to carry its work to the point of drafting on specific rules and forms for the Commission's consideration.

First, one reason for the Study was the lack of coordination which characterized previous efforts by the staff to draw up suggested amendments to the rules and forms. Inevitably, such efforts tended to be responsive to particular problems as they arose. It was the Study's clear responsibility to provide a broader view. Had the Study submitted a report to the Commission containing no more than generalized policy recommendations its work would have been incomplete. A new task force would have been required to undertake the difficult drafting assignment. Further delay would have been inevitable.

Second, the best test of a recommended policy is the effort to reduce it to a coherent set of rules. The Study applied that test to the policies it recommends. Certain of the proposed rules—especially those dealing with secondary distributions<sup>2/</sup> are long and complex. In the case of secondary distributions, however, they replace a large volume of legal lore with some 12 pages of specifics. The Study realizes that any recommendation which would tend to render obsolete such a body of accumulated lore will induce a twinge of regret. As Baron Parke said of new rules proposed in his day: “They will make pleading no art.”

It should also be borne in mind that the rules and forms proposed by the Study, although each has gone through many drafts, are unfinished products. The Study has no doubt that their careful examination by others will disclose matters of importance not yet fully considered, or alternatives that may prove more promising. This report has been written as a report to the Commission. With the foregoing in mind the Commission may wish to publish it as a whole for critical comment.

B. Scope of the Report

This report deals with a limited area of federal securities

---

<sup>2/</sup> See Chapter VI and Appendix VI-1.

regulation, appropriate to the Study's modest size<sup>3/</sup>. It does not analyze the investment process or the economics of investment. It is not directly concerned with securities fraud. Questions which have recently excited the greatest interest, such as the obligation of so-called "insiders" to make appropriate disclosures of unpublished material information in connection with their purchases or sales of securities, are beyond its scope; such questions, arising largely under Rule 10b-5, involve disclosure in the context of Federal policy aimed at the prevention of fraud and manipulation in the securities markets.

Because of its limited focus, the Reports does not cover various specialized aspects of disclosure policy, such as disclosures required by the Investment Company Act, the Public Utility Holding Company Act, or the Trust Indenture Act. Nor has any examination been made of the workings of the provisions of Chapter X of the Bankruptcy Act dealing with voting by security holders and creditors on plans of reorganization.

There are two principal roads to disclosure policy reform. One is by statutory amendment. The Study was aware at the outset of the existence of important and serious proposals for a

---

<sup>3/</sup> For a portion of the last fourteen months, five persons were involved full time in the work of the Study; for the balance of the period, four persons were so engaged. One member of the Commission's staff acted as senior adviser to the Study and others contributed assistance in particular areas.

recodification of the Federal securities laws<sup>5/</sup>. One problem with such a program, however, is its time frame; as a leading authority in the field has observed, “it may take twenty years.”<sup>6/</sup> The Study determined to explore what could be done administratively within the confines of the ’33 and ’34 Acts as they presently exist. It concluded that much could be accomplished by this second road to reform. This conclusion in no way lessens the validity of the codification approach. The two roads run parallel; one may be humbler than the other, but each presents a serious challenge.

It has been the goal of the Study to discover what could be done through the rule-making process—

(a) to enhance the degree of coordination between the disclosures required by the ’33 and ’34 Acts;

(b) to respond to the call for greater certainty and predictability; and

(c) to develop a consistent interpretative pattern which would help to assure that appropriate disclosures are made prior to the creation of interstate public markets in the securities of any issuer.

The Study has attempted to “see disclosure whole” while examining its parts. It has tried throughout to weigh and balance the many interests involved. Its recommendations are interdependent.

---

<sup>5/</sup> See Cohen, “Truth in Securities” Revisited, 79 Harv. L. Rev. 1340 (1966) and Proceedings of the Conference on Codification of the Federal Security Laws, 22 Bus. Law. 793 (April, 1967).

<sup>6/</sup> Loss, History of S.E.C. Legislative Programs and Suggestions for a Code, 22 Bus. Law. 795, 799 (April, 1967).

For example, the proposed rules which set forth objective tests and specific holding periods for resales following private placements under the '33 Act are believed practicable if the pattern and coverage of '34 Act reports is improved. The report and its recommendations should be viewed and considered as a whole.

Finally, this report reflects the conclusion that change in disclosure policy through Commission rule-making should be evolutionary in nature. The results of each stage in that evolution should be tested and evaluated before further changes are made. Thus, in no sense do the recommendations represent a final set of parameters, but only the Study's judgment as to the best practicable steps to be taken at this time.

C. Summary of the Report.<sup>6a/</sup>

1. Chapter II – Background for a Re-examination of Disclosure Policy

A re-examination of disclosure policy is appropriate at this time for several reasons. Among them are: (1) the rapid increase in the American shareholder population and the accompanying increase in the number of investment decisions; (2) the trend toward a greater measure of professionalism in the securities business with the accompanying demand for more information about issuers; (3) the expansion in the coverage of the '34 Act's reporting and

---

<sup>6a/</sup> A condensed list of the specific rule changes and other recommendations made in the report is provided in Appendix I-1.

proxy provisions effected by the 1964 amendments; (4) technological advances that enable users of information to obtain it from such sources as the Commission's files more rapidly and at less expense than was previously possible; and (5) growing criticism of the status quo in disclosure.

Disclosure is and has from the outset been a central aspect of national policy in the field of securities regulation. The emphasis on disclosure rests on two considerations. One relates to the proper function of Federal government in investment matters. Apart from the prevention of fraud and manipulation, the draftsmen of the '33 and '34 Acts viewed that responsibility as being primarily one of seeing to it that investors and speculators had access to enough information to enable them to arrive at their own rational decisions. The other, less direct, rests on the belief that appropriate publicity tends to deter questionable practices and to elevate standards of business conduct. Consistent with these fundamental considerations, a pragmatic balance must be struck between the needs of the unsophisticated investor and those of the knowledgeable student of finance. Information communicated to and absorbed by professionals filters out to and benefits a wider public. This filtration effect is more significant today than ever before because of (1) the growing importance of the professional money manager, and (2) increased brokerage firm stress on research and analysis.

Historically, the Commission's efforts in the disclosure field have been concentrated in the new issue market, despite the far greater statistical importance of the trading markets. This traditional emphasis has a certain justification. The special selling effort by which new issues are normally distributed calls for countervailing measures to protect the public customer. Moreover, transactions through which new capital flows into industry can be regarded as having a more significant impact on the economy than mere trading transactions. However, it is the opinion of the Study that for the future, greater attention must be paid to those continuing disclosures which benefit the trading markets in securities. Prior to 1964, the Commission's ability to meet this need was limited. Its authority with respect to continuing disclosure reached only those issuers whose securities were listed on exchanges and those which had voluntarily registered securities under the '33 Act. Full exercise of that authority might have deterred listing. This is no longer the case, and a serious impediment to progress in disclosure policy has been removed.

## 2. Chapter III – The Form and Content of '33 Act Prospectuses

Throughout its history, the Commission has endeavored to simplify the prospectus and to make it a document of maximum usefulness. Much has been accomplished. More remains to be done,

however, and the Study recommends several further steps. These include: (1) no acceleration of the effective date where the prospectus is unnecessarily complex, lengthy or verbose; and (a) a requirement of an expanded table of contents or “guide” where the text of the prospectus, exclusive of financial statements and the list of underwriters, exceeds 10 pages in length.

The informational content of the prospectus will be substantially improved by adoption of the pending proposal for reporting of sales and earnings of the separate “lines of business” of diversified businesses. Other improvements should be considered, including: (1) requiring a flow of funds statement; (2) improved disclosure of earnings in the case of life insurance companies, and (3) more information bearing on the experience and background of management.

Although company projections of sales and earnings are of great interest to investors, serious problems are associated with requiring, or permitting, such projections to be included in '33 Act prospectuses. Because of their conjectural and rapidly changing character, projections would—if included in prospectuses—raise difficult questions of civil liability. Moreover, projections in filed documents might become traps for the unsophisticated who would be prone to attach more significance to such projections than they deserve. The Study does not recommend any change in present Commission policies relating to projections.

Improvement in the content and dissemination of reports filed under the '34 Act should permit a closer coordination of the disclosures required by that Act and the disclosures required in '33 Act prospectuses. To this end, the Study recommends a substantial expansion of the availability of Form S-7. The requirement that the issuer's business has been of "substantially the same general character since the beginning of the last five fiscal years" would be deleted as would the \$50 million gross sales test. The net income test would be reduced to \$500,000 for each of the last five years. Given time and experience, it is hoped that the Form S-7 prospectus will evolve in the direction of a more thoroughly condensed and simplified disclosure document.

Finally, there are occasions where the need for a full prospectus, even of the S-7 variety, is questionable, although registration is required under the law. The Commission has ample powers to classify types of offerings and should exercise them in imaginative and practical ways. Thus, a one or two page prospectus could be provided for continuous offerings of the registered shares underlying warrants, incorporating by reference significant information in the Commission's files concerning the issuer. This technique can also be applied (1) to an offering of securities underlying the convertible securities of an affiliate, and (2) to secondary offerings on exchanges to which Rule 153 applies. In the latter case, it is impractical to expect brokers whose compensation is limited to the minimum stock exchange commission to

engage in a thorough and complete investigation of the issuer's affairs. A less rigorous "standard of reasonableness" for the purposes of Section 11(c) of the Act could be prescribed by rule without sacrificing appropriate investor protections.

### 3. Chapter IV – The Dissemination of '33 Act Prospectuses

The '33 Act seeks to inform investors through prospectuses. However, under the Act's substantive provisions the actual delivery of the prospectus to the investor may be deferred until confirmation of sale is mailed. The problem of getting the prospectus to the investor at some point before he buys remains unsolved.

This problem is especially acute in first public offerings where the prospectus is a uniquely valuable document. To the extent practicable, each prospective investor in a first public offering should receive a copy of the preliminary prospectus a reasonable time in advance of the effective date. Forty-eight hours would be deemed to be a reasonable time under the Study's proposal, which involves an amendment to Rule 460 dealing with the Commission's discretionary power to accelerate the effectiveness of '33 Act filings.

One purpose of the prospectus is to deter the fraudulent sales pitch. However, under present practice the salesman who does the actual selling during the pre-effective period may never have seen the preliminary prospectus. Moreover, he is sometimes unable to

supply copies to those of his customers who want it. This problem should be dealt with by a new Commission rule establishing that

(1) Participants in underwritings should take reasonable steps to give prospectuses to all who ask for them.

(2) Each salesman who is expected to offer for sale any security as to which a registration statement has been filed should be given a copy of the preliminary prospectus and of any amended preliminary prospectus. If the salesmen are expected to offer securities after the effective date, they should first receive a copy of the final prospectus.

(3) Managing underwriters should be obliged to take reasonable steps to see to it that other participants in the offering (including dealers) receive enough copies of the various versions of the prospectus to enable those participants to comply with the foregoing requirements and with the amended Rule 460. In addition, managing underwriters must furnish any dealer with prospectuses sufficient to enable such dealer to comply with post-effective delivery obligations.

For non-reporting companies, the prospectus is the only reliable source of information generally available following a registered public offering. Therefore, its dissemination should be encouraged. The 90-day post-effective prospectus delivery requirement serves that purpose. It should be retained and enforced. Different considerations apply to the post-effective delivery of prospectuses

of reporting companies. Information about such companies is on file with the commission and available to the financial community. It is questionable whether the dealer's present duty to deliver prospectuses during the 40 days following the effective date of a registration statement is particularly helpful to investors in the trading markets. If the '34 Act reports are improved as recommended in Chapter X of this report, dealers who are not acting as underwriters should be relieved from any post-effective obligation to deliver prospectuses of issuers that report under the '34 Act.

#### 4. Chapter V – The “Gun-Jumping” Problem

When Section 5 of the '33 Act applies, no offering can be made until a registration statement is filed; after such filing, a written offer may be made only by means of a prospectus that meets the statutory requirements. Thus, publicity which develops interest in a forthcoming registered offering may run afoul of the Act's prohibitions. However, the policy of protecting prospective buyers of new securities from undue sales pressures must be harmonized with the need to keep buyers, sellers, and holders of the issuer's outstanding securities appropriately informed.

With respect to issuer-generated publicity, present standards are sound and generally workable. They distinguish the normal flow of corporate news unrelated to an effort to sell securities from

the type of publicity aimed at selling the issuer's stock. Issuers who are making or are about to make public offerings can as a general rule continue to give normal publicity to corporate events. In general, the Study agrees that projections of sales and earnings which would not be permitted in a prospectus should not be released by corporate management when a registered offering is about to take place.

Standards as to publicity generated by brokers, dealers, and investment advisers are less clear. The point in time when restrictions on such publicity commence should be made more definite. Other recommendations are summarized below:

(1) It should be specified that the gun-jumping doctrine generally applies only to the participants in the particular distribution. Assuming that securities of a reporting company are to be offered, non-participants who are truly independent of the participants should be under no restriction.

(2) If an issuer meets the standards for use of Form S-7, expression of opinion about its common stock should be permitted when a registration statement relating only to non-convertible senior securities is pending, and vice versa.

(3) If a securities firm publishes a broad list of recommended securities on a regular basis, it should be permitted to include in the list a recommendation as to securities which are the subject of an underwriting in which it is a participant, subject to certain conditions which guard against abuse.

(4) Factual follow-up reporting on previously recommended securities should be permitted at any time, subject to appropriate conditions.

(5) Pre-filing distribution of market letters and industry surveys that were fully prepared and delivered to printers before the firm reached an understanding that it would participate in the underwriting should be permitted under appropriate conditions.

5. Chapter VI – Secondary Distributions and Brokers’ Transactions

When can securities that have been purchased in non-public transactions from issuers and from controlling persons be reoffered publicly without registration? Present doctrine in this field turns on the private purchaser’s state of mind. The resulting emphasis on subjective factors causes unacceptable uncertainty and administrative difficulty. “How long do I have to hold” is the question most frequently raised in requests for “no-action” letters. The answer often depends upon cloudy concepts which have arisen over the years, such as “change of circumstances” and “fungibility.”

The consequences of this uncertainty are damaging to the healthy administration of the ’33 Act. They include: (1) an increasing burden of requests for no-action letters and interpretative advice, (2) substantial inconsistency in advice given by private lawyers to their clients, which frequently puts careful and

experienced counsel at a marked disadvantage, (3) wide leeway for the unscrupulous, and (4) the existence of formidable problems of proof in the enforcement of the law.

Various alternative solutions examined by the Study are outlined in the body of the chapter. The best of these, in the Study's view, would be the adoption of new rules (to take effect prospectively) which would, to the extent practicable, replace present subjective tests with objective ones. It is believed that the Commission has authority to adopt such rules, an opinion in which the Commission's General Counsel concurs.

A central feature of the proposed new rules would be a definition of the term "distribution" in Section 2(11) of the '33 Act. The new definition would apply both to the sale of securities on behalf of controlling persons and to sales by persons who have purchased their securities in private offerings. In developing such a definition the Study focused its inquiry (in the words of Justice Clark) on ". . . the need of the offerees for the protections afforded by registration."<sup>7/</sup> When securities held by a controlling person are sold, or when securities sold privately by the issuer are resold, under what circumstances do investors need the protection of registration?

It was concluded that a sensible answer to this question could only be found by drawing a distinction between companies

---

<sup>7/</sup> SEC v. Ralston Purina Co., 346 U.S. 119, 127 (1952).

which file regular, informative reports on their affairs with the Commission under Sections 13 or 15(d) of the '34 Act (so-called "reporting companies") and companies which do not. If there has been no full disclosure of a company's business, earnings and financial condition (or if, despite the fact that the company is a reporting company, its reports appear to be defective or out of date), then a sale to the public of that company's securities ought to be accompanied by the disclosures afforded by '33 Act registration. Conversely, if a company has registered a class of its securities with the Commission under the '34 Act and is maintaining the currency of the information in that original registration statement through up-to-date periodic reports to the Commission, then it ought to be possible to permit secondary sales of its securities to the public without the filing of a '33 Act registration statement except (1) where the quantity of those securities to be sold exceeds an amount which the trading market could normally be expected to absorb within a reasonable period of time, or (2) where, in order to move the securities from private into public hands, arrangements for the solicitation of buying customers, or selling incentives exceeding the commissions paid in ordinary trading transactions, are required.

Objective tests were needed to determine what sales are consistent with ordinary trading. Here, a precedent was available to the Study. The draftsmen of the present version of Rule 154 sought a similar objective. That rule was designed to separate

the routine trading transaction from the transaction involving the disposition of a large block of securities by means of extra selling incentives.

The Study reached the conclusion that the general framework of Rule 154 is valid as applied to the securities of reporting companies, at least until the Commission can assess the results of an initial period of experience with improved '34 Act reporting. The basic quantity limitations of Rule 154 were retained, with the following changes: (1) private placements of securities within the preceding six months do not reduce the quantity which may otherwise be sold, (2) only those members of a carefully defined family group are considered together as one "person" for purposes of the quantity limitation, (3) sales may be made in successive six-month periods, (4) inquiry by the broker of other bona fide broker dealers is not prohibited, (5) the broker involved is permitted to remain in the "sheets" if acting as a genuine market maker, and (6) commission limits are specified by reference to the minimum commission required by the exchange on which the security is listed and, for over-the-counter securities, by reference to the minimum New York Stock Exchange commission schedule.

If such a definition of "distribution" is to be workable both for sales on behalf of controlling persons and for sales of privately placed securities, one problem must be solved. The use of ostensible private purchasers as conduits for the sale of securities

to the public without registration must be prevented. To solve this problem, a short mandatory holding period is essential, during which the private purchaser is at risk. (A controlling stockholder who acquired his shares in the trading market would not be subject to any holding period.) All who consulted with the Study recognized the need for such a holding period, but views as to its appropriate length differed appreciably. Some favored a period of six months. Others strongly believe that the period should be two years. The Study recommends a period of one year. During the holding period, a private purchaser could not resell publicly without registration, unless Regulation A, or another Section 3 exemption, is available. He could, of course, always sell in transactions which are not public offerings.

A similar holding period would apply to the purchaser in a private resale. (If it were otherwise, for example, a holder of 5% of the outstanding stock of a company, restricted as to his own public sales without registration to 1% in each six month period, could dispose of his entire block simply by selling it to five intermediaries, each of whom would immediately be in a position to resell all of his shares to the public.) However, on some occasions, such as transfers involving pledges and gifts, those resulting from death, and those resulting from the distribution to beneficiaries on termination of a bona fide trust, a transferee

would be permitted to avail himself of the period during which his transferor held the securities. On other occasions (such as the combination of two bona fide going businesses or the conversion of privately placed convertible securities) where outstanding securities are surrendered in exchange for newly issued securities, a holder of the newly issued securities would be permitted to make use of the period during which he held the surrendered securities.

The so-called Guild Films doctrine and Rule 155 under the '33 Act would be eliminated in the structure of the proposed new rules. To a large extent, the “fungibility” concept would be eliminated. Sales could be made—or could not be made—under the proposed rules irrespective of the private purchaser’s intent at the time of purchase. The existence or non-existence of a “change of circumstances” would be irrelevant.

The essence of the proposed new definition of “distribution” is as follows:

First, non-public transactions are excluded from the term “distribution” and do not require registration of the securities involved.

Second, any public offering of the securities of an issuer which is not subject to appropriate reporting requirements is a “distribution.”

Third, a public offering of the securities of an issuer which is subject to the reporting requirements and is not delinquent in its filings<sup>8/</sup> is not a “distribution” (and no registration of the securities is required) if the amounts involved and the method of sale are within the standards for “ordinary trading” outlined in the preceding paragraphs.

The framework of statutory provisions and Commission rules into which the proposed new definition of “distribution” would fit is, in simplest outline, as follows:<sup>9/</sup>

(1) Any security acquired directly or indirectly from its issuer, or from any person in a control relationship with its issuer, in a transaction or series of transactions none of which was a public offering or other public disposition, would be defined as a “restricted security.”

(2) Any person who disposes of a “restricted security” in a “distribution” would be an “underwriter.”

(3) Transactions by an “underwriter” are not exempt from registration under the '33 Act.

Logic would appear to dictate that the above-outlined framework of restrictions on public resale of securities originally

---

<sup>8/</sup> Such an issuer would be listed on a “qualified list” under proposed Rule 164, which list could be published and kept up-to-date by frequent published supplements.

<sup>9/</sup> An expanded outline of this framework is set forth in a “preliminary note” to the proposed new rules, which are contained in Appendix VI-1 of this report.

taken in private placement should last indefinitely. After long and careful consideration, however, the Study determined that the restrictions should last for a definite period of years (assuming that the issuer has met appropriate tests of a bona fide active business enterprise during the period) after which the securities would be free of restrictions on resale. Perpetual restraints on alienation have been viewed with disfavor and would create difficulties in the administration of the Act. The Study believes that the period should be at least 5 years. The Commission may determine, however, that a longer period is justified by the primary objective of investor protection.

As a part of the above framework, present Rule 154 would be revised in order to provide exemption to a broker whenever he acts as agent either for the account of a controlling person or for the account of a person selling a “restricted security” (i.e., a person who purchased in a private placement) if the broker has made reasonable inquiry of his customer and has no grounds for believing, and does not believe, that the transaction constitutes a “distribution” of the securities. In the interest of a consistent policy for the protection of public investors in all types of secondary transactions in securities, the revised rule would not permit the public sale without registration of control stock of a non-reporting company. It would, however, furnish protection

(not available under present rule 154) to the honest broker who handles the public resale of securities purchased by his customer in a private placement even if the customer, unknown to the broker, is in fact engaged in a “distribution.”

---

There will continue to be close questions involving the distinction between “public” and “non-public” offerings in applying the proposed new rules, as there are in applying present concepts. Various considerations prevented formulation by the Study of a satisfactory objective test of broad applicability which would serve to eliminate such questions. Further efforts in that direction might well be productive and should be encouraged. In one limited area—that of business combinations—a more definite standard to assist the issuer in determining when it may rely on the “private offering” exemption was deemed to be practicable and necessary. It is described in the summary of Chapter VII below.

Questions of “control” will also arise under the framework of the proposed new rules, as at present. Again, no broadly applicable objective test of “control” was found to be practicable. Instead, the Study recommends adoption of a rule which would exclude from the concept of “control” persons who do not have certain defined relationships with the issuer. An explanatory note to the proposed rule indicates that the possession of one of the designated relationships does not necessarily imply a finding of “control” and

gives a series of examples to illustrate situations in which directors, officers, or large stockholders are not deemed to “control” the issuer.

## 6. Chapter VII – Business Combinations

Business combinations in which payment by the acquiring corporation is made in its own securities are effected in three standard ways: (1) a voluntary exchange of securities, (2) a statutory merger or consolidation, and (3) a sale of the assets of the acquired company in exchange for securities of the acquiring company which are thereupon transferred to the seller’s shareholders on its dissolution.

Where method (1) is used, an offer of securities of the acquiring corporation is made directly to the shareholders of the acquired corporation. In methods (2) and (3), the shareholders of the corporation to be acquired are asked to cast their individual votes for or against approval of the acquisition, or, in realistic terms, for or against a legal procedure by which their present shareholdings are exchanged for shares in another company.

The first method subjects the transaction to the disclosure requirements of the ’33 Act. The other two do not. The reason for this lies in the existence of a long-standing Commission rule (Rule 133) under which the submission of the acquisition transaction to the vote of shareholders is not deemed to involve a “sale” or

“offer to sell” the shares of the acquiring company so far as those shareholders are concerned.

Rule 133 has led a controversial life. In 1956, the Commission proposed its abolition. Ultimately, the Rule was retained in amended form. Doubts have persisted, however, as to its applicability in situations where the acquired company is held by a private group of shareholders and the vote of such shareholders approving the acquisition is a mere formality. Since 1967, the Commission has refused to grant “no action” letters to issuers intending to rely on Rule 133 in cases where, if the transaction were structured otherwise than as a merger or sale of assets, the issuance of the new shares would clearly be a private placement.

The Commission’s position points up one of the principal problems created by Rule 133. If Corporation A (a publicly held corporation) wishes to acquire Corporation B (a non-public corporation) through a voluntary exchange of shares, the former shareholders of B must take their new shares subject to severe restrictions on resale if A is to claim the “private offering” exemption from registration. If the structure of the transaction can be changed, however, to a merger or sale of assets and Rule 133 applies, then restrictions on resale affect only the controlling stockholders of B and those restrictions permit immediate public resale in brokerage transactions of substantial quantities of the newly-acquired stock.

Assuming that Corporation B's outstanding shares are held by 400 shareholders of record (so that the requirement of registration under Section 12 of the '34 Act is inapplicable) then, if Corporation A wishes to offer its shares in a voluntary exchange for the outstanding shares of B, it must register the shares to be offered under the '33 Act and deliver a prospectus to the offerees. If the transaction can be structured as a merger or sale of assets and Rule 133 applies, however, not only is registration under the '33 Act avoided but, under the laws of many states, the only document which must be sent the shareholders of B in advance of their vote on the transaction is a bare notice of meeting.

The Study questions whether these important distinctions between the Securities Act consequences of different methods of business combination—differences which affect not only the choice of the method to be used but also the interest of public investors—can be justified.

Several possible alternative solutions to the problem were examined. The most promising of these involves the replacement of Rule 133 with a special kind of '33 Act registration procedure adapted to mergers and sales of assets. The new procedure would be consistent with the proposition that where an acquired company is publicly held, a proxy statement under the Commission's rules is both an appropriate and an adequate form of disclosure; nothing

additional, by way of a prospectus, is needed. Such a solution would substantially eliminate all distinctions under the '33 Act between the three types of business combinations.

There are, of course, certain practical difficulties in applying the '33 Act registration process to transactions now covered by Rule 133. The Study does not minimize these practical difficulties. It believes, however, that they are surmountable.<sup>10/</sup> Under the proposed procedure, one document would serve both as a '34 Act proxy statement (where the acquired company is subject to the proxy rules) and as the '33 Act prospectus. The '33 Act registration statement would consist, essentially, of a proxy statement conforming to the proxy rules. It would be processed in much the same fashion as the proxy statement is now processed and would be made effective prior to mailing. Specific procedures and rules are suggested to authorize appropriate announcements of a forthcoming merger and to deal with prospectus delivery requirements, persons not considered to be “underwriters,” the mechanics of registration in a consolidation, and sale-of-assets transactions which do not require registration.

---

<sup>10/</sup> It is of interest to note that the viewpoint of two very recent commentators appears to be in accord. Schneider, Acquisitions Under the Federal Securities Act – A Program for Reform, 116 U. Pa. L. Rev. 1323, 1349 (1958). (“All acquisitions should be treated as sales for purposes of section 5. Registration under that section should be required in all cases, except where [the disappearing corporation] is closely held and the private offering exemption can be applied”); Knauss, Disclosure Requirements—Changing Concepts of Liability, 24 Bus. Law. 43, 47 (1968).

Where the acquired company is non-public, two new provisions would be applicable.

First, as mentioned in the summary of Chapter VI, the Study found it impracticable to develop a comprehensive definition of “public offering” as opposed to “private placement.” In the field of business combinations, however, it was believed possible to formulate a less ambitious rule which would be of value in answering the question whether a particular transaction may be regarded as one not involving a public offering. A special problem exists in business combinations, where the acquiring company has had no part in the selection of the persons to whom its securities are to be offered. The Study proposes a rule under which an offering of securities made solely in connection with a business combination to not more than 25 offerees who hold interests in the acquired business would be deemed to be non-public, provided later resales by the offerees do not cause it to “involve a public offering.”

Second, under the proposals outlined in the summary of Chapter VI, persons who acquire securities directly from issuers in non-public transactions will be able (if the issuer reports under the '34 Act) to make limited resales on a brokerage basis after holding and being at risk for at least one year. Normally, this holding period would not begin to run until the private purchaser pays for his securities. In a business combination, however, the investor took his risk when he made his initial investment in the

acquired company. Accordingly, the Study believes that the holding period in such transactions should be deemed to begin when the initial investment was made, assuming that the acquired company satisfies an appropriate gross sales test designed to demonstrate that it was a bona fide, going business for at least one year prior to the acquisition.

7. Chapter VIII – Small Offerings Exempt under Section 3(b) of the '33 Act

Consistent with its orientation toward rule changes within the Commission's existing powers, the Study makes no recommendation on proposals to increase the present \$300,000 limit of Section 3(b). However, it has been the Study's aim to improve the usefulness of Regulation A as a vehicle for the public sale, with appropriate disclosures, of limited amounts of securities.

At present, securities sold in secondary offerings under Regulation A by persons in control of an issuer or by persons acquiring securities from an issuer in private transactions are "integrated" with sales under that regulation made on the issuer's behalf. Sales made by the issuer and all such persons in any period of one year may not in the aggregate exceed \$300,000. Thus, if several persons utilize Regulation A for secondary offerings amounting to a total of \$250,000, the issuer is thereby prevented (for one year) from making use of the regulation for a sale

exceeding \$50,000. Conversely, if the issuer uses the entire \$300,000, no secondary sales can thereafter be made under the regulation for one year.

The Study sees no need for so rigid a pattern of restriction. It recommends that any controlling person who has occupied that status for at least one year, and any purchaser in a private placement who has held his shares for at least one year, be permitted to sell up to \$100,000 of securities under Regulation A in any twelve-month period without affecting the issuer's ability to sell up to \$300,000 of securities under the regulation, and vice versa.

If an issuer is newly formed and has just commenced business, it makes sense to restrict the resale of its securities to the public on behalf of promoters, controlling persons and underwriters under a statutory exemption. The issuer itself (under the terms of Rule 253) remains able to use Regulation A for primary financing purposes. However, at present secondary sales under the regulation are prohibited if the issuer has had losses in its last two years. The Study doubts the need for this restriction and recommends its deletion.

At present, no offering circular need be given to public investors so long as the amount of securities sold in any one year does not exceed \$50,000. All of the information required in an offering circular (except financial statements) must, however, be furnished to the Commission as an exhibit to the notification.

Thus, with the single exception of financial statements, all of the disclosures required by Regulation A must be prepared and given—but not to the public. The Study considers this practice inconsistent with good disclosure policy and recommends that delivery of the offering circular be required in all cases.

The rule that now bars Regulation A to an issuer whose prior claim to an exemption under that regulation was suspended by the Commission solely because of an underwriter's misconduct (for which the issuer was in no way responsible) seems unnecessarily harsh. The Study therefore recommends appropriate revision of Rule 252. Certain other technical changes in the rules are suggested.

#### 8. Chapter IX – The Breakthrough in Dissemination of '34 Act Reports

The Study recognizes that it would be impractical to expand '34 Act reporting requirements without first improving existing means of dissemination of those reports. The costs associated with obtaining copies of the reports, together with their limited content, have contributed to a situation in which relatively meager use is made of the reports by the financial community.

The microfiche reproduction system installed at the Commission in the fall of 1968 may prove a significant step toward the improved dissemination that ought to accompany improved reporting. A microfiche is a small sheet of film on which up to 60 pages of typed or printed material can be reproduced. A desk-top “reader

projects the microfiche image on a screen the size of a standard page. With somewhat more expensive equipment, one can obtain full-sized printed copies of the material being viewed on the screen.

At the outset, all of the basic K reports and all quarterly reports of investment companies filed on Form N-1Q were made available on microfiche. In response to the requests of actual and potential subscribers, the contractor has recently undertaken to offer, in addition, microfiche copies of registration statements filed under the '34 Act on Form 10, annual and interim reports to shareholders, definitive proxy statements, effective registration statements under the '33 Act, and Form N-1R reports.

Microfiche are mailed to subscribers within five days after filing of the document.

The microfiche system supplements the Commission's long standing hard copy reproduction service. For someone who has the equipment to use it, microfiche is substantially cheaper than hard copy. For example, a hard copy of a 60-page document costs \$5.40 (9 cents per page) as against 75 cents (1 1/4 cents per page) for a microfiche copy. The latter figure refers to the price of a special order for a single fiche. Per copy costs vary between 50 cents and 23 cents when the microfiche service is purchased on a subscription basis. Moreover, a microfiche library requires only

a tiny fraction of the space needed to house the same volume of material in hard copy form.

Improved content and accessibility of '34 Act reports should tend to enhance the obligation of broker-dealers to consider the information in such reports when making recommendations to investors. Following a period of experience with the new dissemination techniques and with improved '34 Act reports, the Commission and the self-regulatory organizations of the securities industry should give careful thought to steps which would help to insure that material information in reports filed with and made available by the Commission is fully utilized by the brokerage community.

9. Chapter X – '34 Act Registration and Reporting

The recommendations in this report are interdependent. Improved '34 Act reporting would provide continuing sources of disclosure which could act, to a larger degree, as an acceptable substitute for the special and, at best, occasional disclosures produced under traditional '33 Act practice. Such of the Study's recommendations as permitting limited brokerage sales of the privately purchased securities of reporting companies, extending the availability of Form S-7 to a much larger category of issuers, and eliminating the post-effective prospectus delivery requirement for securities of reporting companies, all anticipate substantial improvement in '34 Act reporting.

The Study carefully reviewed the principal '34 Act reporting forms. Its recommendations for revision of these forms will be found in the appendices to Chapter X. The chart in Appendix X-1 may prove helpful in reviewing the Study's proposals which rest on the following general principles:

(1) Reports should be as timely as practicable without imposing undue burdens on those who have to prepare them.

(2) Reports and registration statements should be designed to provide information of maximum utility to investors and their advisers.

(3) Requirements that compel the repetition in a new filing of matter already disclosed in an earlier one should be avoided.

(4) The format of reports and registration statements should be compatible with microfiche reproduction (see the Summary of Chapter IX above) and with other contemporary data processing techniques.

Form 10 is the first document that an issuer files under the '34 Act. It needs improvement and the Study offers a number of suggestions to that end.

Form 10-K, the annual report to the Commission, should be converted into an annual updating of the material in the Form 10. Contribution of separate lines of business to sales and income should be indicated, together with disclosure of specific current developments in the registrant's business.

Groups of securities analysts, accountants, corporate officials, and representatives of the major stock exchanges advised the Study that the 10-K could be filed earlier than is now required. Several accountants informed the Study that improved auditing methods now in use can greatly reduce any burden imposed by timelier reporting requirements, even for smaller companies. In addition, representatives of the major stock exchanges and a number of analysts expressed the view that there is a definite trend toward earlier publication of annual reports to shareholders. Ninety-eight percent of all companies with securities listed on the New York Stock Exchange and a significant number of companies with securities listed on the American Stock Exchange published annual reports to shareholders for 1967 within 90 days or less following fiscal year-end. The Study found no major differences between financial statements in reports to shareholders and those in 10-Ks, except for the schedules required by the latter form.

The Study recommends that the 10-K be required to be filed no later than 90 days after the close of the fiscal year. In order to coordinate the availability of the 10-K report with that of the annual report to stockholders (see Chapter XI), the 10-K should be filed no later than 5 days after publication of the annual report to stockholders if such publication takes place within 90 days after the fiscal year-end. To ease the transition from present requirements, the Study recommends that the proposed 90-day filing deadline not become effective until one year after its

adoption. In addition, the revised form provides that Schedule XVI to the financial statements, which is time consuming to prepare, may at the registrant's option be filed separately at a later date no more than 120 days from the end of the fiscal year.

The Commission's current reporting requirements are not intended to, nor could they adequately, duplicate the timely disclosure policies of the self-regulatory agencies. Commission requirements act to a degree as a backstop for those policies; they operate to encourage willingness on the part of issuers to keep the market place informed. They provide details which may be overlooked in the preparation of a news release or may not be included in a published news report. The Study attempted to balance the requirements which it considered essential for meaningful current reports against the time to be allowed for filing them. It also considered how such reports could best be coordinated with other sources of disclosure. The conclusion reached was that a regular, quarterly report would be more useful than the present, irregular 8-K report.

More and more publicly-held corporations are releasing condensed quarterly financial information. Both the New York and American Stock Exchanges require publication of such information by all listed companies, although the standards which they set for such information are minimal. The Study carefully examined a significant sample of quarterly financial reports and releases provided by the two exchanges. It was readily apparent (and acknowledged by representatives of the exchanges) that they varied from extremely useful to extremely poor and uninformative.

Conferences were held by the Study with accountants representing both large and small firms throughout the country, with members of a special committee of the Financial Executives Institute, and with the American Society of Corporate Secretaries, regarding the feasibility of condensed quarterly financial reporting. It was the general opinion that such reporting was feasible and that a useful advance in disclosure policy could be achieved by developing standards for such reporting. A special committee of the AICPA greatly assisted the Study in this effort.

The Study proposes that a new form to be designated 10-Q be substituted for present Forms 8-K and 9-K. It would be due 45 days after the close of each fiscal quarter (except that a report of a significant acquisition or disposition of assets would be due 10 days after the execution of a written agreement for such acquisition or disposition). It would consist of two parts. Part I would cover the substance of the present 8-K with a number of changes. Part II would consist of condensed, comparative financial information. Part II would not be required for the fourth fiscal quarter. It would not be audited or subject to the liability provisions of Section 18 of the '34 Act. Quarterly reports to shareholders containing the information required by Part II of Form 10-Q could be submitted in lieu of that part of the form.

10. Chapter XI – Annual Reports to Shareholders and Proxy Statements

Annual reports to stockholders and proxy statements are widely disseminated. This gives them an especially important place in the disclosure system. The Study's treatment of annual reports is based on its review of well over 100 examples in the Commission's files. The number of reports that appeared materially misleading was small. Most of these involved textual references to, or condensed tabular presentations of, certain material in the certified financial statements. Such condensations sometimes tend to indicate a financial position or results of operations significantly more favorable than that revealed by the full statements. The Study recommends a rule to prevent this from occurring.

The rapid increase in the number of mergers and corporate acquisitions in recent years has greatly increased the importance of the merger proxy statement in the pattern of disclosure. In conferences with the Study, many security analysts stressed the value of merger proxy statements. No other single document, apart from the prospectus, was regarded as containing information of greater usefulness in evaluating the securities of publicly-held corporations. However, the typical merger proxy statement has been criticized by those to whom it is primarily directed, the shareholders whose approval of the transaction is being sought. In addition, representatives of the American Society of Corporate Secretaries informed the Study that they had received many complaints from

shareholders concerning the length and complexity of merger proxy statements prepared in accordance with the Commission's rules.

The Study reviewed a number of merger proxy statements which ranged from approximately 60 to over 300 pages in length. The complaints of shareholders concerning these massive documents are understandable.

First, the Study questions whether the mass of detailed financial statements provided in many merger proxy statements (and frequently constituting considerably more than half the bulk of the statement) is entirely necessary. A review of the requirements of Item 15 of Schedule 14A of the Proxy Rules should be made with a view to possible reduction of present requirements in the case of business combinations. In particular, if a large corporation purposes to acquire a small corporation by merger and must therefore seek the approving vote of its own shareholders a very short summary of the proposed transaction may be all that is needed adequately to inform such shareholders. More complete information about both parties to the merger may well be needed by shareholders of the disappearing corporation.

Second, some means of summarizing the essential data for the benefit of the average shareholder should be found. Various alternatives were considered. It is recommended that a very short summary of essential information, together with comparative net

income, market price, dividend and per share book value data, be required to be printed separately as the merger proxy statement. Accompanying the merger proxy statement would be an appendix containing the detailed information, financial statements and exhibits not provided in the shorter document. Such a summary, separately printed, should average no more than 6 or 7 pages in length. Its modest size, in comparison with a single, massive document, would respond to the needs of the average shareholder. A summarization of essential data, similar to that suggested for the merger proxy statement, should be required in the forepart of the prospectus used in an offer of exchange of securities.

11. Chapter XII – Administration and Enforcement of '34 Act Reporting Requirements

Previous chapters recommend increased coordination between the disclosure requirements of the '33 and '34 Acts and it is suggested that still greater coordination may evolve as experience is gained with improved '34 Act reporting. The success of any such coordination depends heavily on improved procedures for and increased emphasis on administration and enforcement of '34 Act reporting requirements. The Study is of the opinion that existing enforcement tools are adequate for this purpose if effectively used. Moreover, there are promising opportunities for the development of new EDP programs to permit rapid discovery of reporting delinquencies.

A critical need is for allocation of additional staff to the administration of '34 Act registration and reporting requirements. Should the Study's recommendations in Chapter X be adopted, important new information will be called for in '34 Act reports. If other aspects of disclosure policy are to rely more heavily on this information, assurance that reasonable standards of disclosure are being met is essential. These considerations, set against a background of rapid growth in the trading markets and their importance to increasing numbers of investors, may well justify an increase in the Commission's professional staff.

Under Rule 12b-25, an issuer may by application request an extension of not more than 60 days following the due date in which to file a report. The application is deemed granted unless denied by Commission order issued within 10 days of receipt of the application. The Study found a number of instances in which Rule 12b-25 was clearly abused. Moreover, an extension request can be an attempt to mask a fraud. The Study believes that Rule 12b-25 should be tightened.