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Death in One Act: The Case for Company Registration

“[T]he time has come for a fundamental conceptual change in the scheme of regulation governing public offerings.”¹

I. INTRODUCTION

As the Securities Act of 1933² (Securities Act or 1933 Act) completes its sixty-third year of existence, its future is more uncertain than at any other time in its history. Although its core principles were once hailed as “a permanent and integral part of our legal system,”³ the 1933 Act now merits such descriptions as “obsolete”⁴ and its dictates are addressed in terms of “erosion.”⁵ Now, the innovative “company registration” disclosure model, recently embraced by the Securities and Exchange Commission’s Advisory Committee on the Capital Formation and Regulatory Processes (Advisory Committee or Committee),⁶ may very well signify the demise of the 1933 Act altogether.

The growth of capital markets, the rise of institutional investors, and the advent of modern technology have created a fundamentally different investing terrain than the one envisioned by the drafters of the Act more than sixty years ago.⁷ Competition for capital has never been so fierce. Modern companies, especially small businesses, struggle to raise needed capital without incurring the transaction costs and liability risks

1. SECURITIES AND EXCH. COMM’N, REPORT OF THE ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES, pt. II, at 2 (July 24, 1996) (visited Nov. 23, 1996) <<http://www.sec.gov>> [hereinafter ADVISORY COMMITTEE REPORT].

2. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994).

3. See William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 173 (1933).

4. See John C. Coffee, Jr., *Is the Securities Act of 1933 Obsolete? The SEC Increasingly Appears to Believe so But Has Not yet Adopted a Consistent Policy to Replace It*, NAT’L L.J., Sept. 4, 1995, at B4.

5. See Joel Seligman, *The Obsolescence of Wall Street: A Contextual Approach to the Evolving Structure of Federal Securities Regulation*, 93 MICH. L. REV. 649, 702 (1995).

6. ADVISORY COMMITTEE REPORT, *supra* note 1.

7. See John C. Coffee, Jr., *Re-Engineering Corporate Disclosure: The Coming Debate over Company Registration*, 52 WASH. & LEE L. REV. 1143, 1148-49 (1995).

involved in a typical 1933 Act public offering.⁸ More businesses than ever are turning to private offerings and other statutory exemptions as a means of circumventing the 1933 Act's high costs, often rendering the Act an irrelevant obstacle to needed capital formation.⁹

Over the last thirty years, the Securities and Exchange Commission (Commission or SEC) has begun to acknowledge the increasing pressures for change. Beginning with adoption of the integrated disclosure system in 1980, the Commission has made some headway toward combining the disclosure requirements of the 1933 Act and the Exchange Act of 1934¹⁰ (1934 Act) to arrive at a coordinated, non-duplicative, and less costly system of disclosure.¹¹ Regulation S-K,¹² adopted in 1982, itemized several areas of disclosure common to 1933 and 1934 Acts filings in an attempt to synthesize information provided by companies subject to both Acts.¹³ Shelf registration emerged from the integrated disclosure system as a way for issuers to go to the market more efficiently and more often by relying on disclosures required under the 1934 Act.¹⁴

Company registration represents the culmination of the integrated disclosure process and has been called "the ultimate ascendancy of Exchange Act disclosure over that of the Securities Act."¹⁵ Company registration would allow a seasoned securities issuer, subject to 1934 Act reporting, to offer and sell securities after a one-time registration of all its authorized securities, thereby eliminating the need to register each future issuance.¹⁶

The time has come for fundamental change in the amount and methods of disclosure required from companies issuing securities in the United States. This Comment will take the position that the Securities Act of 1933 is outmoded and should be replaced with legislation implementing, with some changes, the pilot company registration system proposed by the Commission's Advisory Committee. In the alternative, the

8. *See id.*

9. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 45-57; *see also* Coffee, *supra* note 7, at 1186 (noting that Rule 144A offerings have "soared" since the introduction of equity shelf registration). The Supreme Court has partially reaffirmed this conclusion by refusing to extend the strict and vicarious liability provisions of the 1933 Act to private placements, a fast-growing method for issuers to bypass traditional 1933 Act registration. *See Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1065 (1995).

10. Exchange Act of 1934, 15 U.S.C. §§ 78a-78U (1994).

11. Coffee, *supra* note 7, at 1145.

12. 17 C.F.R. § 229.10-915 (1996).

13. *See id.*

14. *Id.* § 230.415.

15. Margaret A. Bancroft, *Responding to Gustafson: Company Registration and a New Negligence Standard*, INSIGHTS, July 1995, at 14, 15.

16. *See* ADVISORY COMMITTEE REPORT, *supra* note 1, at iii.

Advisory Committee should recommend that the Commission request broadened exemptive authority from Congress in order to implement most of the provisions of company registration through administrative rulemaking. Part II presents a brief history of traditional disclosure under the 1933 and 1934 Acts.¹⁷ Part III examines the pressures that resulted in the integrated disclosure system and the system's radical shift away from transactional disclosure to continuous disclosure under the 1934 Act.¹⁸ Part IV turns to the recent call for company registration, both by commentators proposing models of a new company registration system and by legislative and administrative reform efforts.¹⁹ Part V analyzes the proposed model of company registration contained in the Advisory Committee Report, which abandons traditional 1933 Act disclosure in favor of a comprehensive registration and disclosure system unified under the 1934 Act.²⁰ Part VI critically analyzes key points of the proposed system and offers some suggestions for improvement.²¹ The Comment concludes by recommending a combination of congressional legislation and administrative rulemaking in order to fully implement a company registration system.²² Company registration would not only strike the best balance between efficient capital formation and investor protection but also would fulfill the true spirit of full and fair disclosure envisioned by the 1933 Act.

II. OVERVIEW OF THE 1933 AND 1934 ACTS

A. *The Securities Act of 1933*

The Securities Act of 1933 was born in the aftermath of the Great Stock Market Crash of 1929, a catastrophe brought about in large part by widespread and massive investor fraud.²³ Relatively unsophisticated investors purchased millions of dollars of securities in the booming market of the 1920s with virtually no hard information to evaluate the

17. See *infra* notes 23-180 and accompanying text.

18. See *infra* notes 181-343 and accompanying text.

19. See *infra* notes 344-430 and accompanying text.

20. See *infra* notes 431-549 and accompanying text.

21. See *infra* notes 550-75 and accompanying text.

22. See *infra* notes 576-77 and accompanying text.

23. See CHARLES C. JOHNSON, JR., CORPORATE FINANCE AND THE SECURITIES LAWS 1-3 (1990). Half of the \$50 billion in securities floated in the exchange markets during the 1920s was worthless by 1933. *Id.* at 2; see H.R. REP. NO. 73-85, at 2 (1933).

quality of the securities they were buying.²⁴ These fraudulently floated securities were a central force behind the 1929 crash and the resulting poor condition of the nation's economy.²⁵

Until 1933, securities regulation was left wholly to individual states.²⁶ In 1911, Kansas passed the nation's first "blue sky" laws, which required both full disclosure by issuers and qualification based on "merit" or the quality of the investment.²⁷ Several states followed with similar statutes, but these laws ended at the state borders; no coherent system of federal legislation emerged to regulate interstate securities transactions not covered by the blue sky laws.²⁸ The result was an inconsistent patchwork of state regulations with differing protections for investors in each state—a system that was wholly ineffective in stemming the fraud leading to the 1929 crash.²⁹ Thus, in response to increasing calls for federal securities regulation, Congress, led by President Franklin D. Roosevelt, passed the Securities Act of 1933.³⁰

The primary purpose of the 1933 Act is to provide "full and fair disclosure on the special occasion of a public offering."³¹ In short, the 1933 Act requires any company or underwriter making a public offering of securities to disclose certain information to investors and prohibits fraud in connection with the distribution of those securities.³² Ade-

24. JOHNSON, *supra* note 23, at 2; see H.R. REP. NO. 73-85, at 2.

25. JOHNSON, *supra* note 23, at 2. For a more detailed history of the factors leading up to the 1929 crash, see MICHAEL E. PARRISH, *SECURITIES REGULATION AND THE NEW DEAL* 29 (1970).

26. 1 THOMAS LEE HAZEN, *TREATISE ON THE LAW OF SECURITIES REGULATION* 6 (2d ed. 1990).

27. *Id.* These laws became known as blue sky laws because their purpose was to "protect the Kansas farmers against the industrialists' selling them a piece of the blue sky." *Id.*

28. PARRISH, *supra* note 25, at 29.

29. ANNE M. KHADEMIAN, *THE SEC AND CAPITAL MARKET REGULATION: THE POLITICS OF EXPERTISE* 24-25 (1992).

30. JOHNSON, *supra* note 23, at 2; see H.R. REP. NO. 73-85, at 1-2 (1933) (President Roosevelt's message to Congress proposing federal securities legislation, dated March 29, 1933).

31. Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340, 1340 (1966). In the 1930s, underwriters often took six months or more to market and sell an offering, and Congress wrote the 1933 Act with this lengthy time frame in mind; thus, it should not be surprising that the 1933 Act required such an exhaustive and time-consuming issuer investigation prior to a public offering. See Bancroft, *supra* note 15, at 14 n.2.

32. HAROLD S. BLOOMENTHAL ET AL., *SECURITIES LAW HANDBOOK* 23, 59 (1995). According to Professor Frankfurter, the 1933 Act differed from the state blue sky laws in that it did not "place the government's imprimatur upon securities. It is designed merely to secure essential facts for the investor, not to substitute the government's judgment for his own." JOHNSON, *supra* note 23, at 5 (quoting Felix Frankfurter, *The Federal Securities Act: II*, FORTUNE, Aug. 1933, at 53, 108).

quate disclosure for SEC purposes requires (1) registration of the offered securities with the SEC, and (2) distribution of a prospectus containing essential disclosures about the issuer's finances, business, and the offering itself to potential investors.³³ Once filed with the SEC in Washington, D.C., the registration statement is available for public inspection.³⁴

1. The Registration Statement and Prospectus

a. Structure of the registration statement: Parts I & II

Under section 5 of the 1933 Act,³⁵ every company making a public offering of securities by way of interstate commerce or use of the mails (absent an applicable exemption) must file a registration statement with the SEC.³⁶ The registration statement is a long, detailed document that reveals the company's management structure and financial condition, as well as the purposes and uses of the funds raised by offering the security.³⁷ For domestic issuers, Schedule A of the 1933 Act outlines the information they must include in the registration statement,³⁸ while Regulation C details the statement's proper form and mechanics.³⁹

The registration statement is composed of two parts: Part I, containing the prospectus, which will later be distributed to investors; and Part

33. BLOOMENTAL, *supra* note 32, at 59.

34. JOHNSON, *supra* note 23, at 6.

35. Securities Act of 1933, 15 U.S.C. § 77e (1994).

36. 1 HAZEN, *supra* note 26, at 8.

37. *Id.*

38. 15 U.S.C. § 77aa (1994). Schedule A contains 32 items of information that the issuer must disclose in the registration statement, all but five of which must be part of the prospectus. *Id.* These items generally require the following disclosures: the names, addresses, remuneration, and stock holdings of the issuer's directors, officers, underwriters, and shareholders holding 10 percent or more of a class of the issuer's stock; the character of the issuer's business; the issuer's capitalization; the prospective use of the funds to be raised in the offering; the price of the security; and the details of any underwriting agreements concerning the issue. *Id.* The Commission's adoption of Regulation S-K and Forms S-1-2-3 have substantially modified, however, some of the disclosures traditionally required under Schedule A. *See infra* notes 54-63 and accompanying text (discussing the different registration forms); *infra* notes 198-221 and accompanying text (discussing Regulation S-K).

39. 17 C.F.R. §§ 230.400-497 (1996). For example, Rules 403(a)-(c), 17 C.F.R. § 230.403(a)-(c), specify the requisite paper type, paper size, and font, and Rule 420, 17 C.F.R. § 230.420, requires legible printing in the English language or with translations.

II, containing additional information not part of the prospectus filed with the SEC, but kept available for public inspection.⁴⁰ Part I is comprised entirely of the prospectus, which is defined as any "notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security."⁴¹ The prospectus is required to include "essential facts regarding [the company's] business operations, financial condition, and management."⁴² It must disclose the expected use of the offering proceeds, the methods for determining the offering price, the securities to be registered under the statement, and the shareholders selling their holdings in the offering.⁴³ Also, the prospectus details the issuer's business itself, including its management and financial structure.⁴⁴ Finally, and most importantly, the prospectus must contain current audited financial statements.⁴⁵

Section 5 of the 1933 Act makes the prospectus the central selling document between issuer and buyer, requiring the issuer to (1) deliver the prospectus to purchasers prior to sale,⁴⁶ and (2) refrain from soliciting purchasers by any means other than the preliminary prospectus before the registration statement is declared effective.⁴⁷ After the registration statement becomes effective and is reviewed by SEC staff, the prospectus must be made available to both purchasers and any other person offered the securities.⁴⁸ The issuer must give a final prospectus,

40. 1 HAZEN, *supra* note 26, at 8.

41. 15 U.S.C. § 77b(10) (1994).

42. OFFICE OF SMALL BUS. POLICY, U.S. SEC. AND EXCH. COMM'N, Q&A: SMALL BUSINESS AND THE SEC 8 (1994) [hereinafter Q&A: SMALL BUSINESS AND THE SEC].

43. SECURITIES AND EXCH. COMM'N, FEDERAL REGULATION OF SECURITIES: A SYNOPSIS OF FEDERAL SECURITIES REGULATIONS AND AMEX, NYSE, AND NASD LISTING AND REPORTING REQUIREMENTS 5 (1989) [hereinafter FEDERAL REGULATION OF SECURITIES]; see *infra* notes 54-63 and 198-221 and accompanying text (discussing the content of registration statements in Forms S-1-2-3 and under Regulation S-K).

44. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 5; see *infra* notes 54-63 and 198-221 and accompanying text (discussing content of registration statements in forms S-1-2-3 and under Regulation S-K).

45. See FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 5. The form and content of these financial statements are prescribed by Regulation S-X, while the form and content of other disclosures are specified by Regulation S-K. *Id.*; see *infra* notes 198-221 and accompanying text (discussing Regulation S-K).

46. 15 U.S.C. § 77d(3), 77e(b)(2) (1994). These provisions are commonly known as the "prospectus delivery requirement." See Coffee, *supra* note 7, at 1151.

47. 15 U.S.C. § 77e(c) (1994). Soliciting such buyers before the issuer files the registration statement is known as "gun-jumping." See Coffee, *supra* note 7, at 1150; *infra* notes 268-99 and accompanying text (discussing the section 5 gun-jumping restriction).

48. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 8.

Once the registration statement has been filed but before its effective date,

including all amendments, to each offeree of the company's securities prior to sale.⁴⁹ Either at the start of the offering period or five days after the effective date of the registration statement, whichever is later, ten copies of the distributed prospectus must be filed with the SEC before the registration statement can be used to sell the securities publicly.⁵⁰

Part II of the registration statement contains additional information not included in the prospectus which the issuer must file with the Commission.⁵¹ This information is elicited in "item-and-answer format" and discloses indemnification issues, other issuance expenses, and any unregistered securities the issuer has recently sold.⁵² Part II may also provide information that is not included in the prospectus but is needed to render the registration statement, as a whole, "complete and not misleading."⁵³

b. Forms S-1-2-3

Registration under the 1933 Act is accomplished primarily through one of three forms.⁵⁴ Issuers must use Form S-1 if the company has

the [issuer] can distribute a preliminary or 'red herring' prospectus. This prospectus, which does not include the offering price and underwriting commission, has a red ink legend [hence the term "red herring"] stating that the registration statement is not yet effective and the securities cannot be sold.

FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 7.

49. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 8.

50. *Id.* The issuer must also file 10 copies of any changed prospectus, with five copies of a cross-reference sheet. *Id.*

51. *Id.* at 6.

52. *Id.* Part II also contains exhibits, which may include the articles of incorporation, the by-laws, any underwriting agreements, and stock option plans. *Id.* In addition, Part II must disclose all information required under Schedule A that was not included in the prospectus. See *supra* note 38 (detailing information required under Schedule A).

53. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 9. Within 10 days of the end of the offering or the final application of the offering proceeds, whichever is later, the issuer must also file a Form SR report under Rule 463, or file interim reports every six months until the offering ends. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 7.

54. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 3. Other forms exist, but are used less. For example, Form S-4 is used for registration of securities obtained by a company's shareholders in mergers, consolidations, and asset transfers. *Id.*; 17 C.F.R. § 239.25 (1996).

Forms F-1 through F-4 correspond to Forms S-1 through S-4 and are used by

not registered under the 1934 Act for at least three years and does not qualify to register under the other available forms; thus, this is the standard form for companies engaging in an initial public offering (IPO).⁵⁵ Issuers must disclose all required information in the prospectus in a Form S-1 registration statement; information cannot be "incorporated by reference" to any of the issuer's prior 1934 Act filings.⁵⁶ This information generally includes the basic information package (BIP) outlined by Regulation S-K,⁵⁷ the Standard Registration Items,⁵⁸ and certain other areas of detailed disclosure.⁵⁹

Form S-2 may be used if the issuing company has registered under the 1934 Act for at least three years prior to the current issuance.⁶⁰ The issuer is required to disclose the same information as in Form S-1, but Form S-2 permits the issuer to satisfy the disclosure requirement by incorporating several 1934 Act disclosures by reference, such as the annual report to shareholders and the latest 10-Q report.⁶¹

Form S-3 can be used by companies that (1) have at least \$150 million in stock held by non-affiliates, or \$100 million so held and at least three million shares of annual trading volume, and (2) otherwise qualify

foreign issuers. 17 C.F.R. §§ 239.31-34 (1996). FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 3. Forms N-1 through N-4 are used by investment companies to register securities and annuity contracts. 17 C.F.R. §§ 239.14, 239.15, 239.17a, 239.17b, 274.11, .11a-1, .11b-11c (1996). FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 4.

Form S-8 is used to register any securities issued as part of an employee benefit plan. 17 C.F.R. § 239.16b (1996). FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 4.

Form S-18 may be used by small companies to sell a maximum of \$7.5 million of securities with a maximum of \$1.5 million sold by "insiders." 17 C.F.R. § 239.28 (1996). FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 4.

55. 17 C.F.R. § 239.11 (1996); HAROLD S. BLOOMENTHAL, *GOING PUBLIC AND THE PUBLIC CORPORATION* § 4.01 (1992).

56. 17 C.F.R. § 239.11; BLOOMENTHAL, *supra* note 55, § 6.03.

57. 17 C.F.R. § 239.11; BLOOMENTHAL, *supra* note 55, §§ 6.03, 6.06. The BIP, defined largely by disclosures required under Items 101, 201, and 301-304 of Regulation S-K, consists of financial statements and financial information from the last five years, business and market information by segment, Management Discussion and Analysis of Financial Condition and Results of Operation (MD&A), and other required financial and accounting information. 17 C.F.R. §§ 229.101, .201, .301-304 (1996). *See generally* BLOOMENTHAL, *supra* note 55, § 6.06 (discussing the contents of the BIP).

58. 17 C.F.R. §§ 229.501-512, 239.11 (1996); BLOOMENTHAL, *supra* note 55, §§ 6.03-04, 9.04.

59. 17 C.F.R. §§ 229.101-103, 229.401-403, 239.11 (1996); BLOOMENTHAL, *supra* note 55, §§ 6.03, 6.07. Professor Bloomenthal calls this "in-depth disclosure." *See generally* BLOOMENTHAL, *supra* note 55, § 6.07.

60. 17 C.F.R. § 239.12 (1996); BLOOMENTHAL, *supra* note 55, § 9.05.

61. 17 C.F.R. § 239.12; BLOOMENTHAL, *supra* note 55, § 6.02.

to file Form S-2.⁶² Of all the S-registration forms, Form S-3 allows the least amount of disclosure in the prospectus and, except for the Standard Registration Items, permits almost all of the required information to be incorporated by reference to 1934 Act reports.⁶³

c. Review of the registration statement and the effective date

Once the issuer's lawyers, executive and financial officers, and underwriters complete the registration statement, it is submitted to the Commission and deemed "filed" when received by the Commission with the proper filing fee and signatures.⁶⁴ After the issuer files the registration statement, the Commission's Division of Corporate Finance undertakes a selective review process of certain registration statements.⁶⁵ During this review, the Commission makes no determination as to the substantive merit of an offering, but merely ensures that the issuer made all required disclosures.⁶⁶ Under the selective review system, companies issuing securities for the first time receive close scrutiny and a complete review, whereas seasoned issuers often receive little or no review.⁶⁷ The SEC will frequently send a "letter of comment" to the issuer that requests changes, corrections, or a more complete disclosure in the registration statement.⁶⁸ The issuer must then amend the registration statement or provide further information to comply with requests in the letter of comment.⁶⁹

The registration statement must often undergo review by other regulatory bodies as well. The National Association of Securities Dealers (NASD) reviews registration statements if the "underwriting or selling group participants are NASD members."⁷⁰ This review typically looks at the "fairness and reasonableness of the underwriting arrangement

62. 17 C.F.R. § 239.13(b)(1) (1996); BLOOMENTAL, *supra* note 55, § 9.05.

63. 17 C.F.R. § 239.13; BLOOMENTAL, *supra* note 55, § 9.05. Under Rule 415, companies that qualify to file Form S-3 can use shelf registration for some securities. 17 C.F.R. § 230.415(a)(1)(x) (1996); *see infra* notes 222-34 and accompanying text (discussing shelf registration).

64. 17 C.F.R. § 230.456 (1996); BLOOMENTAL, *supra* note 55, § 9.02.

65. 17 C.F.R. § 200.30-1 (1996); BLOOMENTAL, *supra* note 55, § 9.02.

66. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 6.

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.* at 8.

and compensation," but does not review the merits of the offering itself or the offering price.⁷¹

State regulatory agencies also review a new issue in the issuer's state of incorporation as part of the "blue skying" process.⁷² An issue must comply with the blue sky laws of every state where the issue is to be offered.⁷³

Under section 5 of the Securities Act,⁷⁴ a security cannot be sold publicly until its registration statement becomes "effective."⁷⁵ Under section 8(a) of the Securities Act,⁷⁶ the registration statement normally becomes effective twenty days after the date of filing of the last material amendment, but under Rule 473,⁷⁷ modern registration statements include a "delaying amendment" on the facing sheet which automatically delays the effective date until the SEC has reviewed the statement.⁷⁸ This prevents a defective statement from becoming effective without SEC review.⁷⁹

2. Restrictions on Solicitation

Section 5 of the Securities Act contains two important restrictions on the solicitation of investors prior to the effective date: (1) the directives against "gun-jumping" in section 5(c), and (2) the directives against "free writing" in section 5(b)(1).⁸⁰ First, a company cannot sell or

71. *Id.* See generally BLOOMENTHAL, *supra* note 55, § 9.14 (discussing NASD review).

72. ROBERT W. HAMILTON, *CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS* 371-72 (5th ed. 1994).

73. *Id.* States generally allow for one of the following three alternative forms of registration: (1) registration by qualification (full registration for securities not required to be registered under the 1933 Act); (2) registration by coordination (state registration of securities in the process of 1933 Act registration, accomplished by filing copies of the prospectus and other requested information with the state); and (3) registration by notification (registration on a simplified form for publicly traded issuers who "have had an established business for five years" and whose securities fit other financial requirements). *Id.* at 372.

74. 15 U.S.C. § 77e (1994).

75. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 8.

76. 15 U.S.C. § 77h(a) (1994).

77. 17 C.F.R. § 230.473 (1996).

78. JOHNSON, *supra* note 23, at 7 n.13. Issuers normally submit a "pricing amendment" on the day of the scheduled effective date that includes the offering price and other disclosures regarding underwriting. BLOOMENTHAL, *supra* note 55, § 9.02. Along with the pricing amendment, the issuer also asks the Commission to "accelerate" the effective date by issuing an order making the registration statement effective before the customary 20-day waiting period. *Id.*; see 17 C.F.R. §§ 230.460-461 (1996).

79. BLOOMENTHAL, *supra* note 55, § 9.02.

80. Coffee, *supra* note 7, at 1150-51; see 15 U.S.C. § 77e(c) (1994) (gun-jumping prohibition); *id.* § 77e(b)(1) (free writing prohibition).

make oral or written offers to sell its securities before filing the registration statement with the Commission—the issuer may only make a statement disclosing a proposal to make a registered public offering.⁸¹ This is commonly referred to as the gun-jumping prohibition—issuers cannot “jump the gun” and offer their securities to potential investors before the registration statement becomes effective.⁸² Until recently, the Commission construed section 5(c) to forbid issuers from conditioning the market in any way prior to the filing of the registration statement.⁸³

Second, during the period after submission of the registration statement to the SEC, but before SEC review and the effective date, the issuer and underwriter may *orally* solicit potential investors and obtain “indications of interest” from prospective buyers; the only *written* solicitation allowed, however, is through the preliminary or “red herring” prospectus included in the pending registration statement.⁸⁴ This is commonly called the free writing prohibition.⁸⁵

81. Coffee, *supra* note 7, at 1150-52; see 15 U.S.C. § 77e(c); see also FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 7.

82. Coffee, *supra* note 7, at 1150.

83. *Id.* at 1151-52. The Commission's decision in *In re Carl Loeb, Rhoades & Co.*, 38 S.E.C. 843 (1959), extended the section 5(c) solicitation prohibition to pre-filing evaluations of the offered securities or other securities and assets, viewing such estimates as a form of “conditioning the market.” *Loeb*, 38 S.E.C. at 848-51; see *Chris-Craft Indus. v. Bangor Punta Corp.*, 426 F.2d 569, 574-76 (2d Cir. 1970); *SEC v. Arvida Corp.*, 169 F. Supp. 211, 215 (S.D.N.Y. 1958). The Commission substantially retreated from this position in proposing Rule 135(d), which would allow issuers to test the waters by soliciting indications of interest prior to filing the registration statement. See *infra* notes 271-83 and accompanying text (discussing Proposed Rule 135(d)).

84. Coffee, *supra* note 7, at 1151-52; see 15 U.S.C. §§ 77d(3), 77e(b)(1) (1994); see also FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 7. “Tombstone ads,” named for their tombstone-like appearance and style when printed, generally announce that the preliminary or red herring prospectuses are available for interested investors, and are allowed during the pre-review period. JOHNSON, *supra* note 23, at 31. Most companies prefer to issue these advertisements after the effective date, however, once registration is complete. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 7.

85. Coffee, *supra* note 7, at 1151. Normally, public corporations subject to the disclosure requirements of the 1934 Act cannot use their regular 1934 Act disclosures to publicize an upcoming securities offering. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 7.

3. Exemptions From Registration

Over the years, the SEC has developed alternatives for issuers who wish to avoid the high cost and extensive disclosure associated with full registration under section 5 of the Act in the form of exemptions to registration.⁸⁶ In general, the exemptions allow sales of securities to certain institutional investors and other sophisticated purchasers who are more informed and thus less in need of the forced disclosure protections of the 1933 Act.⁸⁷ Exempted offerings are still subject to the anti-fraud provisions of the 1933 Act⁸⁸ and will often be subject to state blue sky laws and other regulations as well.⁸⁹

Section 4(2), commonly referred to as the "private placement exemption," exempts issuers from having to file a registration statement and issue a prospectus to potential investors of the class of securities in "transactions by an issuer not involving any public offering."⁹⁰ Initially, a transaction was deemed to fall under the private placement exemption only if the number of offerees did not exceed twenty-five.⁹¹ The Supreme Court has since ruled, however, that the propriety of the private placement exemption should be based not simply on the number of offerees, but on the sophistication of the target investors and their ability "to fend for themselves."⁹² Thus, for the private placement exemption to apply, all offerees must have sufficient access to issuer information and a level of sophistication indicating that they do not need the protection afforded by the traditional disclosure protections of section 5 of the 1933 Act.⁹³

Section 4(6), the "accredited investor exemption," exempts offerings or sales solely to accredited investors if the aggregate amount of the

86. JOHNSON, *supra* note 23, at 9. The burden falls on the issuer to prove that it qualifies for the desired exemption and is not subject to § 5 registration requirements. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

87. JOHNSON, *supra* note 23, at 9-14. Some exemptions focus not on the buyer, but on the seller, excluding, for example, certain types of banks and government securities from the registration requirements. See BLOOMENTHAL, *supra* note 55, § 4.01.

88. See *infra* notes 116-21 and accompanying text (discussing section 11 liability).

89. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 13; see *supra* notes 72-73 and accompanying text (discussing blue skying an issue).

90. 15 U.S.C. § 77d(2) (1994). Professor Bloomenthal calls this the "principal exemption" used by investors. BLOOMENTHAL, *supra* note 55, § 4.01. For an in-depth discussion of the boundaries of the private placement exemption under section 4(2), see JOHNSON, *supra* note 23, at 315-76.

91. Johnson, *supra* note 23, at 318-19.

92. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953).

93. *Id.* An offering is considered public under the *Ralston Purina* rationale when "the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made." *Id.* at 124 (quoting SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (9th Cir. 1938)).

offering is less than \$5 million and the issuer employs no advertising or public solicitation prior to, or during, the offering.⁹⁴

Section 3(b) of the 1933 Act exempts offerings of less than \$5 million if the SEC determines that registration is "not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering."⁹⁵ Pursuant to this exemption, Regulation A⁹⁶ exempts 3(b) offerings up to \$5 million in any one year if the issuer follows a simplified registration process by submitting a short, unaudited financial statement to the Commission, filing an offering statement (consisting of an offering circular and exhibits) with the Commission's regional office, and distributing the offering circular to prospective investors and offerees of the securities.⁹⁷

Section 3(a)(11), known as the "intrastate offering exemption," exempts securities offered and sold only to residents of the state where the issuer is incorporated and doing business.⁹⁸ To qualify for the 3(a)(11) exemption, an issuer must verify the residence of each purchaser of the securities.⁹⁹

Section 3(a)(2), the "municipal securities exemption," exempts securities issued by state and local governmental entities.¹⁰⁰ These securities are not subject to 1933 Act or 1934 Act registration or disclosure, but are still subject to the anti-fraud provisions of both acts.¹⁰¹

Finally, Regulation D, Rules 504-506¹⁰² (the "limited offering" exemptions) exempt certain issuances of securities based on the amount of the offering and the absence of general solicitation or advertising.¹⁰³ Rule 504 exempts all offers up to \$1 million in any one year by companies not subject to the reporting requirements of the 1934 Act, so long as the offering is not accompanied by general solicitation or general advertising.¹⁰⁴ Rule 505 exempts offers up to \$5 million in any one

94. 15 U.S.C. § 77d(6).

95. *Id.* § 77c(b) (1994).

96. 17 C.F.R. § 230.251 (1995).

97. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 15-16.

98. *Id.* at 13.

99. *Id.* at 14.

100. 15 U.S.C. § 77c(a)(2).

101. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 12.

102. 17 C.F.R. §§ 230.501-508 (1996).

103. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 16-20.

104. 17 C.F.R. § 230.504; Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 17.

year if the number of "non-accredited investors"¹⁰⁵ is less than thirty-five, those investors are given specialized information, and the offering is not accompanied by general solicitation or general advertising.¹⁰⁶ Rule 506 exempts offers of unlimited amounts and without general solicitation or advertising, if made to accredited investors and a maximum of thirty-five non-accredited investors reasonably believed by the issuer to have sufficient knowledge and experience in financial matters to evaluate the risks and merits of the investment and specialized information given to them.¹⁰⁷

The SEC may subject persons holding unregistered shares obtained pursuant to an exemption to registration requirements if the holders resell the securities.¹⁰⁸ Restrictions apply only to the securities of the issuer gained by the exemption; the holder may freely sell other publicly acquired securities of the issuer.¹⁰⁹ Restricted securities generally cannot be resold except under certain conditions. Rule 144A allows the resale of certain restricted securities to qualified institutional buyers for their own accounts.¹¹⁰ Rules 144¹¹¹ and 144A complement the private placement exemptions in reducing or eliminating barriers to distribution to secondary markets.¹¹² Regulation D and Rule 144A have significantly increased the use of private placements, partly because they allow avoidance of traditional registration and review.¹¹³ As a result, domestic Rule 144A placements between 1990 and 1993 skyrocketed from an aggregate total of \$916 million (eight placements) to a whopping \$44.672 billion (243 placements).¹¹⁴

105. Under Rule 501(a), accredited investors include, inter alia, traditional institutional investors, directors and officers of the issuer, natural persons with minimum \$1 million net worth, large trusts, and entities owned by accredited investors. 17 C.F.R. § 230.501(a); Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 17-18.

106. 17 C.F.R. § 230.505; Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 17-19.

107. 17 C.F.R. § 230.506; Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 19-20.

108. CARL W. SCHNEIDER & JASON M. SHARGEL, NOW THAT YOU ARE PUBLICLY OWNED 26 (1994).

109. *Id.*

110. 17 C.F.R. § 230.144A (1996); see Adoption of Proposed Rule 144A, Securities Act Release No. 6862, [1989-1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,523 (Apr. 23, 1990).

111. 17 C.F.R. § 230.144 (1996); see Adoption of Proposed Rule 144, Securities Act Release No. 5223, [1971-1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,487 (Jan. 11, 1972).

112. Bancroft, *supra* note 15, at 14.

113. *Id.* at 14 n.3. The adoption of the short form S-3 registration statement and the 1982 universal shelf registration regulations has also shortened the waiting period during which the Commission reviews an issue prior to registration, although the period can still extend over a month or more. *Id.*

114. *Id.*; see Staff Report on Rule 144A, [1994-1995 Decisions] Fed. Sec. L. Rep.

4. Liability Under the 1933 Act

Private investors may seek three types of remedies based on an issuer's violation of provisions of the 1933 Act.¹¹⁵ Section 11 of the 1933 Act¹¹⁶ provides that an issuer will be strictly liable for losses incurred by a buyer purchasing a security within three years¹¹⁷ of the offering if the registration statement or prospectus contained material misrepresentations or materially false or misleading statements or omissions which caused the losses.¹¹⁸ The issuer's board of directors, underwriters, executive officers, attorneys, accountants and other experts, controlling persons of the issuer, and other signatories of the registration statement can also be held liable under section 11,¹¹⁹ but only if they did not perform a reasonable investigation into the accuracy of the misstatements or otherwise did not have a reasonable belief that the statements were true and not misleading (the due diligence defense).¹²⁰ Plaintiffs generally need not show reliance on the registra-

(CCH) ¶ 85,428 (Aug. 18, 1994).

115. BLOOMENTHAL, *supra* note 55, §§ 10.01-02. In addition, a sale without registration can result in civil and criminal liability for the issuer and its controlling persons. HAMILTON, *supra* note 72, at 369.

116. 15 U.S.C. § 77k (1994).

117. *Id.* § 77m (1994).

118. *Id.* § 77k(a). A showing that the plaintiff's losses cannot be traced to the misrepresentations but to another source (e.g. market fluctuations) constitutes an absolute defense to liability both for the issuer and other defendants, but the defendant bears the burden of proof to show the separate cause of the losses. *Id.* § 77k(e).

119. *Id.* § 77k(a).

120. *Id.* § 77k(b)(3)(A). Under the due diligence defense, a reasonable investigation and a good faith, reasonable belief that the statements were not misleading precludes liability for most defendants other than the issuer. *Id.* § 77k(b)(3)(A), (c). This investigation normally takes place prior to the filing of the registration statement and typically includes checking the "background of prior transactions, determin[ing] whether disclosure may be required of transactions between the issuer and the managers, [and] determin[ing] whether issues of securities were lawfully made pursuant to an available exemption." HAMILTON, *supra* note 72, at 371. See generally BLOOMENTHAL, *supra* note 55, § 10.07 (describing the due diligence process prior to registration).

The defendant carries the burden of proving due diligence and reasonable belief in the truth of the statements based on personal investigation, "not . . . made on the authority of an expert." 15 U.S.C. § 77k(b)(3)(A). If the statements were made on the authority of an expert, the defendant must show he or she "had no reasonable ground to believe and did not believe" that the statements were false or misleading. *Id.* § 77k(b)(3)(C). If the defendant is an expert in the particular portion of the registration statement challenged, however, the burden is upon him or her to show reasonable grounds to believe the portion was true and did not contain false or mislead-

tion statement.¹²¹

Section 12(1) of the 1933 Act¹²² permits rescission of a purchase of unregistered securities if the issuer should have registered the securities and allows recovery of damages if the securities have been sold.¹²³ A buyer must bring a section 12(1) action within one year of the purchase of the unregistered securities.¹²⁴

Finally, section 12(2) of the 1933 Act¹²⁵ imposes strict liability on any seller of securities for a buyer's losses resulting from material misrepresentations or misleading statements made in connection with the sale, regardless of whether the securities are covered by the registration statement.¹²⁶ Under section 12(2), any person involved in the sale of securities during which a material misrepresentation or omission is made may be liable for damages if it is shown that they knew or should have known of the misstatement.¹²⁷ Any private action must be brought within one year after discovery of the material misstatement or omission, or at most, three years after the public distribution of the security misrepresented.¹²⁸

ing statements. *Id.* § 77k(b)(3)(B)(i),(ii). *See generally* Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 682-703 (S.D.N.Y. 1968) (discussing reasonable reliance on experts by non-experts).

121. 15 U.S.C. § 77k(a); *see also* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 575-80 (E.D.N.Y. 1971) (holding that an omission of \$100,000 of "surplus surplus" was a material omission from the registration statement). Certain purchasers buying in the secondary markets must show reliance if the issuer has disclosed income statements for the year following the effective date. 15 U.S.C. § 77k(a).

122. 15 U.S.C. § 77l(a)(2) (1994).

123. *Id.*; *see* HAMILTON, *supra* note 72, at 369 n.28. This provision allows a purchaser to get a refund of consideration given for the unregistered securities regardless of whether the failure to register was the issuer's fault. 15 U.S.C. § 77l(a)(2). *See generally* BLOOMENTHAL, *supra* note 55, § 10.02.

124. 15 U.S.C. § 77m (1994).

125. *Id.* § 77l(2).

126. HAMILTON, *supra* note 72, at 369 n.28. The liability is "strict" insofar as neither intent nor negligence are conditions to the seller's liability. *Id.* The seller may raise with validity, however, the defense of a lack of knowledge of the misstatement's falsity or omission, coupled with proof that the seller could not have discovered, through exercise of reasonable care, the falsity or omission. *Id.*

127. *Id.* Sellers of the securities may claim the same due diligence defense available under section 11. *See* BLOOMENTHAL, *supra* note 55, § 10.02; *supra* note 120 and accompanying text (discussing the due diligence defense).

128. HAMILTON, *supra* note 72, at 369 n.28; *see* 15 U.S.C. § 77m.

*B. The Exchange Act of 1934*¹²⁹

The 1934 Act requires periodic disclosure from companies that are "presumed to be the subject of active investor interest."¹³⁰ This includes companies issuing securities traded on an exchange and also those with more than a specified number of shareholders and level of assets.¹³¹ In general, the 1934 Act performs four functions: (1) it provides a system of registration for publicly traded securities; (2) it regulates certain types of securities transactions, usually by requiring additional disclosure upon their occurrence; (3) it establishes a system of regular reporting for publicly traded companies; and (4) it prohibits fraudulent practices and transactions in connection with the trading of publicly held securities.¹³²

1. Registration of Publicly Traded Securities

The 1934 Act contemplates "one-time registration of the entire class of securities which is publicly-owned."¹³³ The 1934 Act requires submission of a registration statement if the security is (1) "[t]raded on a national exchange,"¹³⁴ or (2) "[t]raded over-the-counter and the issuer has more than \$5 million in assets and over 500 shareholders of record,"¹³⁵ or (3) "[f]irst sold with an effective registration statement under the 1933 Act."¹³⁶ In addition, certain persons and entities involved in securities trading must also register.¹³⁷

129. 15 U.S.C. §§ 78a-78j (1994).

130. Cohen, *supra* note 31, at 1341.

131. *Id.*

132. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 13-14.

133. SCHNEIDER & SHARGEL, *supra* note 108, at 7.

134. 15 U.S.C. § 78l(b) (1994).

135. *Id.* § 78l(g); 17 C.F.R. § 240.12g-1 (1996). A registration statement under § 78l(g) is due 120 days after the end of the fiscal year in which the company becomes subject to registration and becomes effective 60 days after filing unless accelerated by the Commission upon the registrant's request. 15 U.S.C. § 78l(g)(1); see SCHNEIDER & SHARGEL, *supra* note 108, at 8 & n.14.

136. 15 U.S.C. § 78o(d) (1994).

137. See, e.g., 15 U.S.C. §§ 78o, 78o-4 (1994) (brokers and dealers trading securities covered by the 1934 Act or municipal securities); *id.* § 78o-4 (broker and dealer associations); *id.* § 78k-1 (1994) (processors of securities information); *id.* § 78q-1 (1994) (clearing agencies and transfer agents); *id.* § 78f (1994) (national securities exchanges); see also FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 13 (categorizing who must register with the Commission).

Under the 1934 Act, disclosure requirements, which include "periodic reports," continue until: (1) less than 300 owners of record at the beginning of the fiscal year hold the class of securities offered, or (2) less than 500 record owners hold the class of securities offered and the issuer's total annual assets have been less than \$5 million during the past three fiscal years.¹³⁸

Registration under the 1934 Act occurs through the use of one of two forms: Form 10 or Form 8-A.¹³⁹ Form 10 is used for the "initial registration of securities . . . when no other form is prescribed."¹⁴⁰ An issuer must file eight copies of this form—three of which must be complete with financial statements, exhibits, and supporting papers—with the SEC.¹⁴¹ Form 8-A is a "simplified form for registering securities under the 1934 Act."¹⁴² This form is available to any company that has registered before under either the 1933 or 1934 Act.¹⁴³

2. Regulated Transactions

The 1934 Act also regulates several kinds of transactions and entities based on the SEC's perceived importance of disclosing certain transactions to public investors and the importance of Commission regulation of the transactions and entities.¹⁴⁴ Regulated transactions include proxy solicitations,¹⁴⁵ tender offers,¹⁴⁶ transactions involving credit used in carrying or buying securities and credit margins in other transactions,¹⁴⁷ trading activities which can affect market prices and price stabilization,¹⁴⁸ mortgaging of or borrowing on securities,¹⁴⁹ short-swing profits and short sales made by corporate "insiders,"¹⁵⁰ and certain activities of securities dealers.¹⁵¹ Regulated entities include

138. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 11.

139. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 15.

140. *Id.*

141. *Id.*

142. *Id.*

143. *Id.*

144. *Id.* at 13.

145. 15 U.S.C. § 78n(a) (1994).

146. *Id.* § 78n(d). A tender offeror must file 10 copies of Schedule 14D-1 with the SEC on the first day of the offer if it could result in the offeror owning more than five percent of a class of 1934 Act-registered securities. *Id.*

147. 15 U.S.C. § 78g (1994).

148. *Id.* § 78i (1994).

149. *Id.* § 78h (1994).

150. *Id.* § 78p(b), (c) (1994). For a discussion of what constitutes an insider, see *infra* note 154 and accompanying text.

151. 15 U.S.C. §§ 78i, 78k, 78o, 78o-4, 78q (1994).

the national securities exchanges, the NASD, and various other agents and processors of securities information.¹⁵²

3. Reporting Requirements

The 1934 Act requires the issuer,¹⁵³ insiders of the issuer,¹⁵⁴ certain institutional investment managers,¹⁵⁵ and investors acquiring more than a five percent interest in one of the issuer's 1934 Act-registered equity securities¹⁵⁶ to make periodic reports to the SEC disclosing certain aspects of their holdings and other financial information.¹⁵⁷ Insiders must report their equity holdings, any changes in those holdings, and any short-swing profits (profits resulting from a purchase and sale within six months) that are required to be disgorged to the issuer by statute.¹⁵⁸

Periodic disclosure required under section 13 of the 1934 Act¹⁵⁹ must reveal the latest information about business operations, including any unusual trends or influences which would be reasonably necessary to understand the company's business and financial data; salaries and benefits accruing to management or shareholders; audited financial statements; and any other major transactions between the company and directors, officers, shareholders, creditors, or other parties.¹⁶⁰ This disclosure is largely effected through three forms. The first is Form 10-K, which is an annual report disclosing management and shareholder information, audited financial statements, and other annual information that must be filed with SEC.¹⁶¹ The 10-K report includes Management's Discussion and Analysis of Financial Condition and Results of Operation

152. *Id.* §§ 78f, 78k, 78k-1, 78o-3, 78q.

153. *Id.* §§ 78m(a), 78o(d) (1994).

154. 15 U.S.C. § 78p (1994). For purposes of 1934 Act reporting, insiders of an issuer include officers, directors, and shareholders who beneficially own more than 10% of the issuer's outstanding shares. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 14.

155. 15 U.S.C. § 78m(f).

156. *Id.* § 78m(d).

157. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 14.

158. *Id.*

159. 15 U.S.C. § 78m.

160. Q&A: SMALL BUSINESS AND THE SEC, *supra* note 42, at 11.

161. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 15. This form is due 90 days after the end of the company's fiscal year and recounts all information disclosed in the Form S-1 registration statement under the 1933 Act, except for "information on the underwriting and use of proceeds." SCHNEIDER & SHARGEL, *supra* note 108, at 4.

(MD&A), which must disclose to shareholders any material trends, uncertainties, or other events which are known to the company and are reasonably believed to have a probable impact on the company's business.¹⁶² The second is Form 10-Q, which is a quarterly report disclosing financial information (unaudited) and other events of significance occurring during the quarter, including the start of any significant litigation.¹⁶³ The issuer must also include an MD&A, updating likely trends or uncertainties reported in the annual 10-K if needed.¹⁶⁴ The third is Form 8-K, which is a current event report filed when a significant or important business event occurs.¹⁶⁵ These events include mergers and acquisitions, receivership or bankruptcy, and other shifts in shareholder control.¹⁶⁶

4. Prohibition Against Fraudulent Practices

Section 10 of the 1934 Act prohibits fraud, deceptive practices, and market manipulation in connection with the purchase and sale of securities.¹⁶⁷ Violations of this section, which include violations of rules promulgated by the Commission to enforce section 10, may give rise to both civil and criminal liability.¹⁶⁸ Generally, section 10(b) prohibits the use of any "manipulative or deceptive device or contrivance" connected with the sale of securities "in contravention of such rules and regulations as the Commission may prescribe as necessary."¹⁶⁹

Rule 10b-5 is the most prominent of these prescriptive rules, and disallows trading by "tippers," "tippees," and other insiders based on information not available to the general public without first disclosing that information to the public.¹⁷⁰ Other significant rules include Rule 14a-9,¹⁷¹ which bars false or misleading statements or omissions of material facts in connection with proxy solicitations, and Rule 14e-3,¹⁷² which forbids using inside information in trading the securities of an offeror or target company while a tender offer is pending.¹⁷³

162. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 15.

163. *Id.* at 6.

164. *Id.* This report is due 45 days after the end of each of the company's first three fiscal quarters. *Id.*

165. *Id.* The Form 8-K is generally due within 15 days of the significant event. *Id.*

166. *Id.*

167. 15 U.S.C. § 78j (1994).

168. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 22.

169. 15 U.S.C. § 78j(b).

170. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 22; *see* Rule 10b-5, 17 C.F.R. § 240.10b-5 (1996).

171. 17 C.F.R. § 240.14a-9 (1996).

172. *Id.* § 240.14e-3.

173. FEDERAL REGULATION OF SECURITIES, *supra* note 43, at 22.

5. Other Disclosures

Aside from the information required by the forms and the duty not to affirmatively mislead, a company has no general duty to disclose *all* material events to the general investing public.¹⁷⁴ Nevertheless, under some circumstances, a company may have a duty to issue a press release disclosing material information regarding the company, its securities, or a significant transaction.¹⁷⁵ This duty normally applies only (1) to companies whose securities are listed on NASDAQ or a public exchange,¹⁷⁶ (2) when incomplete disclosure has been made to the public,¹⁷⁷ (3) when an insider or the company itself is acquiring the company's securities,¹⁷⁸ (4) when a public statement made by the company is discovered to have been inaccurate at the time disclosed,¹⁷⁹ or (5) when the company is responsible for leaking a rumor, market report, or other material information.¹⁸⁰

174. SCHNEIDER & SHARGEL, *supra* note 108, at 22. Form 8-K requires disclosure of certain significant events, but does not require companies to disclose all material events. *Id.* Rule 10b-5 forbids false or misleading statements of material fact and omissions that make an existing statement misleading, but does not impose an affirmative duty to disclose material facts. *Id.*

175. *Id.* at 22-24.

176. These companies must disclose material events and information to all public investors. Both the New York Stock Exchange and the American Stock Exchange require these companies to disclose material events and information to all public investors. *See* New York Stock Exch., Listed Company Manual § 202.00 (1996); American Stock Exch., American Stock Exch. Company Guide, Part 4, § 402 (1996); American Stock Exch., Agreement to Conform with the Rules and Regulations, Listing Form SD-1 § 12 (1996). For NASDAQ disclosure requirements, see Schedules to the By-Laws, Schedule D, pt. II § 1(c)(16), NASD MANUAL (CCH) ¶ 1803 (1995).

177. *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 163 (2d Cir. 1980); *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 236 (2d Cir. 1974).

178. *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 850 n.12 (2d Cir. 1968); *Green v. Hamilton Int'l Corp.*, 437 F. Supp. 723, 728-29 (S.D.N.Y. 1977); *see also* Purchases of Certain Equity Securities by the Issuer and Others; Adoption of Safe Harbor, Securities Act Release No. 6434, [1982 Transfer Binder] Fed. Sec. L. Rep. ¶ 83,276 (Nov. 17, 1982) (adopting Rule 10b-18 safe harbor for company acquisitions of own stock).

179. *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 268 (2d Cir. 1993); *see also* *Sharp v. Coopers & Lybrand*, 83 F.R.D. 343, 347 (E.D. Pa. 1979) (holding that an accounting firm must rectify an opinion letter found to be materially inaccurate).

180. *Elkind*, 635 F.2d at 166-67; *In re Sharon Steel Corp.*, Exchange Act Release No. 18271, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,049 (Nov. 19, 1981); SCHNEIDER & SHARGEL, *supra* note 108, at 23-24. Material information is defined as information that "a reasonable investor would consider important" in deciding to buy or sell a security. *Id.* at 21 (citing *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988)).

III. DEVELOPMENT OF THE CURRENT DISCLOSURE SYSTEM

Since the inception of the 1933 Act, significant changes have occurred throughout the capital markets and in the Commission's approach to securities regulation. These changes have led to a fundamental reassessment of the 1933 Act¹⁸¹ and the idea of company registration. Information about companies and issues has become more widespread and accessible to investors.¹⁸² Sophisticated institutional investors now comprise the vast majority of all trading volume and equity holdings across the market.¹⁸³ Competition among underwriters for issuers' business has intensified to new levels.¹⁸⁴ In short, the world that gave birth to the 1933 and 1934 Acts has long since passed away, leaving the unwieldy dual system of transactional and continuous disclosure dangerously close to complete obsolescence.¹⁸⁵

At the same time, development of the disclosure scheme over the past sixty years has uncovered the best and worst of both Acts. Milton H. Cohen's classic theory that "the combined disclosure requirements of these statutes would have been quite different if the 1933 and 1934 Acts . . . had been enacted in the opposite order, or had been enacted

181. Bancroft, *supra* note 15, at 14.

182. See Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 747-49 (1985) (suggesting that technological developments giving investors access to a wide variety of information about issuers may make adoption of an integrated system such as the Federal Securities Code preferable).

183. See Seligman, *supra* note 5, at 657-58. Institutional investors own more than half of all equity securities in the United States, and account for 60 to 80 percent of the New York Stock Exchange's trading volume. *Id.* For a discussion of the rise of institutional investors and their equity holdings as a percentage of total market equity, see *infra* notes 238-44 and accompanying text.

184. See ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 53 & n.60; see also *Welcome to the Free-For-All; Private Placement Bankers Adjust to a Radically Changing Marketplace*, INV. DEALERS' DIG., Aug. 28, 1995, at 14 (noting "[f]erocious competition" among investment and commercial banks for modern private placement businesses).

185. Indeed, some observers contend that "[s]tatutory obsolescence is the fate of all legislation." Coffee, *supra* note 7, at 1144; see also GUIDO CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* (1982) (advocating judicial revisionism in re-interpreting outdated statutes by modern standards instead of interpreting original legislative intent); GRANT GILMORE, *THE AGES OF AMERICAN LAW* 97 (1977) (discussing the shift over a statute's "life cycle" from court's deference to legislative intent to deference to modern administrative implementation and interpretation); Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of Courts in Federal Banking Legislation*, 85 MICH. L. REV. 672 (1987) (arguing for judicial revisionism in reinterpreting older federal finance and banking laws to more current standards).

as a single, integrated statute,"¹⁸⁶ has been borne out: the disclosure system is ever weakening the 1933 Act, and the market has thus come to rely on 1934 Act disclosures in order to strike a balance between the full and fair disclosure today's investors want and the capital today's companies need.¹⁸⁷ As issuers make more offerings by means of off-shore placements and registration exemptions, the question quickly becomes whether the burdens of section 5 on capital formation are worth its disclosure benefits to investors, or whether it is time for a new system of disclosure.

A. *The Shift to Integrated Disclosure*

1. Cohen and "The Need for a New Look" at Securities Disclosure¹⁸⁸

In the years following the adoption of the 1934 Act, two parallel systems of securities disclosure developed: one based primarily on the registration of certain securities transactions (public offerings) under the 1933 Act, the other based on the periodic disclosure by most publicly held companies under the 1934 Act.¹⁸⁹ The result was often duplicative disclosure; though provided at different times and under different circumstances, disclosure under both Acts flowed from a "common core of information."¹⁹⁰

Recognizing this phenomenon, in 1966 Milton H. Cohen wrote the landmark article, "*Truth in Securities*" Revisited, which suggested that the securities regulation system could be simplified by emphasizing the periodic disclosure of the 1934 Act to protect and inform investors, while relaxing or eliminating overlapping 1933 Act disclosure requirements.¹⁹¹ Cohen noted that a seasoned public corporation making peri-

186. Cohen, *supra* note 31, at 1341.

187. Coffee, *supra* note 7, at 1145, 1148-50. Professor Coffee argues that Cohen's analysis is vindicated by such market developments as the rise of institutional investors, the growth of the secondary markets, and the acceptance of the efficient capital markets hypothesis—all of which contributed to Commission interpretations that have eroded the "pillars" of the 1933 Act. *Id.* at 1149-50. This "erosion" has been replaced with an increased emphasis on 1934 Act disclosure. Bancroft, *supra* note 15, at 15.

188. Cohen entitled the first point heading of his article: The Need for a New Look. Cohen, *supra* note 31, at 1340.

189. *Id.* at 1340-41.

190. BLOOMENTAL, *supra* note 32, at 60-61.

191. Cohen, *supra* note 31, at 1341-42. Cohen's article illustrates the confusing results produced by overlapping disclosure requirements through four hypotheticals,

odic public offerings of its stock must disclose an extensive amount of information in its prospectus, much of which the corporation may already have disclosed in its periodic 1934 Act filings.¹⁹² According to Cohen, because the goal of full disclosure would be achieved more efficiently in a system which provides continuous and up-to-date disclosure to investors, rather than one that emphasizes one-time disclosure only when the issuer makes a public offering, the securities laws should emphasize 1934 Act disclosure while scaling back or eliminating the repetitive disclosure requirements of the 1933 Act.¹⁹³ Thus, a reporting issuer under the 1934 Act could make a public securities offering and only disclose supplemental information about the issuer and offering not already disclosed in 1934 Act reports.¹⁹⁴

Cohen's article is widely hailed as the genesis for the integrated disclosure movement¹⁹⁵ and was the driving force behind the Wheat Report,¹⁹⁶ a pivotal Commission study which formulated specific proposals for integration of disclosure within the two Acts.¹⁹⁷

each assuming company ZYX lists its stock on an exchange and is subject to the reporting requirements of the 1934 Act. First, if an investor buys 100 ZYX shares on a stock exchange, the investor will receive no prospectus but can rely on information provided in ZYX's periodic reports under the 1934 Act. *Id.* at 1342. This investor thus relies primarily on the protections and required disclosures of the 1934 Act. *Id.* Second, if the same investor goes to the exchange and buys 100 shares of ZYX which are part of a registered issuance by ZYX, the investor should receive a prospectus containing disclosures about ZYX, its business and finances, and the issuance itself. *Id.* This investor receives disclosure mandated by the 1933 Act, but much of the information is also available from the issuer's 1934 Act reports. *Id.* Third, if the investor goes to the exchange at the same time that the registered issuance is being offered, but buys 100 ZYX shares which are *not* part of the registered issuance, he now has no right to a prospectus. *Id.* Thus, while *some* of ZYX's shares come with mandatory 1933 Act disclosure, an *identical* block of shares the investor bought does not come with the disclosure, again forcing the investor to rely solely on 1934 Act disclosure. *Id.* Fourth, if the investor buys 100 ZYX shares from someone other than the issuer or its affiliate, the seller does not need to register the shares. *Id.* The investor has no right to a prospectus and may not even receive information concerning the present issuance. *Id.* Again, the investor receives no 1933 Act disclosure and must turn to the issuer's 1934 Act reports for disclosure. *Id.*

192. *Id.* at 1345.

193. *Id.* at 1366-67.

194. *Id.* at 1341-42; see Coffee, *supra* note 7, at 1145.

195. Professor Coffee calls Cohen's article "the most influential article ever written on the federal securities laws." Coffee, *supra* note 7, at 1145.

196. SECURITIES AND EXCH. COMM'N, DISCLOSURE TO INVESTORS—A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (1969) [hereinafter WHEAT REPORT].

197. BLOOMENTAL, *supra* note 32, at 61.

2. Development of the Integrated Disclosure System and Regulation S-K

By 1969, the idea of integrated disclosure envisioned by Milton Cohen had garnered the support of the American Law Institute (ALI).¹⁹⁸ The ALI commissioned a group of leading scholars in the field of securities regulation, led by renowned Harvard University Professor Louis Loss, to construct a model securities code which would unify the disparate federal securities laws into a fully integrated disclosure system.¹⁹⁹ Despite completion of the Code in 1980 and Commission approval, Congress was reluctant to dismantle the venerable 1933 and 1934 Acts with an untried system, and quietly forgot the Code in the absence of a strong lobby outside the Commission itself.²⁰⁰

Nevertheless, the Commission partially fulfilled the promise of Cohen's model of full disclosure with their adoption of the integrated disclosure system and Regulation S-K in 1982.²⁰¹ In attempting to reduce duplicative disclosure through a system of integrated disclosure, the Commission sought to define (1) what information is material in securities transactions, and (2) when and how such information should be disclosed to investors and the market.²⁰² The Commission determined that information material under one of the Acts would generally be material under the other Act, and that the amount and nature of disclosure necessary depended on how well informed investors already were about the security involved.²⁰³ The result was the adoption of

198. Coffee, *supra* note 7, at 1145.

199. *Id.*; see Louis Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969).

200. Coffee, *supra* note 7, at 1145-46.

201. 17 C.F.R. 229.10-915 (1996) (Regulation S-K). For a discussion of the development of the integrated disclosure system during the early 1980s, see Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 6235, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,649, at 83,484-90 (Sept. 2, 1980). See also Edward F. Greene, *Integration of the Securities Act and the Exchange Act: A Case Study of Regulation in the Division of Corporate Finance of the United States Securities and Exchange Commission*, 3 J. COMP. CORP. L. & SEC. REG. 75, 79-90 (1981).

202. Gerald S. Backman & Stephen E. Kim, *A Cure For Securities Act Metaphysics: Integrated Registration*, INSIGHTS May 1995, at 18, 19; see Adoption of Integrated Disclosure System, Securities Act Release No. 6383, [1981-1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982) [hereinafter Integrated Disclosure System Release].

203. Backman & Kim, *supra* note 202, at 19. The Commission was influenced at least in part by the efficient capital markets hypothesis (ECMH). For example, in de-

Regulation S-K, which provides a single standard for information to be provided under 1933 and 1934 Acts disclosure documents.²⁰⁴

Under the integrated disclosure system, the informational requirements of disclosure in registration statements under the 1933 Act and in filings under the 1934 Act are centralized in Regulation S-K.²⁰⁵ Regulation S-K sets uniform disclosure requirements, or a Basic Information Package, for Forms S-1 through S-4, S-8, S-11, and S-18 under the 1933 Act, and Forms 10-K, 10-Q, and the annual report to shareholders under the 1934 Act.²⁰⁶ The BIP includes information about the issuer's finances and accounting (including the MD&A),²⁰⁷ a description of each segment of the issuer's business²⁰⁸ and the market in which it operates,²⁰⁹ and other disclosures specific to the issue, such as dividend information.²¹⁰

The Commission also adopted new registration forms S-1 through S-3, thereby creating a three-tier system of disclosure under the Regulation S-K regime.²¹¹ The system incrementally permits more incorporation by reference: Form S-1 provides for no incorporation by reference;²¹² Form S-2 incorporates by reference all Form 10-K information into the prospectus and allows the issuer to either provide investors with a prospectus and annual report or incorporate the annual report information into the prospectus when detailing the offering,²¹³ and Form S-3, which only requires disclosure of information particular to the transac-

termining what information should be required to be disclosed in a prospectus, the Commission recognized that some information may already be disclosed to the market and reflected in the security's offering price, thus reducing or eliminating the need to restate that information in an offering prospectus. *Id.* "Thus, in what may be termed the efficient market corollary, an adequately informed market does not require redundant information to price a security." *Id.*

204. 17 C.F.R. §§ 229.10-915. BLOOMENTHAL, *supra* note 55, § 6.03. The Commission's goal was to promote the same quality of disclosure in 1934 Act reports enjoyed by investors in the 1933 Act prospectus, while permitting seasoned reporting issuers to incorporate by reference their 1934 Act reports into the prospectus during a public offering. Coffee, *supra* note 7, at 1158.

205. Backman & Kim, *supra* note 202, at 19; see also Peter G. Samuels, *Statutory Framework of the 1933 and 1934 Act Filing Requirements*, in SECURITIES FILINGS 1981, at 24 (1981).

206. See Integrated Disclosure System Release, *supra* note 202.

207. 17 C.F.R. §§ 229.301, .303, .304.

208. 17 C.F.R. §§ 229.101(b), .101(c)(1)(i), .101(d).

209. *Id.* § 229.201.

210. *Id.* For an exhaustive treatment of the content of the BIP under Regulation S-K, see BLOOMENTHAL, *supra* note 55, § 6.06.

211. Backman & Kim, *supra* note 202, at 19; see *supra* notes 54-63 and accompanying text (describing Forms S-1 to S-3).

212. See *supra* notes 55-59 and accompanying text (describing Form S-1).

213. See *supra* notes 60-61 and accompanying text (describing Form S-2).

tion, incorporates by reference almost all other issuer information through 1934 Act reports as long as the issuer has duly filed its 1934 Act documents for at least one year prior to the disclosure.²¹⁴

Form S-8 and its accompanying Rule 424 provide for registration of employee benefit plans and is a prime example of modern integrated disclosure.²¹⁵ Rather than issuing a formal prospectus, registrants using Form S-8 must give plan participants a "plan description" containing the same information disclosed in Form S-8; however, the registrant does not have to file the plan description with the Commission.²¹⁶ Section 11 liability under the 1933 Act does not apply to these plan descriptions.²¹⁷ The issuer must also tell participants that all of its 1934 Act filings are incorporated by reference into the prospectus and are available for inspection.²¹⁸ The Form S-8 registration statement does not need to restate plan description or prospectus information, but simply must itemize all documents incorporated by reference and describe the securities issued, indemnification issues, "interests of named experts and counsel," undertakings, and exhibits.²¹⁹ Although Form S-8 and Rule 415 shelf registration²²⁰ represent the Commission's closest steps toward establishing a fully integrated system, the ultimate goal of a unified disclosure system remains elusive.²²¹

214. Backman & Kim, *supra* note 202, at 19; *see supra* notes 62-63 and accompanying text (describing Form S-3); *see also* Integrated Disclosure System Release, *supra* note 202. If an initial offering for cash is involved under Form S-3, the issuer must have a minimum \$75 million public float. General Instruction I.(B)(1) to Form S-3 (codified at 17 C.F.R. § 239.13(b)(1) (1996)).

215. Backman & Kim, *supra* note 202, at 19-20; *see* Registration and Reporting Requirements for Employee Benefit Plans, Securities Act Release No. 6867, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,605 (June 6, 1990) [hereinafter Registration and Reporting Requirements for Employee Benefit Plans Release]. The required information to be reported in Form S-8 is located in Part I, Item 1 of the Form. 17 C.F.R. § 239.16b (1996).

216. Backman & Kim, *supra* note 202, at 19; *see* Registration and Reporting Requirements for Employee Benefit Plans Release, *supra* note 215.

217. Backman & Kim, *supra* note 202, at 19.

218. *Id.*; *see* Part I, Item 2 of Form S-8, 17 C.F.R. § 239.16b. Under Rule 428(b)(1)(ii), issuers can state in the plan description that the prospectus provides certain required information. 17 C.F.R. § 230.428(b)(1)(ii) (1996).

219. Backman & Kim, *supra* note 202, at 19-20. The issuer may also incorporate exhibits by reference. *Id.*

220. 17 C.F.R. § 230.415 (1996); *see infra* notes 212-34 and accompanying text (discussing shelf registration).

221. Coffee, *supra* note 7, at 1146.

B. The Advent of Shelf Registration

The American system of securities regulation took another step toward a true company registration model of disclosure with the adoption of Form S-3 universal shelf registration under Rule 415.²²² For years prior to adoption of Regulation S-K, the Commission opposed shelf registration on the grounds that a single prospectus could not adequately provide investors with current information concerning continuing issuances.²²³ When the Commission adopted the integrated disclosure system, however, incorporation by reference to 1934 Act reports allowed the prospectus to remain "current" by directing investors to the issuer's latest 1934 Act filings.²²⁴ Thus, in 1983 the Commission amended Rule 415 to allow shelf registration on Form S-3 for certain issuers.²²⁵

Under Rule 415 shelf registration, an issuer can register any number of securities "to be offered and sold on a continuous basis" at current market value, up to a dollar amount equal to ten percent of its voting stock's aggregate dollar value, so long as it reasonably expects to sell the securities in the next two years.²²⁶ Issuers may register all such securities in an abbreviated version of the Form S-3 registration statement, so long as the issuer (1) had continuously reported under the 1934 Act for at least one year, and (2) had at least a \$75 million public float (owned by non-affiliates) if engaging in a primary offering for cash.²²⁷ The Form S-3 must contain certain information regarding the

222. 17 C.F.R. § 230.415.

223. Coffee, *supra* note 7, at 1158 & n.41. The Commission also opposed shelf registration as violative of § 6(a) of the 1933 Act, which states "[a] registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." *Id.* at 1158 n.41 (quoting 15 U.S.C. § 77f(a) (1994)). The Commission maintained that shelf registration would be inherently misleading because it attempted to register more securities than the issuer presently intended to offer. *See In re Shawnee Chiles Syndicate*, 10 S.E.C. 109, 113 (1941).

224. Coffee, *supra* note 7, at 1158.

225. *Id.* at 1158-59; see Shelf Registration, Securities Act Release No. 6499, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,499, at 86,335 (Nov. 17, 1983).

226. 17 C.F.R. §§ 230.415(a)(1)(x)(a)(4)(ii), (a)(2). The Commission formerly required shelf issuers to specify the precise number of securities offered pursuant to the shelf registration statement, but in 1992 the Commission, in order to avoid market "overhang," began allowing "universal" registration of a total dollar amount of securities in one or more classes. *See Simplification of Registration Procedures for Primary Offerings*, Securities Act Release No. 6943, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,015 (July 16, 1992); see also *infra* note 233 and accompanying text (describing the phenomenon of overhang in shelf registration).

227. 17 C.F.R. § 230.415(a)(1)(x); see Form S-3, General Instructions I(A)(3)(a), I(B)(1) (codified at 17 C.F.R. §§ 239.13(a)(3)(i), (b)(1) (1996)); see also Seligman, *supra* note 5, at 687-88 & n.165. The 1992 amendments to Form S-3 permit registration of an unlimited number of securities within the stated dollar amount. Backman &

issuances and any material changes in the issuer's business.²²⁸ The rest of the information concerning the issuer is incorporated by reference to past and future 1934 Act reports.²²⁹ Thus, when an issuer wants to market, or "takedown," a new offering from "off the shelf," it needs only to file an abbreviated prospectus supplement detailing the offering and the securities.²³⁰

Shelf registration has produced both advantages and disadvantages to traditional 1933 Act registration. Issuers conducting shelf registrations have found it less costly to go to market with an issue, both in terms of the costs of the issuances and of disclosure.²³¹ In contrast, the liability imposed upon issuers by section 11 of the 1933 Act and the accompanying duty imposed upon underwriters to exercise due diligence have not worked well within the shelf registration system because shelf registration transactions occur too quickly for underwriters to exercise proper due diligence.²³² Moreover, some issuers notice that shelf-registered

Kim, *supra* note 202, at 19; see Simplification of Registration Procedures For Primary Securities Offerings, Securities Act Release No. 6964, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,053 (Oct. 22, 1992).

228. Information must be provided under Items 202, 501-12, 601, and 702 of Regulation S-K. 17 C.F.R. §§ 229.202, .501-.512, .601, .702 (1996); see also Seligman, *supra* note 5, at 687 & n.166.

229. 17 C.F.R. § 229.512(a), (b), (e) (permitting incorporation by reference in Form S-3 to issuer's 1934 Act filings and reports); see also Seligman, *supra* note 5, at 687-88.

230. 17 C.F.R. § 229.512(a), (b), (e); see also Seligman, *supra* note 5, at 687-88. The Commission does not review the prospectus supplement and the issuer may use the prospectus immediately to market the new offering. See ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 17-18.

231. Seligman, *supra* note 5, at 688. The Commission estimated that issuers using the shelf registration system as early as 1983 saved nearly \$280 million in complying with federal disclosure requirements. *Id.* at 688-89 n.171 (citing Memorandum to George Kundahl, [SEC] Executive Director, from David Malmquist, Re: Estimates of Savings to Issuers Resulting from Rule 415 (May 17, 1984), reprinted in *SEC Oversight and Technical Amendments: Hearing Before the Subcomm. on Telecomm., Consumer Protection, and Fin. of House Comm. on Energy and Commerce*, 98th Cong., 322-24 (1984)).

232. Coffee, *supra* note 7, at 1148. Because 1934 Act filings are incorporated into the Form S-3 prospectus by reference, issuers and underwriters in a shelf registration arguably face section 11 strict liability in connection with their 1934 Act reports. *Id.* at 1160 & n.46; see 17 C.F.R. § 230.176 (1996). This situation is not ameliorated by the purported safe harbor of Rule 176, which has not yet been interpreted by the courts. Coffee, *supra* note 7 at 1160 & n.46; see 17 C.F.R. § 230.176. While the Commission has never explicitly stated that all 1934 Act documents incorporated by reference are subject to section 11 liability, liability is suggested in Rule 439. Coffee,

securities often suffer a "penalty" or "overhang" from the market, causing investors to stay away from the issue for fear of future dilution by additional unannounced issuances.²³³ Notwithstanding shelf registration's promise of an efficient, rapid means of raising capital, these costs have made shelf registration relatively unpopular among issuers.²³⁴

C. 1933 Act in Transition: Inconsistency and Pressure For Change

Observers argue that the 1933 Act's transactional emphasis is fundamentally incompatible with, and duplicative of, continuous disclosure under the 1934 Act and serves as a costly obstacle to modern capital

supra note 7, at 1165-66; see 17 C.F.R. § 230.439 (1996). *But see* William J. Williams, Jr., *Problems in the Application of the Securities Act of 1933 and Rules Thereunder to Shelf Offerings*, 14 ANN. INST. ON SEC. REG. 293, 297 (1982) (arguing that 1934 Act documents, except for the 10-K, are incorporated by reference only into the prospectus, not the registration statement, meaning that such filings are subject only to section 12(2) liability and not section 11).

233. See David J. Denis, *Shelf Registration and the Market for Seasoned Equity Offerings*, 64 J. BUS. 189, 197-98 (1991). Other observers notice similar price depressions even upon announcement of proposed offerings through traditional 1933 Act registration. See generally Paul Asquith & David W. Mullins, *Equity Issuers and Offerings Dilution*, 15 J. FIN. ECON. 61 (1986); Michael J. Barclay & Robert H. Litzenger, *Announcement Effects of New Equity Issues and the Use of Intraday Price Data*, 21 J. FIN. ECON. 71 (1988). The Advisory Committee suggests that overhang may represent the market's view that the issuer is selling more common stock because the stock price has reached an upper limit. See ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 21 & tbl. 3. Traders who sell the stock short on news of an impending shelf offering then cover when the offering is made tend to reinforce the market's view and accompanying price decline. *Id.* app. A at 22 & n.11-13; see Karen Bernstein, *Some New Buyers Emerge From Gloom*, BIOCENTURY, THE BERNSTEIN REPORT ON BIOBUSINESS, May 6, 1995, at A3. Market overhang seems more pronounced for smaller issuers, whose investors may have greater reason to fear the dilutive impact of new offerings. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A. at 20-21. Moreover, the Commission's amendment of shelf registration in 1992 to allow registration of an unallocated amount of securities has not dissipated market concerns about overhang, as underwriters continue to advise issuers not to use the universal shelf procedure due to overhang. *Id.* app. A. at 23-24 & n.15. Yet, as more companies participate in the universal shelf registration system, the overhang from an issuer's filing of a shelf registration may disappear. See Steven M.H. Wallman, *The SEC and the Capital Formation Process*, INSIGHTS, May 1995, at 2, 3.

234. Coffee, *supra* note 7, at 1170-71; see Denis, *supra* note 233, at 190 (noting a drop in shelf offerings since the adoption of Rule 415). *But see* ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 19 & tbl. 4 (noting that while shelf offerings for corporate debt have declined from 48% of all underwritten debt offerings in 1992 to 33% in 1995, shelf offerings of common stock rose from 3% of all underwritten repeat stock offerings in 1992 to 15% in 1995, and shelf offerings of preferred stock also rose from 38% of total underwritten repeat offers in 1992 to 65% in 1995).

raising.²³⁵ In order to preserve artificial distinctions between the requirements of transactional and periodic reporting, the Commission makes unusual interpretations of terms such as "integration" and "gun-jumping," while investors and issuers make an end run around the 1933 Act's disclosure system through the Act's registration exemptions.²³⁶ According to Commissioner Steven M.H. Wallman, chairman of the Advisory Committee, the experience of the past decade has raised fundamental "question[s] . . . as to whether the current registration requirements erect unnecessary obstacles to capital formation without producing countervailing informational benefits for investors."²³⁷

1. The Rise of Institutional Investors and Changes in the Capital Markets

The development of increasingly competitive capital markets, along with higher levels of investor sophistication and increasing costs of registration, have resulted in enormous pressures on the Securities Act of 1933 to give way to modern realities.²³⁸ Unlike the 1930s, institutional investors dominate American equity markets and hold the majority of equity in domestic corporations.²³⁹ By 1990, pension and mutual funds owned 35.4% of the total equity holdings in the market and 1993 data suggested that both figures were rapidly on the rise.²⁴⁰ As institu-

235. Wallman, *supra* note 233, at 2.

236. *Id.*

237. *Id.* at 3.

238. John C. Coffee, Jr., *An 'Evergreen' Company Registration Approach Would Modernize the 1933 Act, but it Raises Questions About the Limits on the SEC's Authority*, NAT'L L.J., Sept. 11, 1995, at B4. Jonathan Macey goes so far as to say that these changes have not only proven the outdated nature of the 1933 Act, but have also rendered the Commission a largely unnecessary historical anachronism. See Jonathan Macey, *The SEC Dinosaur Expands Its Turf*, WALL ST. J., Jan. 29, 1992, at A12; Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994); see also *supra* note 185 and accompanying text (discussing statutory obsolescence).

239. Coffee, *supra* note 7, at 1148-49. Institutional investors, which include pension funds, mutual funds, life and casualty insurers, bank trusts, foundations, and endowments, accounted for about 53.3% of all equity holdings in the United States in 1990, as compared to 38% in 1981 and 23% in 1955. See John C. Coffee, Jr., *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 848 (1994).

240. Coffee, *supra* note 239, at 848. Pension funds accounted for 28.2% of the market's total equity holdings in 1990, while mutual funds owned 7.2% of the market's equity issues. Professor Mark J. Roe estimated that, based on Federal Reserve System data, these figures rose to 31.3% and 10.3%, respectively, by the first

tional investors have expanded their ownership of, and influence over, public corporations, the investors have increasingly engaged in a monitoring role, gathering extensive data about these corporations both to evaluate the quality of the investment and to exert some measure of control over management decisions.²⁴¹ These sophisticated investors are a far cry from the relatively unsophisticated individual investor targeted for protection by the 1933 Act.

As the character of the average investor has changed, so too has the character of the equity markets in which the investor now participates. The demand for capital has risen dramatically in the trading markets as compared with the primary offering markets: by 1995, the secondary trading markets enjoyed over thirty-five times the volume of the primary issuance markets.²⁴² Moreover, while the secondary trading markets have undergone tremendous growth in the past twenty years, volume in the primary issuance markets remains near its 1975 level.²⁴³ Because secondary trading transactions usually fall outside the coverage of the 1933 Act, market investors have come to rely primarily upon the protections and disclosures of the 1934 Act as opposed to those of the 1933 Act.²⁴⁴

This growth in the secondary markets has also increased market volatility.²⁴⁵ For example, average annualized standard deviations in monthly returns on stocks in the Standard & Poor's 500 index reached 16.6% in the 1975-1993 period, up from 13.3% between 1950 and 1975.²⁴⁶ This volatility led to smaller windows of opportunity for issu-

quarter of 1993. *Id.* at 848 n.38; see MARK J. ROE, THE MODERN CORPORATION AND PRIVATE PENSIONS 1 n.1 (Columbia Center for Law and Economic Studies Working Paper No. 101, 1993).

241. Coffee, *supra* note 239, at 837-38 & n.3.

242. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 57 & fig. 2. In 1995, registrations of equity in the primary issuance markets accounted for \$155 billion of volume. *Id.* The combined exchange and NASDAQ volume for the same period exceeded \$5.5 trillion. *Id.*

243. Since 1975, combined exchange and NASDAQ volume has increased over 1100%, while primary equity offering volume has remained virtually flat. *Id.* The little growth the primary equity markets have experienced can be traced more to an increase in corporate bond issues than to equity sales, which have suffered steep declines in the past 10 years. *Id.* app. A at 58 n.66 & fig. 1.

244. *Id.* app. A at 58. Even in primary issuances governed by the 1933 Act, the rise of S-3 shelf registration and incorporation by reference has led investors to even greater reliance on 1934 Act disclosures. *Id.* app. A at 59.

245. Coffee, *supra* note 7, at 1147.

246. Paul G. Mahoney, *Is There a Cure for "Excessive" Trading?*, 81 VA. L. REV. 713, 730 (1995). Mahoney's article notes the academic debate as to whether this increase in volatility is a pattern over time or simply a localized result of the 1987 stock market crash. *Id.* at 730-31. Nonetheless, the answer may be irrelevant for purposes of issuer expectations; more importantly, issuers believe there is such vola-

ers to capitalize on market demand, and in turn, a strong incentive for issuers to use shelf registration as a way to act quickly to capture that demand.²⁴⁷

While primary issue market volume has remained sluggish, the costs of making traditional 1933 Act disclosure in that primary equity market have steadily increased. For many larger corporations, the costs of registering new securities and issuing a prospectus for every equity offering are extremely burdensome, and for smaller companies, they can be prohibitive.²⁴⁸ These transaction costs make capital formation inefficient and weigh down the growth of otherwise promising companies.²⁴⁹

From 1990 to 1994, issuers raising capital through IPOs incurred costs averaging 11% of the total proceeds raised.²⁵⁰ Thus, in a typical IPO of \$30 million, an issuer would incur approximately \$3.3 million in expenses. Similar costs in periodic equity offerings (non-IPOs) of seasoned issuers averaged about 7.1% of total proceeds raised, or about \$2.1 million in costs for a \$30 million offering.²⁵¹ Figures from 1993 to 1995 show increases in both cost categories for domestic issuers—16.9% of total proceeds for IPOs and 7.3% for repeat equity offerings.²⁵² Thus, issuers face substantial expenses when going to market with an equity offering, attributable in part to the regulatory burdens involved in these offerings.²⁵³

Moreover, from 1993 to 1995, issuers making repeat offers through shelf registration incurred significantly lower costs than their counter-

tility in the markets, and plan accordingly. *Id.*; see Sean Beckett & Gordon H. Sellon, Jr., *Has Financial Market Volatility Increased?*, *ECON. REV.*, June 1989, at 17, reprinted in RESEARCH DIV., FED. RESERVE BANK OF KANSAS CITY, FINANCIAL MARKET VOLATILITY AND THE ECONOMY 3 (1990) ("There is a *widespread perception* that financial market volatility has increased during the 1980s." (emphasis added)).

247. Coffee, *supra* note 7, at 1147.

248. See *infra* notes 250-53 and accompanying text.

249. See ADVISORY COMMITTEE REPORT, *supra* note 1, at 2-3 & app. A at 2-44.

250. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 2-3 (citing Inmoo Lee et al., *The Costs of Raising Capital*, *J. FIN. RES.*, Spring 1996, at 59-74). These costs typically include not only underwriting fees, but also costs such as legal and accounting fees, printing costs, federal and state filing fees, and discounts from market price designed to attract investors to the offering during the review period. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 2-3 & tbl. 1.

251. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 2-3 (citing Inmoo Lee et al., *supra* note 250, at 59-74).

252. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 3 & tbl. 1.

253. *Id.* app. A at 5-6.

parts making the same offers through Form S-1.²⁵⁴ S-1 issuers spent 9.2% of their offering proceeds on costs related to the offering, while shelf registrants using Form S-3 spent only 5% of total proceeds on expenses.²⁵⁵ These cost savings come primarily from the S-3 issuer's ability to market and sell its shelf offerings at current market price, whereas the S-1 issuer typically discounts its securities an average of 2.4% from market price because of delays between registration and public sale.²⁵⁶ Thus, in recent years, Form S-3 shelf registration has successfully reduced part of the burdensome costs associated with raising capital in traditional Form S-1 offerings, while giving issuers more flexibility in deciding when to go to market and how much to raise.

2. Commission Inconsistency and "Metaphysics"

Some commentators have suggested that in recent years, the Commission has created incongruous results by construing key 1933 Act terms and concepts in a "metaphysical" or "hypertechnical" way in order to preserve the idea of transactional disclosure in the 1933 Act.²⁵⁷ This hypertechnicality, observers argue, partially results from the merging of the private and public markets, represented by transactions such as private investment-public entities (PIPEs) and AB exchange offers which start as private placements and end as public offerings.²⁵⁸ The Commission's effort to make strict distinctions between "public" and "private" transactions is incompatible with this merging of the two markets, and has led to issuer uncertainty as to which offerings the Commission will deem permissible.²⁵⁹

254. *Id.*

255. *Id.* app. A at 6 & tbl. 1. Table 2 in Appendix A of the Report shows that these differences are not due solely to the larger amount raised in a typical shelf offering compared to an S-1 repeat offering—they also exist for offers of varying sizes between \$20 million and \$199.9 million. *Id.* app. A at 6 & tbl. 2.

256. *Id.* app. A at 7 & tbl. 1. The cost savings may also be attributed to "just-in-time" financing, a method of capital raising facilitated by shelf registration whereby issuers "can access the market exactly when they want and for the exact amount they want," thereby lowering transaction costs associated with the offering. *Id.* app. A at 7.

257. See Backman & Kim, *supra* note 202, at 18-19; Stanley Keller, *Basic Securities Act Concepts Revisited*, INSIGHTS, May 1995, at 5; see also ADVISORY COMMITTEE REPORT, *supra* note 1, at 10, 51, app. A at 30.

258. See Keller, *supra* note 257, at 6-7; *infra* notes 324-33 and accompanying text (discussing PIPE transactions and AB exchange offers).

259. Keller, *supra* note 257, at 11.

a. Roll-up transactions and integration inconsistencies

The Commission first applied basic concepts in a hypertechnical way in roll-up transactions—reorganizations of “limited-life entities” such as limited partnerships.²⁶⁰ An umbrella partnership real estate investment trust (UPREIT) is a type of roll-up in which a limited partnership transfers its assets to an umbrella partnership (UP) under the control of a real estate investment trust (REIT).²⁶¹ The UPREIT involves two steps: (1) the transfer of partnership assets to the REIT (ostensibly a private offering), and (2) the public offering of REIT shares, the proceeds of which comprise the REIT’s capital contribution to the UP.²⁶² In 1993, in response to reports of abuses, Congress cracked down on roll-ups and required the Commission to tightly regulate all roll-ups involving a public offering.²⁶³ Although the transfer of partnership assets in UPREITs had previously been considered a private offering, the Commission reversed itself and ruled that the asset transfer was “integrated” with the later public offering through the REIT, so that the new statute regulated both steps of the UPREIT.²⁶⁴ Later, the Commission extended this reasoning to all organizations created solely to engage in a public offering and concluded that “a private offer of securities cannot be combined with a registered sale.”²⁶⁵ The Commission partially reversed itself again, however, when it refused to integrate private-to-public transactions, such as PIPEs and AB exchange offers,²⁶⁶ and public-to-private transactions such as failed public offerings which turn into Regulation D offerings after the mandatory six-month waiting period to avoid integration.²⁶⁷

260. *Id.* at 7.

261. *Id.*

262. *Id.*

263. *Id.* at 7 & n.13; see Limited Partnership Rollup Reform Act of 1993, Pub. L. No. 103-202, 107 Stat. 2344 (codified at 15 U.S.C. §§ 78a, 78f, 78n, 78o-3 (1994)).

264. Keller, *supra* note 257, at 7.

265. *Id.*

266. *Id.* at 9; see *infra* notes 324-33 and accompanying text (describing PIPEs and AB exchange offers).

267. Keller, *supra* note 257, at 9-10; see 17 C.F.R. § 230.502(a) (1996).

b. *The problem of gun-jumping: An example of section 5 hypertechnicality*

Section 5(c) of the 1933 Act bars any attempt to offer or sell a security before the effective date of its registration statement.²⁶⁸ Offering or selling before this date is commonly referred to as gun-jumping.²⁶⁹ The Commission's ambiguous treatment of considering only some pre-offering solicitations as gun-jumping, together with the Commission's proposal to eliminate the prohibition on pre-offering solicitations altogether, suggest that section 5(c) may be headed toward obsolescence.

Traditionally, the Commission construed section 5(c) as a broad prohibition on a variety of preregistration marketing activities, even disallowing issuers from distributing estimates of their assets or the value of the offered securities.²⁷⁰ Although the Commission rigorously enforces section 5(c) and clamps down on these forms of gun-jumping, its recently proposed Rule 135(d)²⁷¹ would allow widespread solicitation of investors before an issuer files a registration statement for an initial public offering of the issuer's securities.²⁷² Proposed Rule 135(d) would allow a company to solicit written or oral "indications of interest" in its securities to "test the waters" before preparing a registration statement for an IPO under the 1933 Act.²⁷³ The Commission argued that allowing issuers to evaluate potential buyer interest *before* incurring the costs of registration would help the issuers avoid the costly and inefficient situation of venturing into the market only to find insufficient interest in the offering.²⁷⁴

268. 15 U.S.C. § 77e(c) (1994).

269. See *supra* notes 81-83 and accompanying text (defining gun-jumping). See generally Joseph P. Richardson & Joseph E. Reece, *Gun Jumping*, 26 REV. SEC. & COMMODITIES REG. 1 (1993).

270. See *supra* notes 81-83 and accompanying text.

271. See Solicitations of Interest Prior to an Initial Public Offering, Securities Act Release No. 7188, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,639, at 86,885 (June 27, 1995) [hereinafter Solicitations of Interest Prior to an Initial Public Offering Release].

272. Coffee, *supra* note 7, at 1152; see HAROLD S. BLOOMENTHAL & SAMUEL WOLFF, EMERGING TRENDS IN SECURITIES LAW 3-3 to 3-5, 3-19 (1995).

273. Coffee, *supra* note 7, at 1152; see Stephen I. Glover, *In Proposals Designed for Small Businesses, the SEC Would Permit Issuers to "Test the Waters" and Would Shorten Holding Periods for Restricted Securities*, NAT'L L.J., Aug. 21, 1995, at B6; Solicitations of Interest Prior to an Initial Public Offering Release, *supra* note 271. A test the waters rule has been available for issuers using the Regulation A registration exemption since 1992, but only 61 issuers have actually attempted these pre-offering solicitations under the rule. Glover, *supra*, at B6 n.6.

274. Glover, *supra* note 273, at B6. Proposed Rule 135(d) is designed primarily for smaller issuers such as companies with little resources to evaluate demand for their securities, for which a thwarted venture into the market could spell financial disaster.

Issuers would need to file solicitations of interest under Rule 135(d), whether written or oral, with the Commission prior to the actual solicitation, but the staff would not review the solicitations.²⁷⁵ The issuer would be subject to liability for misrepresentations under section 17(a) of the 1933 Act (but not section 12(2)) and section 10(b) of the 1934 Act.²⁷⁶ These provisions would likely allow typical selling hyperbole but ward off serious fraud.²⁷⁷ Finally, Rule 135(d) would require solicitations to describe the issuer and its business, provide the chief executive officer's name, and include certain disclaimers.²⁷⁸ The issuer could include other disclosures at its own election.²⁷⁹

Proposed Rule 135(d) represents the Commission's implicit abandonment of section 5(c) in favor of new approaches to solicitation that take into account the realities of modern capital raising.²⁸⁰ Section 5(c) was formulated to make the prospectus the foremost, and for a time the *only*, source of information about the new issue available to a purchaser.²⁸¹ Section 5(c) was designed to ensure that the investor received credible, complete disclosure regarding the security and the issuer, instead of the slanted and often incomplete information the investor might receive in a direct pre-offering solicitation.²⁸² Rule 135(d) goes far beyond allowing mere feasibility testing of the offering, which could be accomplished by a narrower solicitation to institutional investors or underwriters, and allows issuers to effectively market the

Id.

275. *Id.*

276. *Id.*

277. The history of the test the waters rule for Regulation A seems to indicate this, for "significant amounts of puffery" were tolerated under that system. *Id.*; see Leonard J. McGill, *Innovative New California Transactional Exemption for Sales to Qualified Purchasers*, INSIGHTS, May 1995, at 23, 24.

278. Glover, *supra* note 273, at B6. Required disclaimers include the following statements: "The solicitation is not an offering of securities; any public offering will be made only by means of a prospectus; no money is being solicited or accepted; no sales will be made or commitments to purchase accepted until a registration statement is filed and becomes effective or until an exemption from registration is used; and indications of interest do not involve a commitment of any kind." *Id.*; see Solicitations of Interest Prior to an Initial Public Offering Release, *supra* note 271.

279. Glover, *supra* note 273, at B6. Optional disclosures may include "information about the type, amount and price of the securities to be offered, audited or unaudited financial statements, projections and other forward-looking financial information."

Id.

280. Coffee, *supra* note 7, at 1153.

281. *Id.* at 1150-51, 1153.

282. *Id.* at 1151, 1153.

security to the general public prior to filing the registration statement.²⁸³

Whether or not the Commission adopts proposed Rule 135(d), the character of this kind of proposal demonstrates that the Commission is ready to significantly modify or abandon many basic concepts once considered indispensable to the Securities Act of 1933. The Commission's call for comments prior to the Advisory Committee Report persuasively reveals this phenomenon.²⁸⁴ The change of heart by the Commission, along with the growing number of calls by companies for deregulation of the capital raising process, signals a need for a comprehensive new system of integrated disclosure based on company registration.²⁸⁵

The Commission's gun-jumping experience has led some commentators to conclude that the combination of the Commission's recent hyperliteral interpretation of the language of the 1933 Act and its Proposed Rule 135(d)²⁸⁶ have produced inconsistent and undesirable re-

283. *Id.* at 1152-53. For this reason, Professor Coffee suggests that the Commission may be signaling, as Eric Chiappinelli argues, that section 5(c) is outmoded and should be scrapped to allow for more aggressive marketing in modern capital markets. *Id.* at 1153; see Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457, 497-501 (1989).

284. Steven M.H. Wallman specifically called for comments to the Commission addressing the following questions:

1. Does the current regulatory scheme, with its focus on the registration of securities offerings rather than on the issuers of those securities, strike an appropriate balance between the capital-raising needs of companies and the disclosure needs of investors? Also, are investors' informational needs now being served by the existing prospectus disclosure and delivery requirements applicable to public offerings?
2. To what extent are issuers' financing decisions influenced by regulatory rather than financial and market considerations? What factors specifically influence a company's choice of public, private, or other capital-raising techniques, whether in the United States or abroad?
3. How have companies adapted their marketing, disclosure and other policies or practices to address regulatory and market uncertainties? Would movement to a company registration scheme, or some other alternate model, reduce or remove any of these uncertainties?
4. Would significant streamlining or elimination of the present transactional registration scheme affect the due diligence exercised by underwriters and corporate officials in connection with the preparation of offering documents and/or other communications with investors?
5. Would adoption of alternative regulatory models—whether company registration or aspects of systems used in other countries—have any impact on the integrity of the nation's securities markets and the incidence of fraud?

See Wallman, *supra* note 233, at 3.

285. See ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 35-36.

286. See Solicitations of Interest Prior to an Initial Public Offering Release, *supra*

sults.²⁸⁷ Gerald S. Backman and Stephen E. Kim contend that the Commission has most recently engaged in "a hypertechnical reading of the registration requirements of the Securities Act of 1933."²⁸⁸ This metaphysical approach, according to Backman and Kim, is a result of "stretching the aim of the Securities Act . . . to cover situations for which such protection may not be necessary."²⁸⁹ The result is an inconsistent interpretation of section 5 of the 1933 Act and uncertainty as to the results the proposed changes will produce in a given situation.

Backman and Kim use three hypotheticals to demonstrate the current inconsistency. First, if an issuer conducts a limited registered offering to a small group of investors who do not have a plan for secondary redistribution, the securities sold in the second transaction do not bear resale restrictions and may be freely traded by the investors.²⁹⁰ Second, if the same investors demand a registered issuance (defined by Backman and Kim as a "filing of a registration statement for the securities") prior to the sale in order to obtain freely tradable securities, the Commission might interpret the issuer's offer as a form of gun-jumping because it was made prior to filing the registration statement under section 5.²⁹¹ Finally, if the issuer sells the securities to the investors

note 271, at 86,885.

287. See Coffee, *supra* note 4, at B4; BLOOMENTHAL & WOLFF, *supra* note 272, at 3-1 to 3-2. According to Stanley Keller, the SEC "staff's positions reflect a return to a more literalist approach to applying the Securities Act and a departure from the flexible and pragmatic attitudes that have characterized the Division for well over a decade." Keller, *supra* note 257, at 5; SEC v. Arvida, 169 F. Supp. 211 (S.D.N.Y. 1958); see Chiappinelli, *supra* note 283, at 499-501.

Professor Coffee argues that the recent positions of Commission staff further indicate "the statutory obsolescence" of the Securities Act of 1933:

Statutory norms that only a decade ago were treated as inviolate are now being distinguished away when policy reasons suggest that compliance with them would be costly. If the high priests of securities law—the staff of the SEC—have lost faith in the old dogma, the question naturally arises whether others should still adhere to the old dogma's premises.

Coffee, *supra* note 7, at 1149-50.

288. Backman & Kim, *supra* note 202, at 18.

289. *Id.*

290. *Id.* The Commission's pronouncement in American Council of Life Insurance, SEC No-Action Letter, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,526, at 78,641 (May 10, 1983) [hereinafter American Council of Life Insurance], put to rest the "presumptive underwriter doctrine" and limited the definition of an underwriter to brokers and those obtaining a security for the purpose of redistributing it in the secondary market. *Id.*

291. Backman & Kim, *supra* note 202, at 18.

via a section 4(2) private placement and subsequently files a resale Form S-3, Rule 152²⁹² allows the transaction.²⁹³ This is the PIPE transaction.²⁹⁴

Two other hypothetical situations illustrate more problems with the Commission's recent positions on gun-jumping.²⁹⁵ First, suppose an issuer begins a private placement of securities under an applicable exemption, but after failing to find the requisite private support, decides instead to conduct a public offering.²⁹⁶ The prior contacts with private investors before filing the registration statement for the public offering is a form of gun-jumping—an offer of securities before the effective date of the registration statement.²⁹⁷ Next, suppose an issuer tries to conduct a public offering, sends a prospectus to potential investors, but does not attract enough interest and the offering fails.²⁹⁸ If the issuer then decides to try a private offering, the Commission may consider the prospectus to investors a “general solicitation” rendering the private placement exemption inapplicable, thereby foreclosing the opportunity of a private offering.²⁹⁹

c. Decline of the traditional prospectus

While the Commission's inconsistency regarding gun-jumping implied a move away from section 5, its recent positions on preliminary and final prospectus delivery fail to indicate a full-scale retreat from traditional 1933 Act disclosure.³⁰⁰ Despite the free writing prohibition that restricts issuers from using any written solicitation of investors other than the preliminary prospectus, the Commission recently allowed “term sheets,” which are brief descriptions of the issuance and the issuer, underlying assets, and the loans involved, in asset-backed securities

292. 17 C.F.R. § 230.152 (1996).

293. Backman & Kim, *supra* note 202, at 18. Rule 152 preserves availability of the section 4(2) exemption for the private placement regardless of whether it is followed by a public distribution or if the issuer received “binding commitments” from the investors before the registration statement was filed. *Id.*

294. *Id.*; see Keller, *supra* note 257, at 6-7, 9; see also *infra* notes 324-26 and 333 and accompanying text (describing PIPE transactions as a new form of equity instrument designed to evade section 5 registration).

295. BLOOMENTAL & WOLFF, *supra* note 272, at 3-3 to 3-5.

296. *Id.* at 3-3 to 3-4.

297. *Id.* at 3-4.

298. *Id.* at 3-33 to 3-34.

299. *Id.* “A fundamental basis for the private offering exemption, . . . is the absence of general solicitation of investors.” Keller, *supra* note 257, at 6.

300. See Distribution of Certain Material Relating to Asset-Backed Securities, SEC No-Action Letter, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,008 (Feb. 17, 1995) [hereinafter Distribution of Certain Material Relating to Asset-Backed Securities].

issuances prior to the effective date.³⁰¹ Although the issuer must file these term sheets with the Commission prior to using the sheets,³⁰² they certainly do not qualify as a preliminary prospectus as envisioned by the 1933 Act, and their permitted use represents further weakening of section 5 by the Commission.³⁰³

The Commission also jettisoned the requirement that the issuers deliver the prospectus to investors as a single document at or before the closing.³⁰⁴ Rule 434 allows issuers to deliver the prospectus information piecemeal to investors at different times, so long as the issuer delivers all required information at or before the final settlement date.³⁰⁵ Rule 430A,³⁰⁶ as recently amended by the Commission in 1995, permits issuers to omit information about the offering price and underwriting arrangements from the final prospectus, allowing issuers to file the information with the Commission within fifteen business days.³⁰⁷ Thus, in the interest of saving time and money, an issuer can break the final prospectus, which is designed to be the central selling document of Securities Act disclosure, and distribute it to the investor over time.³⁰⁸ The collateral result is that the investor's decision to buy may occur long before the last piece of the prospectus arrives, rendering the final prospectus largely irrelevant in the investor's decisionmaking process.³⁰⁹

301. *See id.* An earlier no-action letter allowed use of "computational materials," essentially computer-generated graphs and charts outlining possible returns on investment and characteristics of the underlying assets, in securities issuances. *See Mortgage and Asset-Backed Securities—Furnishing Information to Customers*, SEC No-Action Letter, [1994-1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,941 (May 20, 1994).

302. *See* Distribution of Certain Material Relating to Asset-Backed Securities, *supra* note 300, at 78,939.

303. Coffee, *supra* note 7, at 1153.

304. *See* 17 C.F.R. § 230.434 (1996).

305. *Id.*

306. *Id.* § 230.430A(a)(3) (1996).

307. *See* Prospectus Delivery; Securities Transaction Settlement, Securities Act Release No. 7168 [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,620 at 56,568 (May 11, 1995).

308. Professor Coffee noted that the decision to compromise the statutory language in favor of saving time and money (here, in light of the T + 3 settlement date) places the Commission on the "slippery slope" of using cost and time considerations to excuse erosion of the 1933 Act. Coffee, *supra* note 7, at 1154 & n.34.

309. *See id.* at 1154 (noting the Commission's willingness to accept prospectus material after sales have been made to investors).

Moreover, the prospectus delivery requirement has become nearly irrelevant in the shelf registration scenario because investors receive little information in the truncated Form S-3 prospectus and rely almost wholly on the issuer's 1934 Act reports for needed information about the issuer and the offering.³¹⁰ With the advent of the Electronic Data Gathering Analysis and Retrieval System (EDGAR), electronic disclosure, and Internet filings, some commentators felt that Form S-3 signified the beginning of an administrative repeal of the traditional prospectus delivery requirement as codified in the 1933 Act, and this view should take much firmer root in light of the Advisory Committee Report.³¹¹

3. Increase in Offerings and Instruments Outside Section 5

a. *Private placements and Rule 144*

Increasingly, investors are forsaking traditional public offerings under the 1933 Act in favor of popular, and often less costly, alternatives to raising capital.³¹² The private placement exemption, for example, has never been more attractive to issuers in light of the recent Supreme Court ruling holding the liability provisions of section 11 and section 12(2) of the 1933 Act inapplicable to private placement issuers,³¹³ and the Commission's proposed rule reducing the holding period for restricted securities under Rule 144 of the 1933 Act to one year.³¹⁴ With these and other recent developments, "[i]nstitutional investors and issuers are threatening to obliterate the demarcation between public offerings and private placements."³¹⁵

The Commission proposed a rule which would further encourage the use of private placements by establishing shorter holding periods under

310. *Id.* at 1160.

311. *See id.* at 1162-63 (suggesting that the confirmation of sale could become the new prospectus in a company registration system); ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 27 (suggesting that under company registration system, prospectus delivery may soon be unnecessary "in all but extraordinary circumstances"); Joseph McLaughlin, *SEC Approves Use of Electronic Prospectuses and Proposes T + 3 Relief*, INSIGHTS, Apr. 1995, at 3; *see also infra* notes 403 and 493 and accompanying text (discussing the Advisory Committee proposal to make the confirmation of sale serve as the prospectus in the proposed company registration system).

312. *See infra* notes 313-15 and accompanying text.

313. *See Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995).

314. *See* Revision of Holding Period Requirements in Rule 144; Section 16(A) Reporting of Equity Swaps and Other Derivative Securities, Securities Act Release No. 7187, [1995 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,638 (June 27, 1995) [hereinafter Rule 144 Release].

315. Bancroft, *supra* note 15, at 14; *see* ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 45-57.

Rule 144 of the 1933 Act.³¹⁶ Under current Rule 144(d), buyers may resell restricted securities obtained in private placements after a two-year holding period, within specified volume limits, and in "ordinary brokerage transactions," provided that the issuer first made public the required details about the company's business and the issuance.³¹⁷

After three years, these securities currently can be sold freely without informational or other requirements.³¹⁸ Under similar prerequisites applicable to qualification under the two-year holding period of the Rule, the Commission's proposed rule would shorten the holding period to one year and shorten the unrestricted resale holding period from three years to two.³¹⁹ The Commission justified the proposed change by pointing to the cost and risk borne by most investors buying in private placements under Rule 144, and noting that it designed the change to reduce these costs and make Rule 144 "more useful."³²⁰ The Commission further observed that the one-year holding period should be adequate to ensure that investors buying securities under Rule 144 do not intend to make any public redistribution of those securities.³²¹

The proposed change to Rule 144 would benefit small companies the most, because they stand to gain significantly from the encouragement of private placements and the reduction of the discount needed to market those securities.³²² This change should facilitate stock-based acquisitions because unregistered, privately placed stock would require only

316. See Rule 144 Release, *supra* note 314, at ¶ 85,638.

317. 17 C.F.R. 230.144(d) (1995). The investor selling pursuant to Rule 144 requirements is not treated as an underwriter, and any resale by such a person is entitled to the section 4(1) exemption for sales by persons other than an issuer, its agents, or its underwriters. 15 U.S.C. § 77d(1) (1994). Glover, *supra* note 273, at B6. The holding period "is designed to establish that the owner did not purchase with a view to public distribution." *Id.*

318. Glover, *supra* note 273, at B6.

319. *Id.*; see Rule 144 Release, *supra* note 314, at ¶ 85,638.

320. Glover, *supra* note 273, at B6; see Rule 144 Release, *supra* note 314, at ¶ 85,638. Issuers placing securities in private placements governed by Rule 144 often must reduce the price of those securities by as much as 25% to compensate investors for the risk they incur in holding the security during the Rule's two-year holding period. Glover, *supra* note 273, at B6; see ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 46 & n.47 (estimating a 20% "illiquidity" discount in most private placements).

321. Glover, *supra* note 273, at B6; see Rule 144 Release, *supra* note 314, at ¶ 85,638.

322. Glover, *supra* note 273, at B6.

the one-year holding period and would be more valuable to stockholders of the target company.³²³

b. PIPE transactions and AB exchange offers

One particularly interesting consequence of the increase in private placements is the development of the private investment-public equity transaction. In a PIPE transaction, the buyer agrees to purchase securities offered in a private placement on the condition that the issuer immediately file a resale Form S-3 registration statement.³²⁴ The parties then agree not to close the sale until the Commission declares the resale registration statement effective.³²⁵ According to Stanley Keller, issuers have made liberal use of the PIPE transaction to sell freely marketable securities without enduring the rigors and time delays of full 1933 Act registration.³²⁶

Another capital raising instrument, the AB exchange offer, allows a purchaser to acquire securities in an unregistered private placement and immediately trade them for registered securities from the issuer.³²⁷ Though the Commission has strictly construed the parameters of permissible AB exchange offers, it is clear that these offers are another viable way for issuers to immediately sell marketable securities without the burdens of traditional registration.³²⁸

323. *Id.*

324. Keller, *supra* note 257, at 9.

325. *Id.* The Commission declared PIPE transactions acceptable, so long as (1) the private offering is "completed"—all conditions precedent to the sale are outside the buyers' control—before the resale registration statement is filed, and (2) no further negotiations occur between the issuer and the buyers after the Commission declares the resale registration statement effective. *Id.*; see Black Box, Inc., SEC No-Action Letter, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,510, at 77,571 (June 26, 1990).

326. Keller, *supra* note 257, at 9.

327. See Exxon Capital Holdings Corp., SEC No-Action Letter, 1988 WL 234336 (May 13, 1988); see also Stanley Keller, *Current Issues in Private Placements: Private/Public Offerings*, 933 P.L.L./CORP. 9, 15, 22-23 (1996).

328. Keller, *supra* note 327, at 22. Through a series of no-action letters following the *Exxon Capital* letter, the Commission confined the AB exchange offer to use in various preferred stock offerings, nonconvertible debt, and IPOs by foreign issuers, suggesting that foreign companies may be able to completely evade section 5 in the situation for which it is best designed: the IPO. See Morgan Stanley & Co. Inc., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,018, at 78,884 (June 5, 1991); K-III Comm. Corp., SEC No-Action Letter, 1993 WL 166858 (May 14, 1993); Corimon C.A. S.A.C.A., SEC No-Action Letter, 1993 WL 97703 (Mar. 22, 1993); Vitro, S.A., SEC No-Action Letter, [1991-1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,072, at 78,083 (Nov. 19, 1991); Epic Properties, Inc., SEC No-Action Letter, 1991 WL 216064 (Oct. 21, 1991); Warnaco, Inc., SEC No-Action Letter, 1991 WL 209850 (Oct. 11, 1991); Mary Kay Cosmetics, Inc., SEC No-Action Letter, [1991-

Moreover, also as a result of issuers and investors seeking to avoid the burdens of section 5, offshore offerings under Regulation S³²⁹ have increased significantly.³³⁰ Modern technology and increased interaction among global capital markets have made offshore offerings an attractive alternative for issuers who wish to raise capital quickly and efficiently without the costs of registration.³³¹ Holding periods for these securities can be as short as forty days for foreign investors under applicable exemptions, allowing a quick "flowback" of these securities into the U.S. market—all without the protections of section 5.³³²

The increased use of AB exchange offers, PIPE transactions, and offshore offerings casts considerable doubt on the usefulness of the public-private distinction and provides clear evidence that modern investors increasingly choose to go around the 1933 Act instead of working within its aging dictates.³³³ One effect of this flight from traditional registration may be further circumvention of adequate disclosure to investors concerning these issues, in direct opposition to the main principles underlying the Securities Act.

c. *Gustafson v. Alloyd Co.*³³⁴

A recent Supreme Court holding makes private placement securities even more attractive than securities traditionally registered under the 1933 Act. In *Gustafson v. Alloyd Co.*, the Court held that only public offerings, and not private placements, are subject to the "negligence

1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 76,016, at 78,887 (June 5, 1991).

329. 17 C.F.R. §§ 230.901-904 (1996).

330. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 47-48.

331. *Id.*

332. *Id.* app. A at 54-56. Increasingly, issuers are using the offshore offering as a tool to flout registration requirements entirely; issuers temporarily place securities offshore to "wash" them of any resale restrictions through Regulation S, while true ownership and risk-bearing remains in the United States. *Id.* app. A at 55-56 & n.63, 64; see Problematic Practices Under Regulation S, Securities Act Release No. 7190, [General Guide] Fed. Sec. L. Rep. (CCH) ¶ 3059C (June 27, 1995); see also Jay Scholl, *Easy Money: How Foreign Investors Profit at the Expense of Americans, an Invitation to Scamsters?*, BARRON'S, Apr. 29, 1996, at 31.

333. Keller, *supra* note 257, at 6-7. In the typical PIPE transaction, investors condition the securities purchase on the resale statement being effective at the time of sale, producing a further "blurring of the distinction between public and private offerings in the marketplace." *Id.* at 6, 9.

334. 115 S. Ct. 1061 (1995).

standard” of section 12(2) of the Securities Act.³³⁵ In *Gustafson*, the Gustafson defendants sold nearly all of the stock they owned in Alloyd Co. (Alloyd) to plaintiff Wind Point Partners II, L.P. (Wind Point) through a private contract of sale, which included an estimation of the expected increase in Alloyd’s value above the previous year’s figures by the time of sale in the purchase price.³³⁶ When the increase in Alloyd’s value turned out to be lower than expected, Wind Point sued the Gustafson defendants, seeking rescission under section 12(2) of the 1933 Act for making material misstatements in a securities prospectus.³³⁷ The Court held that the private contract of sale did not constitute a prospectus under the 1933 Act and refused to extend section 12(2) liability to private placements outside section 5 of the 1933 Act.³³⁸ The Court emphasized that only misstatements in a formal prospectus issued in conjunction with a traditional public offering under the 1933 Act could be subject to the rescission remedy of section 12(2) and a private investment contract is not a prospectus to which liability could attach.³³⁹

In removing liability for negligent misstatements in private placements, *Gustafson* creates a particularly strong incentive for issuers to turn to the private placement as a means of raising capital while minimizing liability, even in spite of the concomitant restrictions on distribution of securities sold in private placements to secondary markets.³⁴⁰ Margaret Bancroft suggests that the increased attractiveness of private placements will lead to liberalization of holding requirements and other distribution restrictions surrounding securities sold in these placements.³⁴¹ If this were to happen, “the marketplace will have, in effect, dismissed the Securities Act as irrelevant with respect to seasoned issuers and the integrity of the Act will be compromised.”³⁴² Given that private placements were already a popular method of raising capi-

335. *Id.* at 1072-73.

336. *Id.* at 1064-65.

337. *Id.* at 1065.

338. *Id.* at 1067-69.

339. *Id.* at 1067.

340. Bancroft, *supra* note 15, at 14-15. Bancroft suggests that this is partially because, after *Gustafson*, “participants in private placements are no longer liable for negligent misstatements in any meaningful way.” *Id.* at 15.

341. *Id.* at 15.

342. *Id.*

The rigors of registration under the Securities Act and review by the SEC staff, coupled with a thorough review by underwriters, is invaluable in the context of capital raisings that serve to take a company public. The scrutiny given new issuers by regulators, investment bankers, lawyers and accountants works as a rite of passage.

Id. at 15 n.9

tal for investors and companies interested in avoiding registration before *Gustafson*, the Court's decision will only serve to push more investors toward nonregistered private placements.³⁴³

IV. THE CALL FOR COMPANY REGISTRATION

The idea of company registration stems from the philosophy that public offerings of securities will be made easier and more efficient in a unified, results-oriented disclosure system.³⁴⁴ Some observers view company registration as the next logical step in a historical progression that is driven by increasing reliance on the 1934 Act to adequately inform investors and the market in general, and de-emphasizing or circumventing 1933 Act registration.³⁴⁵ Ideally, this system would be geared toward facilitating capital raising and free marketability of securities, while abandoning attempts to preserve hypertechnical distinctions between 1933 and 1934 Act disclosure; yet, as commentators readily admit, different investors will want different things out of a new company registration system.³⁴⁶ Investors and issuers stand to gain from the increased certainty of a unified system which arguably would improve the quality of disclosure across the board.³⁴⁷ Given full or

343. *Id.* at 14-15.

344. See Wallman, *supra* note 233, at 2.

345. According to Bancroft, company registration "[g]ives logical recognition to the increased role Exchange Act filings have come to play in promoting the federal philosophy of disclosure," and "reflects the ultimate ascendancy of Exchange Act disclosure over that of the Securities Act." Bancroft, *supra* note 15, at 15. See generally Integrated Disclosure System Release, *supra* note 202; Edward F. Greene et al., *Hegemony or Deference: U.S. Disclosure Requirements in the International Capital Markets*, 50 BUS. LAW. 413 (1995).

346. See, e.g., Coffee, *supra* note 7, at 1147; Wallman, *supra* note 233, at 2-3. Wallman argues that the primary goal of any company registration system should be to allow companies to raise capital when and where it is needed, without the undue delay imposed by duplicative disclosure or the vagaries of the Commission's frequent reinterpretation of disclosure requirements. Wallman, *supra* note 231, at 2-3. Coffee predicts that other investors will favor a system that abolishes the chaotic set of registration exemptions that have grown up around the 1933 Act. Coffee, *supra* note 7, at 1147.

347. Wallman, *supra* note 233, at 3. A unified negligence standard governing all periodic transactions under the 1934 Act, combined with certain safe harbor provisions for issuers acting in reasonable reliance on experts, should provide a greater incentive than the current scienter liability of section 10(b) for issuers to provide full disclosure. See *infra* notes 371-78 and accompanying text (discussing Bancroft's new negligence standard for a company registration system).

substantial market participation, a system of company registration has the potential to revolutionize the capital raising process and accommodate the fast-moving securities markets of the Electronic Age.³⁴⁸

Backman and Kim have proposed "virtual elimination of registration for seasoned companies based on reliance on integrated disclosure,"³⁴⁹ while Bancroft has proposed a new negligence standard applicable to public offerings which would reduce the liability concerns surrounding section 11 of the 1933 Act.³⁵⁰ Michael Occhiolini has proposed an alternative system involving the registration of companies based on "qualified issuer lists," while eliminating the concept of restricted securities.³⁵¹ Each model has its advantages and disadvantages, but each represents a significant improvement over the inconsistent patchwork of statutory and administrative disclosure law currently in effect.

A. *Backman-Kim Model*

Backman and Kim suggest reforming the current disclosure system to allow "seasoned" issuers to offer and sell securities upon submitting a short "registration statement" to the Commission similar to Form S-3, containing summary information about the issue and incorporating many 1934 Act disclosures by reference.³⁵² The proposed system assumes that continuous disclosure under the 1934 Act can protect modern investors because transactional disclosure under the 1933 Act largely duplicates information already disclosed to the market.³⁵³ To remedy the inconsistencies created by the Commission's metaphysical approach to the 1933 Act, Backman and Kim recommend abolishing 1933 Act registration for most publicly traded companies in all offerings except IPOs and replacing it with an optional company registration that streamlines the typical registration statement and reconstructs the traditional prospectus.³⁵⁴

348. Nevertheless, Wallman cautioned that "under any new system of disclosure, market integrity must be maintained and investors must remain as fully protected as they are today." Wallman, *supra* note 233, at 3. He added that "the success of such a system would depend on issuers' willingness to use it if the current registration process also were to remain available." *Id.*

349. Backman & Kim, *supra* note 202, at 18.

350. See Bancroft, *supra* note 15, at 15-16.

351. See Michael Occhiolini, *Where to Draw the Line: Distinguishing Between Restricted and Publicly Registered Securities in an Era of Equity Swaps*, 1 STAN. J.L. BUS. & FIN. 209, 233-35 (1995).

352. Backman & Kim, *supra* note 202, at 20-21.

353. *Id.*; see JOHNSON, *supra* note 23, at 50; Cohen, *supra* note 31, at 1342.

354. Backman & Kim, *supra* note 202, at 20-21. Abandoning the 1933 Act registration would likely eliminate most practical distinctions between public and private offerings and render private placement exemptions largely obsolete. *Id.* at 20.

To be eligible for participation in the company registration system, issuers would need to meet the eligibility requirements for Form S-3³⁵⁵ and have their securities listed on a national stock exchange or NASDAQ (thus embracing companies subject to 1934 Act reporting).³⁵⁶ The registration statement in the Backman-Kim model serves as a simple notice to the Commission of the possible sale of a certain class or type of security.³⁵⁷ The Commission would consider the registration statement effective when filed, thus the statement registers the entire class of securities simultaneously.³⁵⁸ The issuer would not be subject to an initial filing fee, but would be assessed a fee at the time of issuance and would be required to send an updated form to the Commission specifying the value of each type of security sold.³⁵⁹

Similarly, the Backman-Kim prospectus would consist of the final confirmation of sale and certain 1934 Act disclosures incorporated by reference, and the issuer would not need to file the prospectus with the Commission.³⁶⁰ Backman and Kim suggest that the prospectus may al-

355. 17 C.F.R. § 239.13 (1996) (allowing certain issuers to use form S-3 for registration).

356. Backman & Kim, *supra* note 202, at 20. Backman and Kim would extend system coverage to all publicly listed companies, but would not impose the Form S-3 primary offering requirement of a \$75 million public float. *Id.* Their proposed system might also cover secondary offerings and offerings in connection with acquisitions, but likely would not work well with Form S-4 acquisition offerings or complicated asset-backed and structured securities. *Id.* at 20 n.25.

357. *Id.* at 20.

358. *Id.* This would remedy the typical overhang problem experienced by issuers using S-3 shelf registration, whereby the market stays away from the shelf-registered security for fear of future dilution by unannounced additional offerings up to the registered dollar amount. *Id.* at 20-21.

359. *Id.* at 20. Backman and Kim do not specify how the fee should be calculated, although logic suggests that it cannot be a direct function of the number or value of securities registered to be sold as in the current system—the Backman-Kim system envisions registration of an indefinite number of securities. *Id.* The best solution may be a flat, one-time fee minimizing the amount of administrative hassle associated with periodic fee assessments based on every additional issuance. *Id.* Nevertheless, these periodic fee assessments closely resemble the “situation in which listed companies file original and supplemental listing applications with the stock exchanges, paying a prescribed fee for all securities issued.” *Id.* The flat, one-time fee suggestion would comport best with the simplification of capital-raising envisioned under the Backman-Kim system. For an explanation of the problems associated with fee calculation under a company registration system, see Coffee, *supra* note 238, at B7.

360. Backman & Kim, *supra* note 202, at 20. This system would pass section 5 muster and essentially duplicate Rule 428, which provides that issuers need not file a prospectus in conjunction with a Form S-8 offering. 17 C.F.R. § 230.428(b)(1)(ii)

so require other information deemed material to investors in a typical offering, such as "a description of any securities not previously registered under the Exchange Act, any 'underwriting' arrangements where a market intermediary is involved, use of proceeds and any additional information deemed necessary or desirable by the registrant for purposes of marketing or otherwise."³⁶¹

Under the Backman-Kim model, the fraud liability provisions of both the 1933 and 1934 Acts apply to the new registration statement and prospectus.³⁶² Section 11 of the 1933 Act would apply to any information contained in the registration statement, while section 12(2) liability would attach to the information disclosed in the prospectus.³⁶³ Backman and Kim predict that under the *Gustafson* decision, "the prospectus used in a transaction that would otherwise constitute a 'private placement' presumably would be subject to liability only under section 12(2)."³⁶⁴

The Backman-Kim model of company registration applies to all qualifying issuers, but is not mandatory across the board.³⁶⁵ It allows issuers to opt out if they desire.³⁶⁶ To ensure maximum use of the proposed system, Backman and Kim impose a penalty on companies opting out, such as barring them from participation in the new system for a year.³⁶⁷

The Backman-Kim model of company registration provides several immediate advantages over the current system of disclosure. It eliminates transactional disclosure entirely for seasoned issuers who are most likely to be adversely affected by the inefficiency of duplicative filings and the burdens of 1933 Act liability.³⁶⁸ It imposes a higher standard of liability on company disclosures under the 1934 Act, ensur-

(1996); Backman & Kim, *supra* note 202, at 20.

361. Backman & Kim, *supra* note 202, at 20. Backman and Kim would generally incorporate acquisition information by reference, not including it directly in the prospectus. *Id.*

362. *Id.* For a more detailed discussion of negligence liability under a system of company registration, see *infra* notes 371-78 and accompanying text, discussing Bancroft's proposed negligence standard.

363. Backman & Kim, *supra* note 202, at 20.

364. *Id.* at 20 n.27. For a discussion of *Gustafson*, see *supra* notes 334-43 and accompanying text.

365. Backman & Kim, *supra* note 202, at 20.

366. *Id.* Despite Backman and Kim's view that the new system would be more efficient and easier to use than the current system, they recognize that issuers may want to remain under the current regime for many reasons, including the increase in liability for 1934 Act reports and lower costs associated with traditional private placements. *Id.*

367. *Id.*

368. *Id.* at 19.

ing the kind of complete disclosure enjoyed under the 1933 Act, but without the inefficient overlapping disclosure and costs associated with formally registering every public offering.³⁶⁹ The Backman-Kim system even improves on current shelf registration under Form S-3 by eliminating market overhang and the use of underwriters in a primary equity shelf offering.³⁷⁰

B. Bancroft's "New Negligence Standard"

According to Bancroft, issuers participating in any new company registration system should agree to a new negligence standard based on section 12(2) of the 1934 Act,³⁷¹ applicable to 1934 Act filings and superseding section 18 of the 1934 Act.³⁷² The standard would apply the section 12(2) brand of negligence liability to both formal security issuances and everyday market purchases by investors.³⁷³

Bancroft, like Backman and Kim, envisions a voluntary company registration system, where issuers can opt out in favor of remaining in the current 1933/1934 Act system.³⁷⁴ Bancroft's proposed standard would give issuers several reasons to stay. First, the new negligence standard would be available only to issuers opting into the new system, while section 11 of the 1933 Act would continue to impose strict liability.

369. *Id.* at 20.

370. *Id.* As experience under Rule 144A and Regulation S has borne out, issuers will probably continue to use underwriters for large distributions in order to better market the security to potential investors. *Id.* at 21.

371. 15 U.S.C. § 781(a)(2) (1994).

372. Bancroft, *supra* note 15, at 15-16. Section 18 of the 1934 Act provides, in pertinent part:

Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . . which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement . . . unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.

15 U.S.C. § 78r (1994). Bancroft considers this section a "dead letter," and urges adoption of a new negligence standard to replace it. Bancroft, *supra* note 15, at 15.

373. Bancroft, *supra* note 15, at 15-16.

374. *Id.* at 16.

ty on all other companies for misrepresentations in the registration statement.³⁷⁵ Second, to increase the attractiveness of staying in the system and to soften the impact of expanded liability for continuous disclosure, Bancroft would implement a safe harbor provision protecting issuers and their agents who act in good faith reliance on experts in determining what information they should reveal in their 1934 Act disclosures, as well as any registration statement and prospectus issued within the company registration system.³⁷⁶ Third, investors would be slow to participate in private placements governed only by the bare scientist requirement of Rule 10b-5, when the increased protection of a negligence standard is available under the new system.³⁷⁷ Finally, the new negligence standard would substantially improve the quality of disclosure under the 1934 Act, attracting more investors and driving up the value of securities exchanged under the new system.³⁷⁸

C. *The Occhiolini Model: Qualified Issuer Lists*

Occhiolini's proposal to register companies through the use of a qualified issuer list, thus doing away with the idea of restricted securities entirely, is an innovative alternative to the Backman-Kim and Bancroft company registration models.³⁷⁹ Occhiolini observed that regulation under the 1933 and 1934 Acts is based on an assumption that an investor is the "owner" of a security, and thus bears the potential risk in buying or selling it.³⁸⁰ The rise of equity swaps³⁸¹ and other derivatives challenge this fundamental assumption and the foundations for today's system of disclosure.³⁸²

375. *Id.* Under the new negligence standard, issuers could claim protection from misrepresentations based on their exercise of reasonable care, a compelling incentive to not opt out of the new system. *Id.*

376. *Id.* This safe harbor would ensure that review of 1934 Act documents under a new company registration system would "replicate, to the extent practical, the valuable, critical review process associated with long-form Securities Act filings." *Id.*

377. *Id.*

378. *Id.*

379. See Occhiolini, *supra* note 351, at 233.

380. *Id.* at 209.

381. Equity swaps are a type of contract ("swap contract") between two investors wherein they agree to periodically "swap" cash flows resulting from certain investments. *Id.* at 211-12. The swap occurs under an arrangement where one investor pays the other a fixed or variable interest rate on a sum certain, in exchange for the other investor paying the first a rate of return on an equity or group of equities in the market. *Id.* An in-depth analysis of equity swaps is beyond the scope of this Comment, but for a discussion of equity swaps, see generally Bernard J. Karol, *An Overview of Derivatives as Risk Management Tools*, 1 STAN. J.L. BUS. & FIN. 195 (1995).

382. Occhiolini, *supra* note 351, at 209. With equity swaps, investing risk is borne

Under Occhiolini's approach, based on the Wheat Report findings,³⁸³ a company registration system could be based upon registration of companies on a Qualified Issuer List similar to that envisioned in the proposed rules of the Wheat Report 160 series.³⁸⁴ The list would contain all companies reporting under the 1934 Act.³⁸⁵ This allows investors to buy and sell freely without regard to whether the securities were obtained in a traditional private placement or public offering.³⁸⁶ The prospectus would actually be a form similar to the Form S-3 registration statement, but would include information about the issuer and its previous securities distributions rather than security-specific information.³⁸⁷ As in the Backman-Kim model, the prospectus could incorporate by reference previous 1934 Act disclosures.³⁸⁸ These disclosures would enable the Commission to continually review the company's disclosures to ensure that the information was materially complete.³⁸⁹

Despite the theoretical consistency of a company registration system, Occhiolini is quick to articulate that bringing such a system to practical reality would involve significant problems.³⁹⁰ Disclosure under a company registration system might fall short of the rigorous and exacting

by investors other than the traditional owner, because these investors may or may not be adequately informed of disclosure by the owner. *Id.* at 210. Thus, the disclosure laws do not always act to protect these investors one or more levels removed from "ownership" in the accepted use of the word. *Id.* at 209-10. The Federal Reserve Board's response to this inadequacy has been to oppose new regulation of derivatives without a more broad-based overhaul of the financial system. *See* Statements to Congress: Federal Reserve Board Chairman Alan Greenspan's Speech to House Subcommittee on Telecommunications and Finance, *in* 80 FED. RES. BULL. 594, 603 (1994).

383. *See* WHEAT REPORT, *supra* note 196.

384. Occhiolini, *supra* note 351, at 233-35. Rule 164 of the Wheat Report 160 series would have established qualified issuer lists for purposes of reselling restricted securities, but the proposed rule ultimately was rejected in favor of what has become modern Rules 144 and 144A. *Id.* at 217, 232. *See generally* DAN L. GOLDWASSER, A GUIDE TO RULE 144, app. B at 464 (1978) (describing qualified issuer lists under the Wheat Report 160 series of proposed rules).

385. Occhiolini, *supra* note 351, at 232-33.

386. *Id.* at 232 (citing GOLDWASSER, *supra* note 384, at 460).

387. *Id.* at 234. The company would also have a duty to update the prospectus if later circumstances materially changed the information initially provided to the investor. *Id.*

388. *Id.*

389. *Id.*

390. *Id.*

disclosure elicited by the current 1933 Act registration.³⁹¹ Occhiolini's model would also give the Commission power to suspend a company from the Qualified Issuer List based on incomplete, misleading, or fraudulent disclosure³⁹²—a situation that could create market uncertainty about which securities of a suspended issuer would be freely tradable.³⁹³ Further, companies traded on a national exchange but not registered under the 1934 Act would need to develop a base of public information similar to their registered counterparts in order for unified 1934 Act disclosure to adequately inform investors about these companies and their offerings.³⁹⁴ Moreover, the system would force the Commission to spend a large amount of time and money keeping the Qualified Issuer List updated in order to maintain a current bank of data on every publicly traded company for investors.³⁹⁵ Finally, the Commission must reconcile any new system of company registration with state blue sky laws, a task which may be too massive for the Commission to undertake and too complicated for states to accommodate.³⁹⁶

According to Occhiolini, "the risk to the securities markets of financial instability that would result from such a fundamental change in the regulation of securities under the [Securities] Acts" makes this proposed company registration system inherently risky and politically precarious.³⁹⁷

D. Coffee's "Re-Engineered" Disclosure System

Perhaps no other commentator's suggestions for a new company registration system find as much representation in the Advisory Committee's Report as those of committee member Professor John C. Coffee, Jr. His proposal for a "re-engineering" of corporate disclosure contains many of the ideas ultimately adopted by the Advisory Commit-

391. *Id.*

392. Proposed Rule 164 of the Wheat Report 160 series would have given the Commission the power to remove a company from the List if it failed to provide adequate disclosure under the 1934 Act. See WHEAT REPORT, *supra* note 196, at app. VI-1. Occhiolini incorporates this Rule into his proposed system of company registration. Occhiolini, *supra* note 351, at 234.

393. Occhiolini, *supra* note 351, at 234.

394. *Id.* Under the current system, the 1933 Act provides the only meaningful disclosure about these companies, a significant hurdle for any proposed company registration system doing away with 1933 Act disclosure entirely. *Id.* Occhiolini suggests that these companies, or all companies smaller than "a certain minimum size would have to be excluded from the Qualified Issuer List for administrative cost and convenience." *Id.*

395. *Id.*

396. *Id.* at 234-35.

397. *Id.* at 233.

tee in its own proposed company registration system.³⁹⁸ It is fair to say that Professor Coffee's influence is clear in the final Advisory Committee Report.³⁹⁹

Professor Coffee proposes a company registration system in which qualified issuers register and file periodic reports under the 1934 Act, allowing them later to conduct public offerings as needed without registering under the 1933 Act.⁴⁰⁰ The system requires only the submission of a confirmation of sale, although the issuer could choose to distribute a prospectus as a marketing tool so long as it conforms to the anti-fraud provisions of the 1934 Act and does not make any false or misleading statements or omit material information.⁴⁰¹ Recognizing that 1934 Act filings alone may not fully inform the average investor, Professor Coffee also urges certain "transaction specific" disclosure for situations in which it is necessary to convey certain material information not already disclosed to the investor.⁴⁰² This additional disclosure would be Form 8-K, which the issuer would incorporate by reference into the confirmation of sale to describe any new material developments or changes to the issuer's capital structure caused by the offering.⁴⁰³

398. For example, Professor Coffee's recommendations for 8-K filings to supplement issuer information and emphasis on the importance of underwriters as the gatekeepers of disclosure quality appear throughout the Advisory Committee Report. *Id.* For a discussion of the role of gatekeepers envisioned by the Advisory Committee, see *infra* notes 452-54, 468, 523-42 and accompanying text and Coffee, *supra* note 7, at 1155-76.

399. See Coffee, *supra* note 7, at 1155-76; *infra* notes 486-90 and accompanying text (discussing adoption of Coffee's Form 8-K proposal).

400. Coffee, *supra* note 7, at 1155.

401. *Id.* at 1155, 1167.

402. *Id.* at 1166-67. For example, the current offering may indicate that the issuer is completely changing its ownership, debt to equity ratio, or even its line of business. *Id.* at 1167. This information may not appear in the issuer's 1934 Act reports and would need to be disclosed in a Form 8-K filing. *Id.* Similarly, if the offering will cause a significant change in the risk level associated with the issuer's stock, the issuer will be required to disclose this information on an 8-K prior to the offering. *Id.* at 1167-68.

403. *Id.* at 1166-67. Professor Coffee recommends this additional disclosure only when the 1934 Act reports do not adequately describe some fundamental change to the issuer's business as a result of the offering, and not as a general requirement for all periodic market offerings. *Id.* The Advisory Committee Report adopted Professor Coffee's Form 8-K recommendation, making the 8-K filing mandatory for some public offerings depending on their size. See *infra* notes 486-90 and accompanying text (discussing the 8-K filing requirement in the proposed company registration pilot system).

The main benefits of this proposed company registration system, according to Professor Coffee, are (1) issuers' ability to go to market quickly with a new offering and take advantage of short-term market opportunities without waiting to file a registration statement or for staff review, (2) reconciliation of Commission hypertechnicality in applying section 5 concepts, (3) elimination of a formal prospectus requirement, (4) enhancement of direct communication between the issuer and the investor without Commission interference, and (5) a substantial reduction in issuer liability.⁴⁰⁴ Professor Coffee warns that this last benefit may impose the greatest cost on investors, to the extent that enhanced issuer and controlling person liability promotes the quality of disclosure.⁴⁰⁵ As the liability of officers, directors, and underwriters is relaxed, Professor Coffee suggests less due diligence will be required of these parties, and lower quality disclosure might result.⁴⁰⁶ The Commission could address this quality problem by specifying additional due diligence review requirements for underwriters and the issuer's officers and agents, or more broadly, by imposing a general quality standard upon all 1934 Act filings.⁴⁰⁷

Professor Coffee also warns of two potentially undesirable effects of any company registration system: (1) a decline in the oversight role of gatekeepers, and (2) accompanying changes in the market structure, making it easier for issuers to sell directly to institutional purchasers and bypass the underwriter completely.⁴⁰⁸ First, gatekeepers, who are underwriters and other issuer agents that have little direct financial interest in the offering but are "subject to special, and usually statutory, liabilities that give [them] a strong incentive to monitor for law violations by others and little incentive to cheat itself,"⁴⁰⁹ face a potential position of relative unimportance in a company registration system because of the impossible time constraints associated with conducting due diligence in short-term "at the market" offerings.⁴¹⁰ Professor Coffee

404. Coffee, *supra* note 7, at 1155-56. The reduction in liability would ostensibly come as a result of abolishing 1933 Act liability for company registration issuers and applying only the liability provisions of the 1934 Act, most notably section 18 and Rule 10b-5. *Id.* at 1156.

405. *Id.* at 1156-57.

406. *Id.* This result may be reflected in the "low-level attention" 1934 Act reports typically receive compared with 1933 Act filings, exemplified by issuers who do not have outside accountants or attorneys review the 10-Q or 8-K Forms, but instead reserve such scrutiny for the annual financial statements. *Id.* at 1157.

407. *Id.* Even these measures, however, could impose substantial costs upon the issuer and its agents by forcing them to incur unwanted liability. *Id.*

408. *Id.* at 1168-70.

409. See *id.* at 1169 n.72; Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Control*, 93 YALE L.J. 857, 890-91 (1984).

410. Coffee, *supra* note 7, at 1169-71. Many underwriters now complain they have

fee argued that the Rule 415 requirement for the issuer to use an underwriter makes little sense when the underwriter cannot possibly conduct reasonable due diligence sufficient to discharge its gatekeeper role.⁴¹¹ Second, the lack of any *raison d'être* for underwriters in a post-company registration world as true gatekeepers would motivate issuers to sell new issues directly to institutional investors, potentially destroying the primary/secondary market distinction.⁴¹²

Finally, Professor Coffee urged the Commission to relax section 11 liability in order to induce issuers to opt into a voluntary company registration system.⁴¹³ Professor Coffee predicts that most issuers will be reluctant to participate in a company registration system if the issuer, its officers, directors, underwriters, and other agents may be subject to expanded section 11 strict and vicarious liability based on the issuer's continuous 1934 Act filings.⁴¹⁴ Issuers may instead opt for private placements and offshore offerings, in which the issuer is subject only to Rule 10b-5 liability and can escape most section 11 and section 12(2) liability, and officers and directors may escape liability completely.⁴¹⁵ The solution to this disincentive to enter a company registration

no time for proper due diligence review due to the short time frames of shelf transactions. See Bancroft, *supra* note 15, at 14 & n.6; see also Committee on Federal Regulation of Securities, *Report of the Task Force on Seller's Due Diligence and Similar Defenses Under the Federal Securities Laws*, 48 BUS. LAW. 1185, 1206-07 (1993).

411. Coffee, *supra* note 7, at 1169-70. This situation arguably leads issuers to avoid using shelf registration or company registration to the extent that these systems require use of an underwriter. *Id.* This conclusion is borne out by the emergence of "bought deals," direct sales of securities from the issuer to a group of institutional purchasers with little or no participation by an underwriter. *Id.* at 1169-70 & n.75; see RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 584-85 (1992).

412. Coffee, *supra* note 7, at 1171-72.

413. *Id.* at 1172-76. Coffee noted that, as a threshold issue, it is unclear whether administrative rulemaking alone can effect real change to section 11 statutory liability, especially given its poor fit with shelf registration in general. *Id.* at 1187. Legislative reform, Coffee contends, is the ideal vehicle for addressing liability in a company registration and for revamping section 11. *Id.*

414. *Id.* at 1172-73.

415. *Id.* at 1173 & n.83; see *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1065-71 (1995) (finding no section 12(2) liability for documents provided in private placements); *Central Bank v. First Interstate Bank*, 511 U.S. 164, 170-92 (1994) (finding no "aiding and abetting" liability for directors and officers in private offerings outside section 5). Professor Coffee argued that any company registration system must not be mandatory, but rather "one alternative among others on a menu of options," in order to retain the possible advantages of the current system of private exemptions and its

system may be to scale back section 11 liability in company registration offerings by fortifying the due diligence safe harbor factors of Rule 176.⁴¹⁶ The Commission could add a reasonable reliance defense to the Rule 176 factors, providing the issuer and its directors with protection from section 11 liability if they reasonably relied on the investigations of a subcommittee of outside directors in determining the accuracy and completeness of 1934 Act disclosure.⁴¹⁷ Additionally, the size of the offering can be one of the Rule 176 factors considered in determining whether the issuer fulfilled due diligence.⁴¹⁸ Thus, smaller offerings would require correspondingly less investigation to be deemed reasonable and to constitute a complete defense.⁴¹⁹ In the end, Professor Coffee noted that whatever requirements are imposed on company registration should also be imposed on shelf registration, in order to avoid the disincentive for current shelf issuers to switch to the new system.⁴²⁰

E. Legislative Deregulation of Securities Markets

The call for significant securities reform has come not only from the Commission's Advisory Committee, but from Congress itself. In 1995, Representative Jack Fields, Chairman of the House Subcommittee on Telecommunications and Finance, introduced H.R. 2131, The Capital Markets Deregulation and Liberalization Act of 1995,⁴²¹ a bill which would substantially overhaul many areas of modern securities regulation, including prospectus delivery and standards for Commission rulemaking, and which would grant exemptive authority to the Commission.⁴²² H.R. 2131, known as the "Fields Bill," could set the stage for

better use of underwriters as gatekeepers. Coffee, *supra* note 7, at 1186.

416. Coffee, *supra* note 7, at 1175-76; see 17 C.F.R. § 230.176 (1995) (outlining certain factors that make up reasonable circumstances in ascertaining a defendant's compliance with due diligence under section 11).

417. Coffee, *supra* note 7, at 1175-76. This defense seems to have been adopted by the Advisory Committee, which recommended a similar reliance defense based on the reasonable investigation of the issuer's audit committee or a disclosure committee. See *infra* notes 513-42 and accompanying text (describing the recommendations of the Advisory Committee Report regarding issuer liability and defenses).

418. Coffee, *supra* note 7, at 1175-76.

419. *Id.* at 1176.

420. *Id.* at 1186.

421. H.R. 2131, 104th Cong. (1995).

422. See *Deregulating Capital Markets: Hearings on H.R. 2131 Before the Subcommittee on Telecom. and Fin. of the House Comm. on Commerce*, 104th Cong. (Nov. 30, 1995), available in 1995 WL 12716028 (opening statement of Rep. Jack Fields (R-Tex.), sponsor of H.R. 2131) [hereinafter *Fields Testimony*].

Other provisions of the Fields Bill are perhaps more troubling, at least from a political standpoint. The bill would preempt existing state securities laws, essentially

more fundamental securities reform in two important respects. First, the Act would virtually eliminate the prospectus delivery requirement, imposing an obligation to deliver the prospectus only when requested by the prospective investor.⁴²³ Second, and more significantly for purposes of future securities reform, the bill would grant the Commission general exemptive authority—the power to exempt certain classes of securities and issuers from the requirements of the 1933 and 1934 Acts completely.⁴²⁴ A grant of exemptive power to the Commission under

nullifying the effect of those laws in all 50 states and mandating enforcement of securities actions under federal law only. *Id.* at *4; see Anita Raghavan et al., *GOP Securities Law Plan May Tilt Balance of Power*, WALL ST. J., July 28, 1995, at C1. Another provision of the bill would relax current margin rules and extend the ability of brokers to borrow against their margin stock, allowing borrowing not only from banks but from any lender. *Fields Testimony, supra*, at *4. Commission Chairman Arthur Levitt expressed his reservations toward the Fields Bill, reiterating that “[a]s we [the Commission] evaluate the legislation, our benchmark will continue to be the protection of American investors.” *Id.*

In contrast, Rep. Edward Markey (D-Mass.), the ranking Democrat on the House Subcommittee for Telecommunications and Finance, stated:

There are several provisions in H.R. 2131 which I am pleased to support, including its effort to boost the capital raising abilities of small businesses and the grant of additional exemptive authority to the SEC. I also support the goal of eliminating duplicative and overlapping regulations which do not provide any additional protections to investors or to the market but which do serve to increase costs.

Deregulating Capital Markets: Oversight Hearing on the Health of American Capital Markets Before the Subcommittee on Telecomm. and Fin. of the House Comm. on Commerce, 104th Cong. (Nov. 14, 1995), available in 1995 WL 674871, at *7 (opening statement of Edward J. Markey). Rep. Markey's position seems to indicate that bipartisan support exists for the provisions of the Fields Bill most essential to implementing a system of fully integrated disclosure, and possible later implementation of a company registration model. *Id.* at *8, *11.

423. *Fields Testimony, supra* note 422, at *9. Rep. Fields observed that the prospectus delivery requirements were both too inefficient and outmoded, and did not favor efficient capital-raising efforts:

The prospectus delivery rules are as antiquated as anything in the federal securities laws. We now require investors to receive a preliminary prospectus, then a nearly identical final prospectus, neither of which the investor usually reads, prior to purchasing a new issue of securities. The costs associated with prospectus delivery are significant, and are particularly burdensome to smaller capitalized companies. We want to facilitate on-line delivery of information to investors. We also want the information investors receive to be useful to them. I firmly believe that often less is more. We can improve this area for our firms and for our investors.

Id.

424. *Id.* at *8-*9. Rep. Fields noted that an express grant of exemptive authority

an enacted H.R. 2131 could pave the way for modernization of the dual system of securities disclosure and ultimately lead to full integration of disclosure under a system of company registration.

F. SEC Advisory Committee on Capital Formation

In February 1995, the Commission created the Advisory Committee on the Capital Formation and Regulatory Processes, chaired by Steven M.H. Wallman.⁴²⁵ The Commission formed the committee for the purpose of “assist[ing] the Commission in evaluating the efficiency and effectiveness of the . . . disclosure requirements relating to public offerings of securities, secondary market trading and corporate reporting, and in identifying and developing means to minimize costs imposed by current regulatory programs”⁴²⁶

The Committee indicated it enthusiastically supports the idea of company registration, and several members of the Committee have expressed their personal support for company registration reform.⁴²⁷ SEC Chairman Arthur Levitt noted that the “rules for capital formation in the twentieth century may not be adequate to meet the needs of investors in the twenty-first century,” and joined many on the Advisory Committee in calling for implementation of the company registration system.⁴²⁸

Chairman Wallman joined the call for investigation of company registration, but expressed concern over “whether adequate protections against fraud can be maintained absent a transaction-based registration process and the attendant liability scheme.”⁴²⁹ Still, even Wallman admitted that the benefits provided to investors by the 1933 Act’s fraud prevention must be weighed against the burdens imposed by the Act possibly “erect[ing] unnecessary obstacles to capital formation without producing countervailing informational benefits for investors.”⁴³⁰ The explicit support of company registration by members of the Commission’s own Advisory Board suggests that the 1933 Act has become burdensome and unwieldy in its old age, and signifies that the

“will enable the SEC to respond more quickly to market changes that render regulation unnecessary. We hope that exemptive authority will prove to be a useful tool to promote further examination of the securities laws by the expert agency.” *Id.* at *9.

425. Wallman, *supra* note 233, at 2.

426. *Id.*

427. *Inside the SEC: SEC Advisory Committee on Capital Formation Favors Company Registration*, INSIGHTS, July 1995, at 25.

428. Wallman, *supra* note 233, at 3.

429. *Id.*

430. *Id.*

time has come for American securities markets to move toward company registration.

V. THE ADVISORY COMMITTEE REPORT

The Advisory Committee was formed with the broad mandate:

[T]o assist the Commission in evaluating the efficiency and effectiveness of the regulatory process and the disclosure requirements relating to public offerings of securities, secondary market trading and corporate reporting, and in identifying and developing means to minimize costs imposed by current regulatory programs, from the perspective of investors, issuers, the various market participants, and other interested persons and regulatory authorities.⁴³¹

Almost immediately, the Advisory Committee began analyzing the costs and benefits of transactional disclosure under the 1933 Act for issuers subject to the continuous reporting requirements of the 1934 Act.⁴³² The Advisory Committee concluded that while the 1933 Act is "well suited for companies that are engaging in an initial public offering," it often produces "uncertainties, complexities, and anomalies . . . that unduly burden capital formation for issuers without providing significant offsetting benefits to investors, and . . . deny needed investor protections."⁴³³ Accordingly, the Committee announced that "the time has come for a fundamental conceptual change in the scheme of regulation governing public offerings" and recommended that the Commission adopt a company registration system to replace the aging system of transactional disclosure under the 1933 Act.⁴³⁴

The Advisory Committee Report consists of two main sections: the justifications and expected benefits of the proposed company registration system,⁴³⁵ and the structure of the proposed system.⁴³⁶ The Report represents the Commission's strongest statement to date that the 1933 Act is not only obsolete with respect to companies reporting under the 1934 Act, but that it should be replaced with a fundamentally new system of disclosure based on a modern securities market.⁴³⁷

431. See SECURITIES AND EXCH. COMM'N, CHARTER OF THE SECURITIES AND EXCHANGE COMMISSION ADVISORY COMMITTEE ON THE CAPITAL FORMATION AND REGULATORY PROCESSES, reprinted in ADVISORY COMMITTEE REPORT, *supra* note 1.

432. ADVISORY COMMITTEE REPORT, *supra* note 1, at i-ii.

433. *Id.* at 1-2.

434. *Id.* at 2-3.

435. See *id.* at 1-21, app. A at 1-67.

436. See *id.* at 21-48, app. B at 1-105.

437. See, e.g., *id.* at 5 ("The Commission's ultimate goal should be the implementa-

A. *Why Company Registration? The Proposed System's Rationale and Impact*

1. Problems With the Current System

The Advisory Committee observed that the current system of transactional disclosure often imposes substantial economic and logistical burdens on widely traded issuers, with little or no disclosure benefits to a market already adequately informed about the issuer through its 1934 Act reports.⁴³⁸ One of these logistical burdens is issuers' inherent uncertainty about what kinds of solicitation are permissible during registration of an issue, and what kinds will constitute gun-jumping in violation of section 5.⁴³⁹ This uncertainty forces issuers to make a critical choice—abstain from solicitation and risk dooming the offering for lack of interest, or engage in the limited solicitation needed to make the offering a success but run the risk of section 5 liability—with a wrong choice creating irreparable delay in the offering.⁴⁴⁰

Second, issuers face substantial direct and indirect expenses associated with public offerings under the current system.⁴⁴¹ These costs include underwriter spread, federal and state filing fees, attorney and accountant fees, printing fees, and discounts in the offered securities from market price.⁴⁴² Transaction costs are generally higher for non-shelf issuers, partly because of heavier regulatory burdens which force a more time-consuming due diligence review and also market discounts resulting from delays in going to market.⁴⁴³ These delays often result from issuer uncertainty regarding when the Commission will complete review of the registration statement and declare the statement effective.⁴⁴⁴ Again,

tion of a system of company registration that *totally* replaces the current transactional registration concept for all reporting companies.”) (emphasis added).

438. *Id.* at 6.

439. *Id.*; see *supra* notes 268-99 and accompanying text (discussing the Commission's inconsistency regarding gun-jumping).

440. ADVISORY COMMITTEE REPORT, *supra* note 1, at 6-7. The delay is especially damaging to shelf registrants, who often choose shelf registration to exploit short-lived market opportunities. *Id.* at 7.

441. *Id.* at 9, app. A at 2-7; see *supra* notes 250-56 and accompanying text (describing the direct and indirect expenses associated with modern equity offerings).

442. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 2-3.

443. *Id.* app. A at 5-7, 8-17.

444. *Id.* app. A at 8-17. Due to the Commission's "selective review" process, issuers generally do not know if the Commission will review their registration statements, how long the review will take, or whether the Commission will require the issuer to make substantial changes to the registration statement before declaring it effective. *Id.* app. A at 8-12. This problem becomes especially important for shelf issuers, who often choose shelf registration to take advantage of a market window that will only be open for a short time. *Id.* app. A at 8.

non-shelf issuers bear the greater burden in regulatory delay: from 1994 to 1995, repeat non-shelf issuers using Forms SB-2, S-1, S-2, S-11, or S-3 had an average of 24.9% of their registration statements reviewed, compared with 16% of all Form S-3 shelf registration statements reviewed.⁴⁴⁵

Third, issuers have been forced to deal with hypertechnical and inconsistent Commission interpretations of key 1933 Act concepts, often pushing them toward offshore offerings and other alternative capital raising techniques designed to evade section 5 requirements.⁴⁴⁶ Not only do issuers incur the cost of an illiquidity discount when engaging in private placements and other equity offering alternatives, but investors incur the cost of less protection from section 5, as more of these alternative offerings circumvent section 5 disclosure requirements.⁴⁴⁷ Moreover, as issuers make increasing use of offshore offerings, private placements, and alternative equity raising instruments, the lines between private and public offerings, as well as domestic and foreign offerings, become less clear.⁴⁴⁸

Fourth, tremendous growth in the secondary markets versus the primary issuance markets have made the 1934 Act, not the 1933 Act, the main statutory protection for investors.⁴⁴⁹ Because 1934 Act reports currently provide far less in-depth disclosure than do 1933 Act registration statements and prospectuses, and thus "tend to be taken less seriously," the Advisory Committee feels that issuers need to pay more attention to these reports, both to improve their quality and their currency.⁴⁵⁰

Finally, perhaps the greatest burden on issuers in the current system has been compliance with due diligence under section 11, especially in the context of shelf registration.⁴⁵¹ Underwriters and other issuer agents

445. *Id.* app. A at 10-12 & tbl. 2. The figures used are from the Commission's Division of Corporate Finance and include only firm commitment underwriting offerings. *Id.* app. A at 11 tbl. 2.

446. ADVISORY COMMITTEE REPORT, *supra* note 1, at 10-13, app. A at 27-40; *see supra* notes 257-311 and accompanying text (discussing Commission's hypertechnicality in construing Securities Acts concepts); notes 324-33 and accompanying text (discussing alternative equity instruments such as offshore offerings, PIPEs, and AB exchange offers).

447. ADVISORY COMMITTEE REPORT, *supra* note 1, at 10.

448. *Id.* at 11, app. A at 48-57.

449. *Id.* at 11-13, app. A at 57; *see supra* notes 238-56 and accompanying text (discussing recent changes in the primary and secondary capital markets).

450. ADVISORY COMMITTEE REPORT, *supra* note 1, app. A at 58-59.

451. *Id.* app. A at 61-66.

complain that they cannot possibly perform traditional due diligence within the short shelf registration time frame.⁴⁵² These gatekeepers often are not involved in filing the issuer's 1934 Act reports, yet must certify within a short period of time prior to a shelf offering that all of the issuer's 1934 Act reports are accurate and contain no material misstatements or omissions.⁴⁵³ This difficulty stems in part from the current system's emphasis on gatekeeping in the primary issuance markets, a transactional emphasis that makes little sense in a system gearing more toward the secondary markets and continuous disclosure.⁴⁵⁴

Other problems with the current transactional disclosure system primarily burden the market by promoting inefficient or incomplete disclosure, which prevents the market from quickly absorbing the information and reflecting the security's optimal price.⁴⁵⁵ Prospectus delivery, designed to disclose important offering and issuer information to the investor, has failed to accomplish the same purposes with respect to the market.⁴⁵⁶ First, because an issuer has no freedom to design the prospectus to address the specific needs of potential investors, the system forces issuers to conform to a statutory standard which results in disclosure with less real benefits and more investor confusion.⁴⁵⁷ Second, under Rule 424(b)(2),⁴⁵⁸ issuers may file the prospectus supplement, which must be delivered to investors in a shelf offering and disclose certain material information concerning the offering and security price, with the Commission as late as two business days after the offering is completed.⁴⁵⁹ Thus, while buyers in the shelf issuance have up-to-date information concerning the issuer and the offering, traders in the secondary market do not enjoy this informational advantage, and the market cannot absorb this current information quickly enough to establish an optimal, efficient price for the security.⁴⁶⁰

452. *Id.* app. A at 62-63.

453. *Id.* app. A at 63.

454. *Id.* app. A at 63-66.

455. *Id.* at 7-9.

456. *Id.* at 7-8, app. A at 40-44.

457. *Id.* at 7, app. A at 40-44. The Commission's attempt to promote "plain English" disclosure in prospectuses is a clear indication of the Committee's concern about investors receiving truly useful disclosure instead of government-mandated language and "legalese." *See id.* at 20-21, 26; SECURITIES AND EXCH. COMM'N, REPORT OF THE TASK FORCE ON DISCLOSURE SIMPLIFICATION 21-24 (last visited March 5, 1996) <<http://www.sec.gov/news/spstindx/htm>>; *see also* Securities and Exch. Comm'n, *Bell Atlantic and Nynex File First Plain English Disclosure Documents With SEC* (last modified Sept. 9, 1996) <<http://www.sec.gov/news/plaineng.htm>>.

458. 17 C.F.R. § 230.424(b)(2) (1996).

459. *Id.*; ADVISORY COMMITTEE REPORT, *supra* note 1, at 7-8, app. B at 13 & n.12.

460. *Id.* at 7-8.

2. Benefits of Company Registration

The Advisory Committee identified several potential benefits to issuers, investors, and the regulatory process under its proposed company registration system.⁴⁶¹ First, issuers would enjoy the reduced transactional costs and greater flexibility associated with a streamlined registration process.⁴⁶² Once a reporting company has filed a new Form C-1—a proposed one-time company registration statement similar to the Form S-3 shelf registration statement—all of its securities would be registered and could be sold in any amount without filing a registration statement or awaiting Committee review.⁴⁶³ Registration of all of the issuer's securities at once would arguably eliminate the troublesome market overhang problem experienced by some shelf issuers, while allowing issuers to pay registration fees on a simple "pay-as-you-go" basis.⁴⁶⁴ Issuers may also avoid the significant drawbacks of private placements, including resale restrictions, illiquidity discounts, purchaser and fungibility restrictions, and the vagaries of integration, under Rule 144A.⁴⁶⁵ Finally, the new

461. *Id.* at 16-17, app. A at 24-26.

462. *Id.* at 17.

463. *Id.* at 17, app. A at 25.

464. *Id.* at 17, app. A at 24-26; see *supra* note 233-34 and accompanying text (describing the problem of overhang in shelf registrations). The Advisory Committee apparently felt that because overhang is ostensibly due to investor fears that later sales of the unallocated securities registered in the shelf registration statement will dilute ownership share, overhang will disappear in company registration because no fixed "allocated" amount exists. See ADVISORY COMMITTEE REPORT, *supra* note 1, at 17. Nonetheless, it is far from clear that company registration will allay the investors' fears; indeed, investors now may fear the same dilution in issuer sales of "unallocated" registered shares.

465. ADVISORY COMMITTEE REPORT, *supra* note 1, at 18, app. B at 50. The Committee pointed out that a full company registration system would "eliminat[e] the notion of exempt private placements and restricted securities altogether" by making all sales of Form C-1-registered securities by the issuer or its affiliates subject to 1933 Act protections and liabilities (i.e., section 11). *Id.* app. B at 50. Company registration would eliminate most restrictions on affiliate resales because the registration would subject issuers to full 1933 Act liability for these and any other sales traceable to the company registration statement. *Id.* app. B at 51. Thus, no prospectus delivery would be required from affiliates—the 1934 Act protections against fraud, insider trading, and short-swing trading would disclose any possible changes to issuer control or its outstanding securities. *Id.* app. B at 54-55. Still, affiliates would have the option in the pilot system of (1) selling their securities within the pilot system under Form C-1, or (2) remaining outside the system and complying with the restrictions of Rule 144. *Id.* app. B at 57-59.

For this reason, only a limited number of control persons would be subject to

system would release issuers from the traditionally strict prospectus requirements of section 5, and give them more freedom to make a prospectus an understandable informational and marketing tool designed specifically for its investors and written in plain English.⁴⁶⁶

According to the Advisory Committee, investors would also enjoy several benefits from company registration. Company registration should enhance investor protection by consolidating disclosure requirements and applying the single liability standard of section 11 to issuers' periodic reports.⁴⁶⁷ By making section 11 the standard to which issuers must conform in their 1934 Act reports, the Advisory Committee predicted that the quality and accuracy of disclosure will improve across the board as a result of (1) greater due diligence efforts by issuers and gatekeepers, and (2) specific direction in the Rules as to what actions constitute such due diligence.⁴⁶⁸

Finally, the Advisory Committee argued that company registration will streamline and simplify the regulatory system. Previous Commission hypertechnicality and inconsistency in its interpretations of section 5 terms such as gun-jumping, private placement, and solicitation would disappear as the system no longer strives to reconcile transactional and continuous disclosure with modern realities.⁴⁶⁹ Disclosure from issuers will not only be of a higher quality, but also a more current source of information for market investors in general, as well as the specific individual offerees and purchasers in a particular offering.⁴⁷⁰

resale restrictions and registration requirements under company registration: (1) the CEO, (2) inside directors, (3) directors representing controlling shareholders, (4) 20% shareholders, (5) 10% shareholders with the right to select one or more directors for the board, and (6) any other person "who can be presumed to be in a position to exercise control." *Id.* app. B at 55-56. This last category creates only a rebuttable presumption of control, and its membership is fact-sensitive, although it may include those persons able "to obtain the signatures necessary to complete the registration process." *Id.* app. B at 55-56 & n.61; *see* Cohen, *supra* note 31, at 1393. This limited definition of "control person" applies only to the determination of who is subject to resale restrictions and registration requirements under the company registration system, and does not alter the existing definition applicable to joint and several control person liability under the 1933 and 1934 Acts. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 56; *see* 15 U.S.C. § 77o, § 78t(a) (1994).

466. ADVISORY COMMITTEE REPORT, *supra* note 1, at 17, 20-21.

467. *Id.* at 18-20.

468. *Id.* at 19-20.

469. *Id.* at 18.

470. *Id.* at 18-19.

B. *How Will it Work? The Structure of the Proposed System of Company Registration*

1. Initial Setup of the Pilot System

The Advisory Committee proposes a "pilot" voluntary company registration system open to seasoned issuers with (1) a completed IPO, (2) a public float of at least \$75 million, (3) at least two years of continuous reports under the 1934 Act, and (4) one or more classes of securities listed either on NASDAQ's National Market System or a national exchange.⁴⁷¹ The pilot would allow foreign issuers to participate so long

471. *Id.* at 32, app. B at 41. It should be noted that the eligibility requirements for the pilot system build on the prerequisites for shelf registration, but add the additional requirement that the issuer be listed on a national exchange and extend the reporting history requirement from one year to two. *Id.* app. B at 41, 44-45; see 17 C.F.R. § 239.13(a)(3), (b)(1) (1996) (codifying General Instructions I(A)(3), I(B)(1) to Form S-3).

The pilot system is designed to admit only larger, more seasoned issuers with a substantial reporting history, and the Committee estimates that about 30% of companies reporting under the 1934 Act would qualify. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 46. If the pilot program is successful, however, the Committee envisions a full company registration system open to all publicly held companies, particularly smaller companies not currently eligible to use shelf registration. *Id.* app. B at 43-46. The company registration system would not be available to any issuer engaging in an IPO, because of the Committee's view that more rigorous disclosure is necessary and appropriate to educate the public about the issuer and to familiarize the issuer with its new disclosure obligations as a public company. *Id.* app. B at 41-42. The system would be unavailable even though the issuer may currently be subject to 1934 Act reporting requirements because of its asset level and number of equity holders, or because the security is traded on an exchange. *Id.* app. B at 41-43, 59; see 15 U.S.C. § 78l(b), (g) (1994) (requiring issuers traded on an exchange or with a certain level of assets to file reports under the 1934 Act); 17 C.F.R. § 240.12g-1 (1996) (requiring issuers with \$10 million in assets and 500 or more equity holders to file reports under the 1934 Act). To this end, the Committee also proposes redefining an "IPO" as "the first registered offering of securities by an issuer." ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 43. This would mean that public offerings by previously reporting companies who had since gone private would be considered IPOs, and the offering could not be made within the new company registration system. *Id.* app. B at 42 n.47. Finally, any securities "not valued on the basis of the issuing company's business and financial information, such as asset-backed or special purpose issues, would not be eligible for the system," though securities partially based on such information or the issuer's performance (e.g., structured and tracking securities) could qualify for company registration with certain required disclosure rules. *Id.* app. B at 59; see Backman & Kim, *supra* note 202, at 20 n.25 (suggesting exclusion of asset-backed, structured, and other "complex" securities from any new company registration system).

as they made periodic disclosure similar to that required of domestic issuers under the 1934 Act.⁴⁷²

Qualifying issuers can choose between two forms of company registration: full company registration or modified company registration.⁴⁷³ In modified company registration, issuers can continue to use registration exemptions and offshore offerings outside section 5 while participating in the company registration pilot.⁴⁷⁴ These exempted offerings would remain outside the company registration system and be subject to the standard conditions and liability rules normally associated with these transactions.⁴⁷⁵ In full company registration, issuances would take place completely within the company registration system, thus all of the issuer's securities would be subject to the same protections and liabilities as registered issuances under the 1933 Act.⁴⁷⁶ As a result, all securities registered under the new system would be freely marketable.⁴⁷⁷

The pilot would allow issuers to opt out of the company registration if they choose by withdrawing their Form C-1s, but these issuers could not

472. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 48. The Committee suggested that foreign issuers may not be good test candidates for the pilot system, however, because foreign disclosure rules often do not require quarterly reports and differ in other material ways from American 1934 Act reporting. *Id.*

473. *Id.* at 33-35, app. B at 59-65.

474. *Id.* at 34-35, app. B at 59-65. Issuers adopting modified company registration would have the choice of (1) preserving their registration exemptions and continuing to make sales outside the company registration system pursuant to the requirements of those exemptions, or (2) waiving the registration exemptions and conducting such transactions under the company registration system. *Id.* app. B at 63.

475. *Id.* at 34-35, app. B at 59-65.

476. *Id.* at 33-34, app. B at 63-64. Issuers opting for full company registration, however, could choose to issue nonconvertible debt securities either within or outside the new pilot system. *Id.* app. B at 51 n.56, 60. The new system would subject securities distributed in offshore offerings to all 1933 Act protections and liabilities once re-entering the United States, and require issuers to register on Form C-1 their "reasonable estimate of the likely flowback into the United States." *Id.* app. B at 60-61. This would eliminate many of the inconsistencies of protection and liability in Regulation S practice; all securities flowing back into the U.S. from offshore transactions would be subject to the same liability standard as if they had been issued domestically. *Id.* app. B at 61. Full company registration would preserve an unusual form of quasi-private placement (a limited placement), whereby an issuer unable to make the required company registration disclosures (e.g., due to confidentiality concerns for business purposes or required reports not completed in time for the offering) may sell its securities to accredited investors on the condition that those investors hold the securities until the issuer files the required public disclosures. *Id.* app. B at 65-66. Issuers would still have to make all otherwise-required disclosures to the accredited investors, and could freely market the securities once the required information was filed. *Id.* app. B at 66. At all times, the full protections of the 1933 Act would apply to securities issued in a limited placement. *Id.* app. B at 65-66.

477. *Id.* app. B at 64.

re-enter the system for two years.⁴⁷⁸ A similar two-year ineligibility period would apply to any issuer failing to meet the eligibility or mandatory disclosure requirements of the system, including any issuer failing to keep its periodic reports current by the start of each new offering.⁴⁷⁹

2. Public Offerings in the New System

a. *The Form C-1 and additional required filings*

A participating company in the pilot company registration system would register its securities in a Form C-1 registration statement "disclos[ing] its plans to sell securities from time to time in the indefinite future on a company-registered basis."⁴⁸⁰ The Form C-1 would in effect register the *company*, not merely a certain number of its securities.⁴⁸¹ The issuer would pay a small registration fee upon submission of the C-1, then pay a full fee upon each public offering of its securities based on the number of securities offered for sale in the offering (the pay-as-you-go approach).⁴⁸² Filing the C-1, along with continuous 1934 Act reporting, would register all of the issuer's securities simultaneously, based on its public file of 1933 Act disclosures, and allow the issuer to sell any of its company-registered securities at any time without further registration or staff review.⁴⁸³ All securities registered under the C-1 would be freely tradable and subject to the liabilities and remedies of the 1933 Act, most notably section 11.⁴⁸⁴

The pilot system would require issuers to make certain filings upon each issuance depending on whether the issuance was either a de minimis equity/non-convertible debt offering, or a non-de minimis equity offering.⁴⁸⁵ In a de minimis equity offering⁴⁸⁶ or non-convertible debt of-

478. *Id.* at 33, app. B at 43.

479. *Id.* at 33, app. B at 46-47.

480. *Id.* at 22, app. B at 7.

481. *Id.* at 22, app. B at 7-8.

482. *Id.* at 22, app. B at 8. This solves the potential problem of the issuer having to pay an unreasonably large fee upon initial registration, based on the current section 6(b) formula of calculating the registration fee as "one twenty-ninth of one per centum of the maximum aggregate price at which such securities are proposed to be offered." 15 U.S.C. § 77f(b) (1994); see Coffee, *supra* note 238, at B7 (discussing problems with, and alternatives to, the current section 6(b) formula).

483. ADVISORY COMMITTEE REPORT, *supra* note 1, at 22-23, app. B at 7-10.

484. *Id.* at 23, app. B at 9. An issuer could even convert its restricted securities into tradable company-registered securities by registering those securities for resale on Form C-1. *Id.* app. B at 8-9.

485. *Id.* at 23-24, app. B at 11-14.

fering, the issuer would have to file either a Form 8-K or a prospectus supplement by the selling date detailing offering-specific information (transactional disclosure)⁴⁸⁷ and any material revisions of the issuer's 1934 Act public disclosure file (updating disclosure).⁴⁸⁸ In a non-de minimis equity offering, the pilot system would require an issuer to file an 8-K (not a prospectus supplement) by the selling date, which would provide the same transactional and updating disclosures.⁴⁸⁹ The Committee designed this latter 8-K filing requirement to incorporate by reference information about larger issuances into the Form C-1 registration statement, thereby making available the full range of section 11 protections and remedies not available for information incorporated by reference into the prospectus only via a prospectus supplement.⁴⁹⁰

b. Prospectus delivery

Prospectus delivery in the pilot system would fall into three tiers of differing delivery requirements, based on the amount of voting equity offered.⁴⁹¹ In routine transactions,⁴⁹² issuers could either deliver a formal prospectus or incorporate their 1934 Act filings (including transac-

486. A de minimis equity offering is an offering amounting to 3% or less of the security's public float made over a three-business-day period. *Id.* at 23.

487. This type of disclosure refers broadly to information particular to the present offering not yet appearing in the issuer's 1934 Act public disclosure file, sufficient to provide notice of the offering and other material transaction disclosure. *Id.* at 23-24, app. B at 11-14. Though the Committee declined to recommend specific "line-item" transactional disclosure, it noted that such disclosure would approximate what regulation S-K requires today. *Id.* app. B at 10. For an example of such disclosure in the current system, see *id.* app. B at 10 n.8 (giving financing example).

488. *Id.* at 23-24, app. B at 12-13. The Committee suggests the three percent de minimis/non-de minimis dividing line as an example, and it is not clear that the suggested three percent figure will be determinative of a de minimis offering in the ultimate pilot system. *Id.* at 23. Normally, transactional disclosure would need to be filed by the date of the first securities sale, while updating disclosure would need to be filed prior to the first sale, perhaps one to three business days before. *Id.* at 24. The Committee feels that an issuer should disclose an updating disclosure a sufficient amount of time before the offering to allow the market to digest the new information and adjust the issuer's security price accordingly. *Id.* at 24, app. B at 11-14. If the issuer chooses to file a prospectus supplement, the supplement would not be incorporated into the Form C-1 and thus not be subject to section 11 liability. *Id.* app. B at 12-13, 63-64.

489. *Id.* at 23-24, app. B at 11-12.

490. *Id.* at 24. Reports under the 1934 Act that the issuer incorporated by reference into the prospectus through a prospectus supplement, however, would still be subject to section 12(2) liability. See 15 U.S.C. § 77l(a)(2) (1994).

491. ADVISORY COMMITTEE REPORT, *supra* note 1, at 28, app. B at 14-29.

492. A routine transaction is an "offering[] of voting equity amounting to [less than] 20% . . . of the existing public float of the security." *Id.* at 28.

tional and updating filings) by reference into distributed documents, such as general selling documents or the confirmation of sale serving as one prospectus.⁴⁹³ In nonroutine transactions,⁴⁹⁴ issuers must deliver a formal prospectus to unaccredited investors that contains transactional and updating disclosures not yet in the issuer's 1934 Act public disclosure file.⁴⁹⁵ Finally, in extraordinary transactions,⁴⁹⁶ issuers must also deliv-

493. *Id.* at 28-29, app. B at 17-18. The Committee estimates that 70% of current firm commitment offerings of equity would qualify as routine under the pilot system. *Id.* at 28 n.23. This prospectus delivery requirement corresponds to most de minimis offerings mentioned above. *See supra* notes 486-90 and accompanying text (describing de minimis offering filing requirements). If the issuer chooses to incorporate its 1934 Act filings by reference, the information in those filings need not also appear in the prospectus documents. ADVISORY COMMITTEE REPORT, *supra* note 1, at 9. This is different from the shelf registration system, in which the issuer must physically deliver the transactional disclosure to the investor. *Id.* at 29, app. B at 18-19. The Committee believes that allowing issuers to designate their selling materials as the prospectus will allow issuers to tailor the prospectus content to the needs of the individual investor, making disclosure more accessible (i.e., in plain English), while including only information that is most useful and relevant to the investor. *Id.* at 25-26, app. B at 14-19; *see also supra* note 457 (describing the Commission's efforts to encourage plain English disclosure). Information in selling materials would be deemed a prospectus, but would not be incorporated by reference into the Form C-1, thereby avoiding section 11 liability, but not section 12(2) liability. ADVISORY COMMITTEE REPORT, *supra* note 1, at 27. Indeed, the Committee suggests that the ultimate goal of a fully developed company registration system may be elimination of the prospectus requirement altogether. *Id.* app. B at 19 ("Because market forces reasonably can be relied upon to ensure the delivery of the appropriate level of information (at least in the case of seasoned issuers), a substantial argument could be made that there is no need to mandate prospectus delivery in *any* instance.") (emphasis added).

494. A nonroutine transaction is an "offering[] of voting equity amounting to 20% or more of existing public float of the security." ADVISORY COMMITTEE REPORT, *supra* note 1, at 29-30.

495. *Id.* at 29-30, app. B at 20-24. "Those offerings, because of their size, are likely to alter substantially the information previously provided to the market and to involve significant oral and written selling efforts." *Id.* app. B at 20. The Committee suggested that the Commission may decide to merge this second tier with routine transactions and simply require prospectus delivery for extraordinary transactions. *Id.* at 28; *see infra* note 496 (defining extraordinary transaction). The issuer would need to file with the Commission prior to the offering, but the Commission would not review the prospectus, as in shelf registration. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 21. The Committee would also require in both nonroutine and extraordinary transactions that the prospectus be delivered to the investor "prior to the time the investor determines to purchase," to give the investor enough time to consider the information and make an informed investing decision. *Id.* app. B at 22. The formal prospectus would be required to contain the same amount of disclosure required under current S-3 shelf offering prospectuses, along with any information needed to

er a formal prospectus to unaccredited investors with transactional and updating disclosures and that prospectus would be subject to Commission review prior to the offering.⁴⁹⁷

c. Disclosure enhancements

In addition to filing and prospectus delivery requirements, the company registration program would also require issuers to provide certain additional disclosures (disclosure enhancements) not currently required by the shelf registration system.⁴⁹⁸ The Commission would design these disclosure enhancements to improve gatekeeper due diligence efforts with respect to 1934 Act disclosures by improving the accuracy and reliability of the reports as they assume a more central role in the new disclosure system.⁴⁹⁹

First, an issuer would need to make "Top Management Certifications" on every Form 10-K, 10-Q, and 8-K filed with the Commission, given in the form of attestations by any two of four qualifying officers: the issuer's chief executive officer, chief financial officer, chief accounting officer, or chief operating officer.⁵⁰⁰ The two officers must certify in the attestation attached to the filing that "they are not aware of any misleading disclosures or omissions" in the filing.⁵⁰¹ The Committee hoped that this certification requirement would impress upon management their responsibility to ensure the accuracy of the issuer's 1934 Act reports.⁵⁰²

Second, the issuer's management would need to produce a "Management Report to Audit Committee," detailing the "procedures followed to ensure the integrity of periodic and current reports and procedures instituted to avoid potential insider trading abuses."⁵⁰³ The management

prevent the prospectus from being false or misleading, even if the information is duplicated in 1934 Act reports. *Id.* app. B at 25-26.

496. An extraordinary transaction is a "securit[y] transaction[] that fundamentally change[s] the nature of the company [such as] . . . offerings of voting equity amounting to 40% or more of the existing public float of the security." ADVISORY COMMITTEE REPORT, *supra* note 1, at 30.

497. *Id.*

498. *Id.* at 36-39, app. B at 67-85.

499. *Id.* at 36-37, app. B at 67-70. The Committee recognized the popular conception that present 1934 Act disclosures "still tend to be taken far less seriously, and to be of lower quality, than those historically provided, and still aspired to, under the [Securities] Act." *Id.* app. B at 67 n.71 (quoting Milton H. Cohen, *The Integrated Disclosure System—Unfinished Business*, 40 BUS. LAW. 987, 992 (1985)).

500. *Id.* at 37, app. B at 74-76.

501. *Id.* at 37.

502. *Id.* at 37, app. B at 74-75. Importantly, the certification creates no independent liability for the officer-signatories; rather, the Committee expects that the act of certification alone will psychologically "refocus" management on enhancing the quality of the issuer's 1934 Act reports. *Id.* app. B at 74-75.

503. *Id.* at 37, app. B at 76-79. The Committee feels that disclosure of these proce-

would deliver this Report to the issuer's audit or disclosure committee⁵⁰⁴ and file it with the Commission as part of the issuer's Form 10-K.⁵⁰⁵

Third, "Form 8-K Enhancements" would require the issuer to file a Form 8-K notifying the market of certain changes to its securities, management, and 1934 Act reports within five business days of the change.⁵⁰⁶ These changes would consist of (1) "material modifications to the rights of security holders,"⁵⁰⁷ (2) "resignation or removal of any of the top five executive officers," (3) "defaults of senior securities,"⁵⁰⁸ (4) "sales of a significant percentage of the company's outstanding stock,"⁵⁰⁹ and (5) any occasion when the "issuer [is] advised by [an] independent auditor that reliance on [an] audit report included in previous filings is no longer permissible because of auditor concerns over its report."⁵¹⁰

Fourth, "Risk Factors" and risk factor analysis would be required in the issuer's Form 10-Ks in the same manner as presently required in 1933 Act filings.⁵¹¹

dures will lead issuers to compare their practices with those of other issuers and arrive at a set of "best disclosure practices." *Id.* app. B at 77.

504. *See infra* notes 543-49 and accompanying text (describing the proposed issuer disclosure committee as a due diligence mechanism in the company registration system).

505. ADVISORY COMMITTEE REPORT, *supra* note 1, at 37-38, app. B at 76-79. The Report would need to be resubmitted in a future 10-K only if these safeguard procedures changed. *Id.* at 38.

506. *Id.* at 38, app. B at 80-82. Under the current system, an issuer only needs to file a Form 8-K within 15 calendar days of a reportable event. *See* SEC Form 8-K General Instruction B(1).

507. This disclosure is already required as part of the Form 10-Q. *See* Form 10-Q, Part II, Item 2. The Committee believes that these disclosures may be "stale" by the time the issuer's 10-Q is publicly available, and that current disclosure of the modifications will correct the frequent inequity of only institutional investors receiving this information directly from the issuer. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 81.

508. This disclosure is also required on the 10-Q. *See* Item 3 of Form 10-Q.

509. The sales may be either of common shares, convertible warrants, or the equity equivalents of convertible warrants. ADVISORY COMMITTEE REPORT, *supra* note 1, at 38. The Committee does not answer the question of how large a sale must be to be a significant percentage of the issuer's stock.

510. *Id.* at 38, app. B at 80-82. These concerns may address the issuer's ability to function after the audit report or the issuer's request for a "second opinion" on a covered audit period by another auditor. *Id.* app. B at 82.

511. *Id.* at 38, app. B at 82-85; *see* 17 C.F.R. §§ 229.503, .506 (1996) (requiring dis-

Finally, the Commission would urge other "voluntary measures" to be taken by the issuer to enhance its due diligence efforts, including regular audits of its interim financial reports and material events occurring after financial statement dates, auditor and counsel opinion letters for offerings, and formation of a disclosure committee or audit subcommittee to review 1934 Act disclosures prior to filing.⁵¹²

4. Liability

a. Issuer liability

Under the pilot system, all protections and remedies available to investors under the 1933 Act would apply to securities issued under the Form C-1 registration statement.⁵¹³ Thus, section 11 liability would attach to all securities traceable to a false or misleading company registration statement.⁵¹⁴ Also, section 12(2) liability would attach to selling materials serving as the prospectus.⁵¹⁵

The import of adopting section 11 liability for an issuer's continuing 1934 Act disclosures cannot be ignored. Under section 11, issuers and their agents could escape liability for materially false or misleading disclosures in the Form C-1, or the issuer's 1934 Act filings incorporated by reference into the C-1, if they could show that "they engaged in a reasonable investigation and had reasonable grounds to believe in the accuracy of the disclosure."⁵¹⁶ This is commonly known as the due diligence defense.⁵¹⁷ Section 12(2) provides a narrower damages remedy for securi-

closure of issuer risk factors and possible dilution in current equity holdings).

512. ADVISORY COMMITTEE REPORT, *supra* note 1, at 38-39, app. B at 36-39, 87-94.

513. *Id.* at 39-40.

514. *Id.* at 39-40, app. B at 51, 87-94. Section 11 imposes strict liability on the issuer, its directors and officers, and other agents such as underwriters and accountants for "materially false or misleading statements" or omissions in the registration statement. 15 U.S.C. § 77k (1994); ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 87; *see supra* notes 115-21 and accompanying text (discussing section 11 liability). The Committee felt that a single liability standard for all disclosures made under the company registration system would correct present deficiencies in disclosure liability, such as the lack of section 11 protection for prospectus supplements issued in shelf offerings, offerings pursuant to registration exemptions, and flowback from offshore offerings. ADVISORY COMMITTEE REPORT, *supra* note 1, at 39; *see* Elimination of Pricing Amendments and Revision of Prospectus Filing Procedures, Securities Act Release No. 6672, [1986-1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,038 at 88,302 (Oct. 27, 1986) (presenting for comment "proposals intended to simplify the filing requirements").

515. ADVISORY COMMITTEE REPORT, *supra* note 1, at 40; *see supra* notes 122-28 and accompanying text (discussing section 12 liability under the 1933 Act).

516. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 87.

517. *See supra* note 120 (discussing due diligence defense under section 11).

ties purchasers against sellers under the Form C-1, "unless the sellers can show that they were not negligent in failing to discover false and misleading statements."⁵¹⁸ Thus, the pilot system would often subject the issuer and its agents to section 11 liability in many transactions now subject only to section 12(2) liability, if at all.⁵¹⁹

Securities sold by the issuer to a third party who immediately turns around and sells the securities to the public on the issuer's behalf would be deemed sold by the issuer, and section 11 would apply.⁵²⁰ To temper this type of broad underwriter liability, the Committee recommended creating a safe harbor for company-registered offerings, by limiting the definition of underwriter in section 2(11) of the 1933 Act⁵²¹ to "persons engaged in the business of a broker-dealer, whether or not registered as such (including banks not required to register as a broker-dealer), who participate in the distribution of securities by an issuer or affiliate."⁵²² This narrower definition of underwriter would confine the strict liability provisions of section 11 and accompanying due diligence obligations to only the named underwriters conducting the offering.⁵²³

b. Due diligence and the role of gatekeepers

According to the Committee, one of the key goals of the new company registration system would be to strengthen and clarify the gatekeeping role played by underwriters and other agents of the issuer in an attempt

518. 15 U.S.C. § 771(a)(2); ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 87-88; *see supra* notes 125-28 and accompanying text (discussing section 12(2) liability under the 1933 Act).

519. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 91-94. Indeed, the Supreme Court's decision in *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995), seems to suggest that private placements escape *both* section 11 and section 12(2) liability, subject only to the requirements of Rule 10b-5. *See id.* at 1073-74. Thus, issuers participating in the full company registration system may incur substantially higher liability levels than previously enjoyed in exempt offerings. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 93-94.

520. ADVISORY COMMITTEE REPORT, *supra* note 1, at 51.

521. *See* 15 U.S.C. § 77b(11) (1994).

522. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 51-52; *see* American Council of Life Insurance, *supra* note 290, at 78,692 (stating that insurance companies and pension and employee benefit plans are not within the definition of underwriter).

523. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 52. The narrower definition also would allow resales of an acquiring company's securities by the acquired company's affiliates and insiders after the acquisition, reversing the current rule. *Id.* app. B at 53; *see* 17 C.F.R. § 230.145(c) (1996) (defining underwriter).

to improve the quality and reliability of 1934 Act reports.⁵²⁴ Because section 11 would apply to all of the issuer's continuous filings in the company registration system, gatekeepers such as underwriters and auditors would have an increased incentive to verify the accuracy of these reports.⁵²⁵ Accordingly, the Committee would recommend amending Rule 176 to include additional factors gatekeepers may consider in determining the level of review they must undertake to satisfy due diligence, based on the mandatory and voluntary disclosure enhancements implemented in the pilot.⁵²⁶ Further, the Committee would allow gatekeepers such as underwriters and outside directors to rely on the efforts of other gatekeepers in determining what actions would satisfy their own due diligence.⁵²⁷ These added considerations would facilitate gatekeepers' reasonable care and reasonable investigation obligations under the 1933 Act, while providing a clear and certain standard under which gatekeepers could structure their actions.⁵²⁸

The various gatekeepers within the company registration system would fulfill differing, but complementary, roles in monitoring issuers' disclosures. The Commission would still be an important gatekeeper, but its focus would shift from review of sporadic, 1933 Act registrations to broader oversight of the continuous disclosure system.⁵²⁹ As mentioned before, the Commission would not review the Form C-1 or offering-specific transactional disclosure given to the investor (i.e., prospectus/confirmation of sale or selling materials) prior to each offering of securities in the new system.⁵³⁰ Instead, the Commission would focus on selective review of 1934 Act reports to ensure the integrity of the disclosures relied upon most by investors under company registration.⁵³¹

524. ADVISORY COMMITTEE REPORT, *supra* note 1, at 40-41, app. B at 29-40; *see supra* notes 408-12 and accompanying text (describing the role of gatekeepers in the current system).

525. ADVISORY COMMITTEE REPORT, *supra* note 1, at 41, app. B at 33-40.

526. *Id.* app. B at 33-40; *see supra* notes 480-90 and accompanying text (discussing the proposed disclosure enhancements of the pilot system).

527. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 97-99.

528. *Id.* at 41-42. Notably, the Committee refused to recommend adoption of an express safe harbor from liability encompassing these factors, and quoted *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968), for the idea that "[i]t is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case." ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 97 (quoting *Escott*, 283 F. Supp. at 697).

529. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 29-33, 95.

530. *Id.* app. B at 29; *see supra* note 483 and accompanying text.

531. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 30-31, 95-96. Review of the issuer's offering-specific transactional disclosures could occur as part of a more general review of the issuer's periodic reports, but would not be a condition prece-

Underwriters occupy perhaps the most prominent gatekeeper role under the current system, and the Committee's proposed system strives to preserve that role. Responding to the concerns of many underwriters that current shelf offerings afford too little time to complete an adequate due diligence inquiry into the accuracy and integrity of issuer disclosures, the Commission adopted the 8-K filing requirement before each public offering to provide a "focal point" for underwriter due diligence duties.⁵³² The Committee emphasized that strengthened due diligence by underwriters and outside directors "is critical to maintaining and increasing investor protection" under the pilot system; thus, instead of scaling back the due diligence obligation altogether, the Commission gave clearer direction as to what actions constitute acceptable due diligence procedures, helping underwriters "limit their exposure by reducing the opportunity for material misstatements to be disseminated to the public."⁵³³ The Committee felt that the recommended additional Rule 176 factors and the permissible reliance on other gatekeepers' efforts would help reduce underwriters' fears of added liability in the new system and improve the quality of issuer disclosures overall.⁵³⁴

dent to equity offerings. *Id.* The Committee would recommend that potential Commission review be preserved, however, for extraordinary transactions, distributions which would not be able to proceed until the Form 8-K was formally declared effective by the Commission. *Id.* app. B at 31-32; *see supra* note 496 and accompanying text (detailing extraordinary transactions and their disclosure requirements).

532. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 33-35. The Committee rejected the "speed bump" approach to underwriter due diligence, wherein some delay would be required (e.g., three days) between the issuer hiring the underwriters and the offering in order to give the underwriters time to adequately review all the issuer's transactional and updating disclosures. *Id.* The Committee argued that this approach "artificially disrupts the process," and that issuers and their underwriters should decide how much time would be enough to conduct due diligence. *Id.* app. B at 33-34. Moreover, the Committee points out that underwriters would have time to review issuer disclosures prior to the offering, during the time the issuer files any updating disclosure and delivers any formal prospectus required as a result of the offering size. *Id.* app. B at 35.

533. *Id.* app. B at 96-97.

534. *Id.* app. B at 96-100. The Committee laid out the specific factors underwriters should consider in determining the required level of due diligence: (1) Senior Management Certifications, (2) Management's Report to the Audit Committee, (3) reviews of issuer disclosures by auditors and other independent gatekeepers, (4) opinions of the underwriter's own analysts who "have followed the issuer for a significant period of time," (5) any review conducted by the issuer's disclosure committee, and (6) the absolute and relative size of the offering versus the size of the issuer. *Id.* app. B at 100-01; *see supra* notes 500-02 and accompanying text (discussing Top Management Certifications), and notes 503-05 (discussing Management Report to the Audit Commit-

Auditors play another gatekeeping role both in the current system and in the proposed company registration pilot.⁵³⁵ As in shelf registration, auditors must give consent to issuers to use their audit reports before each offering, and auditors must file that consent with the Commission by the offering date.⁵³⁶ Before giving consent, the auditor undertakes a review of the issuer's annual financial statements to determine whether any material changes that would necessitate changes to the auditor's prior report have occurred since the issuer filed the statements.⁵³⁷ Annual audits of the issuer's financial statements provide an added certification that information about the issuer and its business is current and accurate, thereby fortifying the reliability of the issuer's continuous disclosure.⁵³⁸ Moreover, underwriters often work closely with auditors in review of financial disclosures in the prospectus, in order to ensure that the information is accurate and not misleading.⁵³⁹

Finally, outside directors are important gatekeepers in the pilot system, working to ensure that all disclosure leaving the issuer is accurate and not misleading.⁵⁴⁰ The proposed disclosure committee, discussed below, is a way to position outside directors as the first line of gatekeepers and enable the issuer to work more closely with its auditors and underwriters to ensure disclosure integrity.⁵⁴¹ According to the Committee, outside directors on the disclosure committee (or audit committee, if assigned the task of reviewing issuer disclosures) should be permitted to base their due diligence procedures on the Committee's proposed disclosure enhancements, as well as the efforts of other gatekeepers involved in the offering.⁵⁴²

tee).

535. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 35-40.

536. *Id.* app. B at 35-36. This consent may apply to all C-1 offerings until the issuer files new audited financial statements. *Id.* app. B at 36.

537. *Id.* app. B at 40. The Statement on Auditing Standards (SAS) No. 37, an accounting guideline designed to standardize auditor reviews, outlines this review. *Id.*

538. *Id.* app. B at 37-40.

539. *Id.* app. B at 40. These accounting reviews are governed by SAS No. 72, and cover issuer compliance with relevant disclosure regulations in audited financial statements and schedules, as well as other unaudited financial information contained in the prospectus. *Id.*

540. *Id.* app. B at 102-04.

541. *Id.*

542. *Id.* at 103-04. The Committee detailed three factors outside directors should consider in determining what level of due diligence the new system requires: (1) Senior Management Certifications, (2) Management Report to the Audit Committee, and (3) reviews of issuer disclosures by auditors and other independent gatekeepers. *Id.* app. B at 104; *see supra* notes 500-02 (discussing Top Management Certifications); *supra* notes 503-05 (discussing Management Report to the Audit Committee).

c. The disclosure committee

As a part of an issuer's general due diligence procedures, the Committee recommended creation of a disclosure committee comprised of outside directors who would review the accuracy and integrity of the issuer's 1934 Act disclosures under the new system.⁵⁴³ The issuer's directors could then safely rely on the committee's investigation into the accuracy of the issuer's 1934 Act disclosures if (1) the delegation of due diligence is reasonable,⁵⁴⁴ (2) the delegating directors "reasonably believe that the disclosure committee's procedures are adequate and were being performed" based on regular oversight,⁵⁴⁵ and (3) "the delegating directors reasonably believe that the disclosure is not materially false or misleading."⁵⁴⁶ If these factors are met, delegating directors can shield themselves from section 11 liability.⁵⁴⁷

The Committee believed that issuer adoption of the disclosure committee program would direct and simplify due diligence efforts, as well as enhance the overall quality of 1934 Act disclosures made to the market.⁵⁴⁸ Through a coordinated effort with other gatekeepers (i.e., underwriters, accountants, and counsel), the disclosure committee would give issuer agents, as well as the issuer itself, greater protection from liability under the company registration system's expanded section 11 standard.⁵⁴⁹

543. ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 43-48. Alternatively, the issuer could assign the duty of such review to the audit committee. *Id.* app. B at 43-44.

544. "[T]he delegating directors [must] reasonably believe that the member(s) of the disclosure committee are sufficiently knowledgeable and capable of discharging due diligence obligations on behalf of the outside directors (if necessary, with the assistance of their professional advisers) and are provided with adequate resources to conduct the requisite investigation" *Id.* at 44.

545. This oversight "would entail requiring the disclosure committee to report periodically to the Board on the procedures followed to ensure the integrity of the disclosure." *Id.*

546. *Id.*

547. *Id.* at 44-45. This defense would mimic the current state law "reliance defense." See Coffee, *supra* note 238, at B7 (arguing for adoption of a reliance defense through use of disclosure committees). Thus, the Committee believed that following these factors would also protect delegating directors from most state liability. See ADVISORY COMMITTEE REPORT, *supra* note 1, at 45 n.33 (noting that Delaware and Pennsylvania law allow creation of committees to discharge directors' fiduciary duties).

548. ADVISORY COMMITTEE REPORT, *supra* note 1, at 47.

549. *Id.* at 46-48.

VI. ANALYSIS OF THE ADVISORY COMMITTEE REPORT

There are numerous potential advantages of the proposed company registration system. Under the system, the hypertechnical interpretations of integration, general solicitation, and restricted securities, with all of their concomitant problems in holding periods, and the troublesome public-private distinction, might cease to exist.⁵⁵⁰ The system would also obviate many disadvantages of the registration exemptions under the 1933 Act.⁵⁵¹ The new system would not subject investors to holding periods or prohibit them from otherwise transferring newly issued securities, thus promoting the marketability of such stock and, consequently, its attractiveness to potential investors.⁵⁵² Company registration would eliminate prohibitions against the solicitation and advertisement of securities, so long as company registration requirements were met.⁵⁵³ Finally, the system has the potential to greatly enhance the quality and integrity of 1934 Act reporting across the capital markets, as well as the gatekeeping functions of underwriters, outside directors, and other professionals.⁵⁵⁴ In sum, capital formation should become easier for companies under the company registration system, and this could lead to more efficient and productive capital markets.⁵⁵⁵

Serious questions remain, however, as to whether the company registration system proposed by the Committee would attract enough issuers to be viable, even in the pilot stage. First, and perhaps most importantly, issuers opting into either the full or modified company registration pilot would be taking on significantly more liability than they are subject to under the current system. The *in terrorem* remedy of section 11 would now apply not only to *all* of the issuer's securities issued under the Form C-1, but also to *all* of the information contained in the issuer's 10-Qs, 10-Ks, and 8-Ks.⁵⁵⁶ This added liability has led commentators to suggest

550. *Id.* at 18, app. B at 50-51 (discussing benefits to registered security transactions); see Wallman, *supra* note 233, at 2-3 (examining effects of the proposed company registration model).

551. See ADVISORY COMMITTEE REPORT, *supra* note 1, at 18, app. B at 50-51.

552. *Id.* app. B at 54-55.

553. *Id.* at 18.

554. *Id.* at 18-20.

555. *Id.* at 16-17, app. A at 24-26.

556. *Id.* app. B at 91. Moreover, it is unclear that further "clarification" of the due diligence defense will comfort issuers entering into potential strict liability for all of their periodic reports. As its name indicates, the due diligence defense is precisely that: a defense. It will not prevent investors from filing lawsuits against issuers for alleged false or misleading statements in the issuer's 1934 Act Forms, a disincentive to enter the system in itself. See *id.* app. B at 89 ("According to several commenters, there are few reported cases actually decided on Section 11 grounds, but in meetings with industry representatives the Committee staff was informed that a significant number of potential Section 11 claims are settled without actions being instituted or

that under the new system, plaintiffs could bring lawsuits for false or misleading disclosures in the issuer's 1934 Act filings without having to prove either scienter or negligence.⁵⁵⁷ Though the proposed system purports to be a model of deregulation, "it contains as many ideas for reregulation as deregulation."⁵⁵⁸

This substantial increase in potential issuer liability raises another problem with the proposed system: do the incentives for issuers to opt into the pilot outweigh the added liability and disclosure costs?⁵⁵⁹ If not, the new system may have trouble attracting *any* participants. The Supreme Court's decision in *Gustafson v. Alloyd Co.*⁵⁶⁰ indicates a trend toward deregulation, suggesting that if issuers remain with the present system a little longer, they may get even greater deregulation of the registration exemptions and further scaled-back liability resale restrictions than under the company registration system.⁵⁶¹ In other words, why should the issuers simply have their cake when soon they will be able to eat it too?

A potential solution to both the incentive and liability problems would be the adoption of a lesser standard of liability for 1934 Act filings and transactional disclosures incorporated by reference into the Form C-1, such as a form of section 12(2) negligence liability as suggested by Bancroft.⁵⁶² This negligence standard could be adopted in place of section 11 for transactional and updating disclosures made in the pilot system, and could incorporate a formal safe harbor reliance defense based on reasonable reliance on outside directors and independent professionals.⁵⁶³ Thus, given a choice between issuing freely tradable shares governed by a negligence standard under a company registration system, or

without reported decisions.").

557. Roberta S. Karmel, *Deregulation: Real or Alleged?*, N.Y. L.J., June 20, 1996, at 7.

558. *Id.*

559. *See id.*

560. 115 S. Ct. 1061 (1995); *see supra* notes 334-43 (discussing the *Gustafson* case).

561. *Id.* at 1073 (holding that the term "prospectus" under the 1933 Act refers to public, not private offerings). For example, a company registration system would subject distributions qualifying as exempt private placements under the current system (thus subject only to section 12(2) liability) to section 11 strict liability. *See* ADVISORY COMMITTEE REPORT, *supra* note 1, app. B at 91-94.

562. *See* Bancroft, *supra* note 15, at 15; *see also supra* notes 371-78 and accompanying text (discussing Bancroft's proposed negligence standard in company registration).

563. *See* Bancroft, *supra* note 15, at 15; *see also supra* note 374 and accompanying text (discussing Bancroft's suggested safe harbor).

issuing restricted shares governed by Rule 10b-5 under the current system, issuers might have legitimate marketing incentives to choose the former.⁵⁶⁴

Another problem with the proposed pilot is whether the Commission will agree to implement it and whether the Commission can fully implement the program by administrative rulemaking alone. Underwriters strongly opposed the adoption of shelf registration for fear that it would reduce or eliminate issuers' need for underwriters altogether and forced the Commission to insert a provision in Rule 415 requiring the use of an underwriter.⁵⁶⁵ Though that situation never happened, underwriters will again make up one of the strongest constituencies in opposition to the proposed pilot, unless, as in shelf registration, the Commission includes an underwriter requirement in the pilot.

Moreover, the Commission's authority to implement a full company registration system is unclear. Company registration represents a clear departure from the express dictates of section 5 of the 1933 Act, at least insofar as it would allow for modification or elimination of the prospectus and registration statement requirements.⁵⁶⁶ Thus, significant disputes may arise over the power of the Commission to implement features of such a system through rulemaking, especially when doing so would either implicitly or directly conflict with the express language of the 1933 Act.⁵⁶⁷ On the other hand, creating a company registration sys-

564. Bancroft, *supra* note 15, at 15. Bancroft suggests that investors would help the issuer make the choice by their preference, and that demand for marketable securities and the added costs of a negligence standard might be low enough not to discourage the issuer from opting into company registration. *Id.*

565. 17 C.F.R. § 230.415(a)(4)(iii) (1996); *see also* Coffee, *supra* note 7, at 1171 ("With some justification, a cynic could describe this requirement as a full-employment act for underwriters, who otherwise were prepared to fight the adoption of shelf registration vehemently."). Indeed, one commentator suggested that underwriters will *inevitably* become obsolete, even in the current system, because of the rise of institutional investors. *See* Langevoort, *supra* note 182, at 750-63.

566. *See* Coffee, *supra* note 238, at B4, B7. Section 5(a) of the 1933 Act makes it unlawful to sell or deliver a security "unless a registration statement is in effect as to [the] security." 15 U.S.C. § 77e(a) (1994). Section 5(b) makes it unlawful to deliver a security "unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title." *Id.* § 77e(b)(2). Section 5(c) makes it unlawful to offer to sell or buy any security "unless a registration statement has been filed as to such security." *Id.* § 77e(c). Thus, outside the scheme of express registration exemptions, the statutory language mandates at least *some* form of "registration statement" and "prospectus."

567. *See* Coffee, *supra* note 238, at B4, B7. Coffee noted that "[a]dministrative implementation of a company registration system would be politically easier but legally more problematic because it poses some close questions about the SEC's statutory authority." *Id.* at B4. As the Securities Act currently is structured, the Commission may not escape the confines of the registration and prospectus concepts in Sections

tem solely through legislation which restructures or partially repeals section 5 could prove too controversial, too impractical, or simply impossible.⁵⁶⁸ Thus, a complete solution to the woes of the current system would almost definitely require action both from the Commission and Congress.⁵⁶⁹

This combined legislative and administrative implementation may be as simple as Congress granting the Commission authority to exempt qualified companies from registration under the 1933 Act, similar to the authority granted to the Commission under section 303 of the American Law Institute's model Federal Securities Code.⁵⁷⁰ Section 303 of the Code permits the Commission to exempt "any person, security, transaction, or any class of persons, securities, or transactions, from any or all the provisions of this Code."⁵⁷¹ Congress could adopt a similar rule with respect to the 1933 Act, giving the Commission the power to bypass the Act through rulemaking and essentially effect an administrative repeal of section 5 of the 1933 Act.⁵⁷² Alternatively, Congress could enact the Federal Securities Code as written, effectively replacing the 1933 Act in favor of a fully unified system of securities disclosure, though such a step is less probable given political practicalities.⁵⁷³

Even in the absence of Congressional action, the Commission could implement some of the features of a company registration system through administrative rulemaking.⁵⁷⁴ The 1933 Act allows the Commission to change the registration and prospectus delivery requirements "if it determines that the requirement of such omitted information is inapplicable to such class and that disclosure fully adequate for the protec-

5 and 10 of the 1933 Act. *Id.*

568. *See id.* at B4.

569. *Id.*

570. Backman & Kim, *supra* note 202, at 21; *see* AMERICAN LAW INST., FED. SEC. CODE § 303 (1980). The Federal Securities Code outlines a unified system of disclosure based essentially on 1934 Act disclosure and company registration. *Id.* § 402-406 (1980). Under the Code, issuers would register securities through an "offering statement" filed with the Commission containing material information and 1934 Act-type disclosures incorporated by reference. *Id.* §502(a)(c) (1980). Issuers would then deliver a prospectus to investors after the confirmation of sale. *Id.* § 504 (1980).

571. FED. SEC. CODE § 303.

572. *See* Coffee, *supra* note 4, at B4.

573. *Id.* at B7. Congress failed to enact the Federal Securities Code once before, in 1980, despite popular support both from the Commission and the academic community. Coffee, *supra* note 7, at 1145-46. This experience suggests that meaningful legislative securities reform may be difficult or impossible to achieve. *See id.*

574. *See* Coffee, *supra* note 4, at B4.

tion of investors is otherwise required to be included within the registration statement."⁵⁷⁵ It is unclear, however, whether these provisions would permit the kinds of wholesale administrative changes involved in company registration.

VII. CONCLUSION

Prior to the Advisory Committee Report, Professor Coffee noted that "[r]eports of the death of the '33 Act can be exaggerated," and cited the limitations of section 5 prospectus delivery, the section 6 proscription against registering multiple securities, and section 11 liability.⁵⁷⁶ As these limitations recede or disappear in the face of the Commission's proposed company registration system, it may be time to write the obituary for section 5.

The company registration system proposed by the Advisory Committee has the potential to provide investors and corporations with the best of both worlds: investors would still be able to obtain the vital information they need concerning new issues to prevent fraud and misinformation from leading them into overly speculative or high risk investments, while companies would be able to acquire needed capital without undue regulatory burdens or delays. Indeed, the interests of the two groups largely coincide; prospective investors have a valid interest in seeing the corporation they wish to invest in obtain other investors' capital quickly and efficiently, thereby allowing the company to increase profits and returns to the new investors.

On the other hand, the proposed system imposes potentially substantial liability costs on issuers and gatekeepers. The section 11 strict liability standard would arguably subject issuers to more lawsuits based on 1934 Act reporting, notwithstanding issuer and gatekeeper attempts to perform due diligence. To the extent that the threat of a lawsuit is significant to issuers, few issuers may choose to enter the new system and subject themselves to more litigation, opting instead to stay with the current system of registration exemptions and resale restrictions.

575. Backman & Kim, *supra* note 202, at 18-19 (quoting 15 U.S.C. §77s(a) (1994)). Section 7 of the 1933 Act, 15 U.S.C. § 77g (1994), details the information required to be disclosed in the registration statement, but section 19(a), 15 U.S.C. § 77s(a), "specifically places the registration statement within the purview of the Commission's rulemaking authority." Backman & Kim, *supra* note 202, at 19 n.7. Moreover, section 10(a)(4), 15 U.S.C. § 77j(a)(4) (1994), gives the Commission express authority to remove any information from the prospectus which is not "necessary or appropriate in the public interest or the protection of investors." Backman & Kim, *supra* note 202, at 19.

576. Coffee, *supra* note 7, at 1159.

As Milton Cohen noted, securities regulation would have looked much different if the Exchange Act had been enacted before the Securities Act or if the two Acts had been formulated initially as a single statute.⁵⁷⁷ Perhaps in such a world, American securities laws would have balanced the best of both worlds: full and fair disclosure to the individual investor, and an efficient system of capital formation for securities issuers. Unfortunately, that is not the world which evolved from the passage of the Securities Act of 1933 and the Exchange Act of 1934. Despite our enlightened hindsight in 1997, we should not forget that in post-crash 1933 the outlines of an efficient securities system were, at best, seen through a dark glass.

Still, modern securities terrain differs fundamentally from that surveyed by the architects of the 1933 Act, now featuring intense competition for capital dollars, the dominance of savvy institutional investors, and the Information Superhighway. The Securities Act of 1933 was simply not designed for this world. Instead, the Commission should incorporate the Act's goal of full and fair disclosure into a new generation of disclosure system, one which eliminates the inefficiency and hypertechnicality needed to sustain the old system, and replaces them with unified, continuous disclosure designed to make all material information about a company and its securities available to an investor for the least cost. If and when a company registration system is adopted, the Securities Act of 1933, at least as it has been known for over sixty years, will be dead. Experience with the integrated disclosure system and universal shelf registration, however, should instruct us that the system is going in the right direction. Company registration is the next logical step.

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577. Cohen, *supra* note 31, at 1341.

