

RUN # - 05209213

LT05.CHO007.RR2

PAGE RANGES - (409-479)

TYPESET PAGE COUNT - 71

PREAMBLE - D2-17

PAGE IMAGE SIZE: 35.500 x 50.000

PREAMBLE - UCBCHOI

PUB TYPE - 25

PROOF

PUB DATE - 12/31/05

REV. - 7.1

DATE - 07/28/05

TIME - 14:38

JOB NAME - CHO007

JOB # - 59778

REG# - 0-3102-2

OUTPUT DSN = video.pf05.cho007.rr2

FILENAME = 20900427.ps

GRAPHICS PATH=\ANALYTICAL\40355240

CHAPTER 7

PUBLIC OFFERINGS

Rules and Statutes

—Sections 2(a)(3), 2(a)(4), 2(a)(7), 2(a)(10), 2(a)(11), 4(1), 4(3), 4(4), 5, 7(a), 8, 10 of the Securities Act

—Rules 134, 135, 137, 138, 139, 153, 163, 163A, 164, 168, 169, 172, 173, 174, 405, 408(b), 409, 412, 413, 415, 420, 421, 424, 430, 430A, 430B, 430C, 433, 460, 461, 462 of the Securities Act

—Forms S-1, S-3

—Regulation S-K, Item 512(a)

—Rule 15c2-8 of the Exchange Act

—Regulation M, Rules 100-105

MOTIVATING HYPOTHETICAL

Sherry is the CEO of Smartway, Inc., an Internet company providing an on-line market for unsold airline tickets. Smartway's primary customers are last-minute travelers willing to fly on a moment's notice for heavily discounted tickets. Established in 2000, Smartway now sells over \$10 million in tickets per month and has a growing base of customers, many of whom provide Smartway with repeat business. Smartway has contracts with several of the major airlines to sell last minute tickets. Many of these contracts, however, are due to expire in the next couple of years. Afraid that the airlines may attempt to set up their own last-minute air travel service, Sherry believes that Smartway must expand rapidly to become the dominant player in the last-minute travel market. Once Smartway achieves a "monopolist" position, Sherry believes that the airlines will have no choice but to sell their last minute tickets through Smartway. To fund the expansion, Sherry is considering various financing options, including an initial public offering (IPO) of Smartway common stock. Smartway common is not currently publicly traded.

I. ECONOMICS OF PUBLIC OFFERINGS

Businesses exist to make a profit. To create those profits, businesses sell both goods and services to customers in return for money. Revenues translate into profits, however, only after businesses pay for the inputs required to produce those goods and services. Costs may include expenses for employees, electricity, supplies, leases, and so on. Certain expenses go to

17 items that provide value in the immediate future (e.g., the wages for an
employee to work for the next month). Other expenses, termed capital
expenses, reflect purchases of tangible assets that can be used for produc-
tion for an extended period of time (e.g., a computer network).

18 Some businesses require relatively few capital assets. Consider a pho-
tography business run by a sole proprietor. The sole proprietor may
purchase a camera and some developing equipment. By far the greatest
expense of the photographer is her own time and effort (commonly referred
to as the photographer's "human capital," although not by accountants).
At the other end of the spectrum are businesses requiring significant
amounts of more traditional capital assets. General Motors makes automo-
biles and trucks. To produce those vehicles, General Motors owns a number
of factories. In addition, it purchases large amounts of steel and other raw
materials.

19 Capital-intensive businesses may have a timing problem. Products will
eventually generate revenue when sold, but businesses often must make
expenditures well before the time of sale. General Motors needs to spend
considerable amounts of money up front either constructing or purchasing
factories (say \$200 million). The expenditure on a factory, characterized by
accountants as a capital expense, will generate revenue when output is
sold, not only in the year the factory is built but also for many years after
(say \$10 million per year). Although the stream of revenues over time may
eventually exceed the initial capital costs, a capital-intensive business
initially spends far more cash than it receives (in the case of GM, a \$190
million deficit after one year).

20 Companies have a number of options to cover such a cash flow
shortfall. Many smaller businesses find investment funds through either
internally generated funds, such as the prior year's profits, or through
contributions of money from the founder-owners of the business. A photog-
rapher in a sole proprietorship will often put up her own money into
buying a camera and development equipment. As the business grows, the
photographer may use some of the earnings to purchase additional gear.

21 Larger businesses often face capital expenditures that dwarf the re-
sources of most individuals. Few individuals are able to finance the pur-
chase of an entire automobile factory (and even if they could, they may not
wish to put such a substantial portion of their wealth into one particular
investment). Some larger businesses may finance a large capital expendi-
ture out of internally generated funds. Microsoft, for example, sits on an
enormous cash hoard that it can draw upon to purchase other businesses
without relying on outside sources of financing. Businesses lacking the
tremendous cash flow of Microsoft have a range of external solutions to the
timing problem.

22 Banks lend considerable sums to businesses. As part of the loan, banks
will typically demand a security interest in the assets of the debtor-business
and possibly a personal guarantee from the owners of the business. Bank
debt, however, is not without problems. As a loan, bank debt typically
requires businesses to make regular interest and principal payments. For

22 some types of investments, the expected stream of revenues may be uncertain and only available far into the future, if at all. In the late 1990s, entrepreneurs started a flurry of new Internet-based businesses. These startups, including Amazon.com for example, promised potentially high returns, but only in the distant future and with great risk. (Most of these startups did, in fact, fail.) Such companies simply will not generate adequate revenue to make interest and principal payments in the first few years after the loan is made. Banks will also often impose numerous covenants designed to protect their debt investment, including minimum debt-equity ratios and limitations on the ability of a company to spend their money.

23 Many businesses will seek additional capital in the form of equity. Equity capital affords the flexibility of not requiring any fixed monetary payoff, such as an interest payment for a loan. As the saying goes, “Equity is soft; debt is hard.” Companies that only expect to be profitable in the distant future may find equity financing better suited to their needs. Equity, however, has a downside. From the perspective of the companies’ pre-existing owners, bringing in more equity owners dilutes the potential upside return from the business. Common stock, for example, provides holders the “residual” return of all profits after everyone else is paid, including creditors. If the company sells more common stock, the pre-existing common stock holders (e.g., the founders of the company) are left with a smaller proportionate share of the profits. This effect is commonly called “dilution.”

24 Bringing outside investors into a business also poses another problem: How will the outside investors know that the business will be operated to benefit *all* the equity owners, rather than have its profits and assets diverted to the founders or managers of the firm? Businesses seeking to expand their ownership base typically will take advantage of one of the off-the-shelf organizational forms provided under state law (e.g., limited partnership, LLC, or corporation). Those forms carry with them restrictions on self-dealing by managers, which are intended to ease the concerns of potential investors. If effective, these restrictions increase the amount investors are willing to pay for an ownership stake in the business.

25 In summary, a business project requiring large initial amounts of money and promising to provide even more money in the future is typically at the heart of the desire for more capital. Moreover, the process of raising capital is not one-size-fits-all because businesses face choices. Companies may self-finance through retained earnings or seek a loan from a bank. Companies may turn to their existing shareholders for more capital contributions. Or companies may turn to the broader capital markets for financing. In this chapter we discuss the application of the federal securities laws to one avenue for raising capital—the decision on the part of companies to raise capital through a public offering of securities into the U.S. capital markets. Later in Chapter 9, we discuss a different option—the private placement of securities to more sophisticated investors.

A. A BRIEF DESCRIPTION OF THE PUBLIC OFFERING PROCESS

Suppose that Sherry and the board of directors of Smartway, Inc. make the decision to pursue an initial public offering of the common stock of Smartway. How do they proceed? The first step is talking to an investment bank, typically located in Wall Street. Among the large investment banks are household names such as Goldman Sachs and Morgan Stanley.

If Smartway has a visible public presence and the market for IPOs is “hot,” investment bankers already may have approached Sherry about a potential public offering. The market for IPOs ebbs and flows and the number of offerings rises dramatically during hot periods. In a slower market, or if Smartway is less prominent, Sherry may need to seek out the Wall Street investment banks herself, either directly or through an intermediary such as Smartway’s attorneys (who may in turn have contacts with Wall Street law firms and investment banks).

What role do investment banks play in a public offering? In their capacity as underwriters, investment banks perform several critical tasks. First, for companies going public for the first time (and to a lesser extent for more seasoned issuers), underwriters provide advice on the structure of the corporation, the offered securities, and the offering amount and price. The goal of this process is to depict the firm and the offering in the best light possible for public investors. Many startup companies develop complex capital structures and control relationships to accommodate the interests of various early-stage investors. The public capital market, in contrast, prefers simplified capital structures. For example, IPO companies will typically have only one class of common stock. Among other things, a simplified capital structure makes it easier to value the stock of a corporation. Certain corporate governance features are also favored in the public capital markets (such as an independent board and a separate chairman and CEO), so companies going public will typically adjust their board structure to appeal to public owners.

Second, investment banks help guide companies through the SEC’s registration process. As you will discover in this chapter, the securities laws require companies making a public offering to file and distribute mandatory disclosure documents containing information on the company, its management, and financials as well as information related to the offering (e.g., the security being offered, the underwriters, the discount for the underwriters, the number of securities offered, and the offering price). The securities laws also restrict the ability of companies to discuss the offering and disseminate information that may influence or otherwise condition the market for the upcoming public offering.

Finally, investment banks will take on a marketing role, assisting the company in selling the securities to the public. As repeat players in the capital markets, investment banks bring with them a wealth of contacts with institutional investors and securities dealers. As we discuss below, the role of the investment bank turns on the form of offering employed.

32 1. DIFFERENT TYPES OF OFFERINGS

33 Issuers can access the public capital markets in a number of ways. The securities laws do not mandate any particular means of sale to the public. Indeed, recent years have witnessed the rise of Internet-based offerings and auction offerings. The most common type of offering by far, however, is the firm commitment. Below we describe briefly the firm commitment as well as three lesser-used alternatives—best efforts, direct public offerings, and the Dutch auction.

34 *Firm Commitment.* In a firm commitment, the underwriter guarantees the sale of the offering. Technically, the underwriter (or a group of underwriters forming a “syndicate”) will purchase the entire offering from the issuer before turning around and reselling the securities to investors. From the issuer’s standpoint, the underwriter’s purchase ensures that the issuer will receive a certain amount of proceeds from the offering. The underwriter purchases the securities from the issuer at a discount to the price at which they subsequently will be offered to the public. The underwriter receives the discount for both helping to sell the offering and taking on the risk that the offering may not sell.

35 Consider the following example. If Smartway plans on selling 10 million shares at \$20 per share, the underwriter may purchase the shares from Smartway at \$18.60 per share, for a \$1.40 underwriter’s discount—often referred to as the “gross spread.” Typically, the gross spread accounts for 7% of the public offering price for an initial public offering. The underwriter earns its return when it resells the shares to the public at \$20 per share.

36 The certainty enjoyed by the issuer by way of a firm commitment offering may help ensure the value of the offering. Consider a company that needs to raise \$100 million to develop a new product. A firm commitment offering ensures all investors that the company will in fact obtain the full \$100 million. Knowing that the company will receive the financing it needs to launch the new product may reassure investors that the offering will be a profitable investment for them.

37 *Best Efforts.* An investment bank assisting in a best efforts offering agrees only to use its “best efforts” to sell the offering. Unlike a firm commitment, the investment bank does not purchase the securities. Instead, the investment bank acts purely as a selling agent, receiving a commission on each security sold. Compared to the firm commitment offering, the investment bank assumes less risk and the issuer retains more risk. If the securities do not sell, the issuer will receive smaller proceeds. The underwriter will only bear the opportunity cost of commissions unearned; it will not be stuck holding unattractive securities. Typically smaller, more speculative companies that cannot attract a firm commitment underwriting from an investment bank raise capital through best efforts public offerings.

38 Investors face greater risks in a best efforts offering. First, because the investment bank is not putting its own money on the line, the investors

38 have less confidence in the securities' valuation. Investment banks in a
firm commitment offering, by contrast, have a strong incentive to ensure
that the offering is priced correctly, or even underpriced, lest they be left
holding the securities.

39 Second, the issuer may not sell out the entire issue in a best efforts
offering. If the offering is intended to fund the development of a new
product, or the entry into a new market, obtaining only a fraction of the
expected offering proceeds may jeopardize the business plan. How can a
company launch a new product that will require \$100 million if it only
raised \$25 million in a best efforts offering? To combat such fears, a variant
of the best efforts offerings is the conditional best efforts offering under
which the underwriters and issuer promise to rescind all sales if the
offering is not sold out ("all or nothing").

40 *Direct Public Offering.* Issuers can sell securities directly to the invest-
ing public without an underwriter. The most common form of direct public
offering involves an offering by a company to its existing public sharehold-
ers (referred to as a "rights" offering), but it is also possible for a company
to sell to the public at large. Direct public offerings to the public at large
are rare. First, many issuers lack the necessary expertise to complete a
public offering (pricing, marketing, etc.). Issuers also lack a pre-existing
network among securities dealers and large institutional investors. Second,
investment banks play a gatekeeping role. Investors look to the investment
bank to screen out poor or fraudulent offerings. With no investment bank
to vouch for the offering, investors are likely to discount substantially the
price they are willing to pay for the offered securities.

41 *Dutch Auction Offering.* A recent innovation in public offerings is the
Dutch auction. In a Dutch auction, the issuer and underwriters do not fix a
price for the offering. Instead, investors place bids for a desired number of
shares at a specified price. After all the bids are placed, the issuer then
chooses the highest price that will (given the range of bids) result in the
offering completely selling out. So for example, imagine that Smartway
wants to sell 1 million shares. The following bids are made:

42 Bid 1: 200,000 shares for \$50 per share

43 Bid 2: 150,000 shares for \$45 per share

44 Bid 3: 500,000 shares for \$40 per share

45 Bid 4: 150,000 shares for \$35 per share

46 Bid 5: 300,000 shares for \$30 per share

47 Bid 6: 400,000 shares for \$20 per share

48 In this case, the market-clearing price for 1 million shares is \$35 per share.
At the offering price of \$35 per share, the issuer will be able to sell the full
1 million shares. Put another way, the Dutch auction procedure allows the
issuer to set the highest single price that will still allow it to sell all the
desired shares. It also tends to result in substantially lower fees for the
underwriters.

49 2. THE UNDERWRITERS

50 An important hierarchy exists among underwriters. Some well-known underwriters stand at the top of the hierarchy (such as Goldman Sachs and Morgan Stanley, among others). This group is often referred to as the “bulge bracket.” Typically, after a successful issuance of securities, the underwriters involved will publish an advertisement known as a “tombstone” providing details of the offering. The tombstone will list all of the underwriters in a series of brackets, with the bulge bracket at the top. Placement in the different brackets depends on the reputation of the particular underwriter and the amount of the offering underwritten by the underwriter (the two concepts are linked, with bulge bracket underwriters typically underwriting the largest portions of the offering and receiving greater selling concessions relative to the other, lower-ranking underwriters participating in the offering). Higher-reputation underwriters generally participate only in offerings of more established, well-known companies.

51 In recent years, many new firms have joined the ranks of underwriters. For example, Wit Capital Group Inc. was established in the late 1990s to assist companies engaged in offerings over the Internet. Having more investment banks competing for underwriting business may reduce the cost to issuers. Competition, on the other hand, may lead individual investment bankers eager to drum up more business to sacrifice the long-term reputation of the underwriter to land the big deal at hand, even if the issuer is of questionable quality. Doing so may result in a large bonus for the specific investment banker for bringing in more business, while the reputational hit the underwriter will eventually receive once the market learns of the issuer’s problems is spread across the entire firm.

52 In the red hot public offering market of the late 1990s, investment banks competing with one another would often bring in-house analysts along for a sales pitch to an issuer’s management (a practice known as a “bake-off”). Allegedly, the investment banks would attempt to win the issuer’s business by promising, among other things, that the analyst would provide very positive analyst reports, whatever the merits, on the company. The positive reports would help elevate the public offering price and sustain the secondary market price of the company, allowing the company’s insiders to eventually sell their own holdings at a higher price. The New York State Attorney General, Eliot Spitzer, investigated such practices at Merrill Lynch and other investment banks, eventually resulting in a joint settlement with the SEC and ten major Wall Street investment banks for over \$1.4 billion in 2002. NASD and NYSE rules now limit such bake-offs.

53 3. THE UNDERWRITING PROCESS

54 Most public offerings are conducted as firm commitment offerings. Although in theory a single investment bank could take on the entire firm commitment offering, typically a syndicate of underwriters will share the offering. Spreading the offering out among multiple underwriters reduces the risk to any one underwriter of purchasing the securities from the

54 issuer. Although this reduces the potential profit for any one underwriter,
it also reduces the risk of an unsold offering.

55 In the syndicate, typically one to three underwriters will take on the
role of the managing underwriter. Even if an offering has more than one
managing underwriter, one investment bank will still take the primary role
in the offering (often referred to as the lead or book-running manager). The
managing underwriter in charge of the “book” is responsible for allocating
the offered shares to investors. The managing underwriter will take charge
for getting the issuer ready for the public offering, ensuring that the
registration statement is filed and becomes effective, pricing the offering,
performing due diligence for the registration statement, negotiating with
the issuer on behalf of the syndicate, and managing the ultimate distribu-
tion of the securities to the public. For these extra services, the lead
managing underwriter will typically take 20% or so of the gross spread. So
if Smartway sells shares to the underwriters at \$18.60 and the IPO price is
\$20.00, the lead managing underwriter will receive from the underwriters
\$0.28 per share (20% of the \$1.40 gross spread) as compensation for its role
as lead manager.

56 Initially the managing underwriter and the issuer will sign only a non-
binding letter of intent to do the public offering. The letter of intent will
specify the role of the managing underwriter in the registration process and
the size of the underwriting discount (i.e., the gross spread). The letter of
intent often will also specify an overallotment option for the underwriters
(referred to as the “Green Shoe option,” after the first company to use the
technique) under which underwriters, at their discretion, may expand the
number of shares in the offering up to 15%. The letter of intent will not
specify one critical term: the price of the offering. Pricing is left until
later—just before sales commence. Only at that point will the issuer and
the underwriters enter into a binding underwriting agreement.

57 After the registration statement is filed, the managing underwriter(s)
will invite other underwriters to participate in the syndicate for the firm
commitment offering. To govern their relationship with each other, the
members of the syndicate will sign an agreement among themselves. The
agreement among underwriters will grant to the lead underwriter the
authority to act on behalf of the syndicate. The agreement among under-
writers will also specify each underwriter’s liability for the offering, which
will typically be proportionate to the amount of shares they underwrite.

58 Members of the syndicate are compensated out of the gross spread
through a “selling concession.” Typically, the selling concession is about
60% of the gross spread. For the Smartway gross spread of \$1.40 per share,
the selling concession is equal to \$0.84 per share. Each underwriter
receives a selling concession in proportion to the number of shares that the
underwriter purchases from the issuer (the underwriter’s “allocation” of
shares). If any of the allocated shares are sold by another underwriter or a
dealer, the selling concession goes to them.

59 The remaining 20% of the gross spread (equal to \$0.28 per share in the
Smartway offering) then goes to paying various expenses involved with

59 underwriting the offering. These expenses include the fees of the counsel for the underwriters, expenses relating to the “road show,” and the costs of stabilization (covered below). The road show involves representatives from the issuer and lead underwriter traveling from city to city promoting the offering to institutional investors.

60 Just before the offering is made to the public, the issuer and the lead underwriter, acting on behalf of the underwriter syndicate, will finally sign a formal underwriting agreement. The underwriting agreement will set forth the terms of the offering including the number of shares to be sold (by the issuer to the underwriters), the public offering price, the gross spread, and the over-allotment option. The terms of the agreement are determined by bargaining and regulations. The NASD requires that underwriting fees be “reasonable.” Moreover, the SEC will not declare a registration statement effective (i.e., ready for public sale) until the NASD approves the underwriting arrangement. See Rule 461 of the Securities Act. The underwriting agreement will also contain representations and warranties by the company to the underwriters, relating to, among other things, the completeness and accuracy of the information contained in the registration statement. In addition, the underwriting agreement frequently will include a provision requiring the issuer to indemnify the underwriters for certain securities law liabilities arising from the offering. (The enforceability of this provision, however, is open to question, as discussed below.)

61 4. UNDERPRICING

62 One of the most curious aspects of the IPO market is underpricing. Companies going public for the first time on average experience a large first-day jump in their stock price from the initial public offering price. During the late 1990s, some Internet companies experienced a first-day increase of over 100%. For example, theglobe.com, an Internet website hosting company, went public at \$9 per share and ended its first-day of trading at \$63½ per share, trading as high as \$97 on that first day. Underpricing of this sort suggests that issuers are leaving money on the table when they negotiate with the underwriters over the offering price. Issuers could price their offerings higher and obtain greater offering proceeds; rather than obtaining \$9 per share for its offering, theglobe.com could have received up to \$60 or so per share. Instead, the difference between the offering price and the secondary market price on the first day of trading goes to those investors lucky enough to purchase at the \$9 offering price. What explains the underpricing phenomenon?

63 Underpricing is even more puzzling given the fact that offerings that are substantially underpriced, and experience a correspondingly large first-day “pop” upwards in the stock price, perform relatively poorly over the first three years of the offering. (Query: Where is theglobe.com today?) Why are investors paying steep secondary market prices to buy shares that are likely to perform poorly? Underpricing is greater during “hot” issues markets when large numbers of IPOs are sold into the public capital markets. One of the central advantages claimed for the Dutch auction

process, described above, is the elimination of underpricing, which means that the issuer is able to capture greater proceeds from the offering. Recall that in a Dutch auction, the issuer obtains information on the market's willingness to pay for its securities from individual bids for specific quantities of securities at certain prices. Using the information from the pool of bids, an issuer can select the highest price that produces sufficient bids to sell out the offering. The issuer through a Dutch auction obtains the maximum the market is willing to pay, leaving no money on the table.

The Dutch auction process, while beneficial for the issuer, is less clearly good for the investing public. If underpricing results from the irrational exuberance of investors artificially driving up stock prices on the first-day of the IPO above fundamental values, the Dutch auction process may not eliminate the underlying irrational exuberance. The exuberant will simply put in an inflated bid in the auction. The winners in a traditional offering—at the expense of the exuberant investors—are the initial IPO purchasers (often institutional investors), who purchase underpriced shares and profit by reselling these shares in the secondary market. In a Dutch auction, the issuer profits instead of institutional investors. Although the issuer may gain higher offering proceeds, the offering price produced by the auction will still reflect any irrational frenzy in the market, leading to an offering price far in excess of the company's fundamental value. As the market cools, the secondary market price may decline just as it would under a more traditional public offering.

5. CAPITAL STRUCTURE

A common misperception is that companies going public sell their entire capital stock to the public as part of that initial offering. Suppose that Smartway seeks to sell 10 million shares at \$20 per share in its IPO. After a successful offering, Smartway will have \$200 million in gross proceeds (ignoring, for now, the gross spread and other expenses) and 10 million shares of publicly traded common stock. As depicted in the table below, the 10 million shares *could* represent the entire amount of outstanding Smartway common stock. For example, a company could engage in a public offering creating the *initial* capital stock of the corporation as depicted below:

	Assets	Liabilities (Equity)
Pre-Offering	\$0	\$0 (from 0 shares of common stock)
Post-Offering	\$200 million	\$200 million (from 10 million shares of common stock sold in the public offering)

Such offerings are not common. A company is unlikely to succeed with such an offering. Investors will be dubious of an offering by a company with no assets, no prior owners and no operating history. A company without any operating history is simply too great a risk. Even if the initial managers of the corporation have a strong business background, investors will wonder why the initial managers have not invested any of their own money prior to the offering.

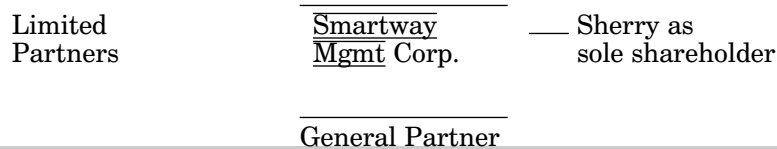
78 Companies typically come to an initial public offering with at least
 some, and often extensive, operating and financial history. With this
 history come assets and a pre-existing ownership base. Consider the exam-
 ple of Smartway as depicted in the table below.

	Assets	Liabilities (Equity)
80 Pre–Offering	\$25 million	\$25 million (from 15 million out- 82 standing shares of common stock 84 primarily in the hands of Sherry, 85 the CEO, and other insiders)
86 Post–Offering	\$225 million	\$225 million (from 25 million out- 87 standing shares of common stock af- ter 10 million are sold in the public offering)

89 Things could get even more complicated. Suppose that in the past, the
Smartway business needed a quick injection of capital to overcome a short-
 term liquidity problem. Jack, a wealthy outside investor, provided the
 capital in return for preferred stock in Smartway.

	Assets	Liabilities (Equity)
91 Pre–Offering	\$25 million	\$10 million of preferred stock in the 93 hands of Jack (convertible into 5 95 million shares of common stock)
		\$25 million (from 15 million out- 97 standing shares of common stock 98 primarily in the hands of Sherry, the CEO, and other insiders)
99 Post–Offering	\$235 million	\$225 million (from 30 million out- standing shares of common stock af- ter 10 million are sold in the public offering—with Jack converting his 100 preferred into 5 million shares of common stock)

102 Moreover, not all businesses are structured as corporations. Not only
 do businesses have a choice in the form of external financing they pursue,
 but they also have a choice of the organizational form under state law
 (including sole proprietorships, partnerships, limited liability companies
 and corporations). Prior to its initial public offering, for example, suppose
Smartway conducts its business through two separate (and interrelated)
 organizational forms: the limited partnership (Smartway Partnership) and
 the corporation (Smartway Management Corp).



Smartway
Partnership

The limited partnership form allows outside investors (pre-public offering) to invest in Smartway while enjoying limited liability and favorable tax treatment. Limited partnerships require one general partner to face unlimited liability. To avoid unlimited liability, a corporation, Smartway Management Corp., takes on the role of general partner. Sherry then receives her return as the shareholder of Smartway Management Corp.

Although this moderately complicated structure may work for a small number of outside investors, investors in the public capital markets typically prefer a simple corporate structure, with the entire business held by one formally incorporated entity, and a simple capital structure, e.g., only common stock for equity. The simple corporate and capital structure makes it easier for outside investors to determine precisely what they will receive from the investment and what the pre-existing investors of the corporation will receive. Prior to going public, the business, the lead underwriter, and attorneys will reconfigure the various ownership interests and state law entities into a single corporate form with common stock ownership.

Further changes may be necessary. Investors typically prefer companies incorporated in Delaware, the choice of most large public companies. As part of the process of reorganizing for the initial public offering, businesses incorporated in other states will typically reincorporate in Delaware.

B. PUBLIC OFFERING DISCLOSURE

The primary problem facing investors in a public offering is valuing the offered securities. Issuers and their insiders enjoy an informational advantage over outside investors. The risk for outside investors is that issuers may use this advantage to sell overvalued shares. More sophisticated investors compensate by demanding a lower price to purchase shares. The result is that issuers are forced to accept less for their securities than they would otherwise receive if investors had full information, which raises the cost of capital for issuers.

The securities laws respond to the problem of informational advantages by requiring disclosure. The two primary disclosure documents are the registration statement and the statutory prospectus, which consists of Part I of the registration statement. The two documents give rise to two different levels of liability exposure (a topic covered in considerably more detail in Chapter 8):

<u>Document</u>	<u>Use</u>	Special Antifraud Provision
Registration	Filed with <u>SEC</u>	Section 11 Liability

130	Statement	—Due diligence de- fense for non-issuer participants
131		
132	Statutory Prospectus	Section 12(a)(2)
133	Distributed to	Liability
134	Investors	—Reasonable care de- fense for sellers
135		

137 For domestic companies engaged in a public offering, the two basic forms for the registration statement are Forms S-1 and S-3. Information on these registration forms can be divided into three categories: (a) transaction-related information (e.g., the offering amount, use of proceeds, underwriters, etc.), (b) company information, and (c) exhibits and undertakings. The forms differ both in what they require and in their eligibility requirements as follows:

- 138 ● Form S-1 is available to all issuers. Form S-1 is the most comprehensive of the disclosure documents and contains all three categories of information disclosure. The prospectus under Form S-1 contains both company information and transaction-related information. Form S-1 issuers that are Exchange Act reporting issuers and current in their filings for the past twelve months, among other requirements, may incorporate company-related information by reference from prior SEC filings.
- 139 ● Form S-3 is available to issuers, that have, among other situations, been a reporting company for one year and have over \$75 million capitalization in the hands of non-affiliates. Form S-3 companies may incorporate by reference company-related information contained in documents already filed with the SEC and are not required to give investors an annual report.

140 Forms S-1 (for certain Exchange Act reporting issuers) and S-3 reflect the SEC's choice to allow incorporation-by-reference of certain information. Under incorporation-by-reference, issuers are able to refer to similar information disclosed in the past in another SEC filing—e.g., Forms 10-K, 10-Q, and 8-K (discussed in Chapter 4).

141 Facilitating incorporation-by-reference is the SEC's streamlined integrated disclosure system (also covered in Chapter 4), which provides a consistent set of disclosure requirements in Regulations S-K and S-X for both the Securities and Exchange Acts. Incorporation-by-reference relies on both integrated disclosure and an assumption about how the capital markets process information. Investors for companies trading in a relatively efficient market can rely on publicly available information being reflected in the stock market price. Alternatively, for well-known companies, brokers and others who filter information on behalf of retail investors may canvass the entire array of SEC filings for a company, providing a unified assessment.

142 The Internet also makes it easier for investors to get information from multiple documents. Indeed, the notion of “a” document is somewhat

142 amorphous on the Internet. If a document on the Internet hyperlinks to
disclosure contained in another document, should this be treated as one or
two documents? Does it matter from the perspective of an investor if the
investor has to “click” through a link to obtain more information on a
potential investment, as opposed to scrolling down within the same docu-
ment?

143 1. PLAIN ENGLISH DISCLOSURES

144 In the late 1990s, the SEC reformed the statutory prospectus to make
it more accessible to everyday investors. Instead of turgid prose containing
jargon and terms comprehensible only to financial professionals, the SEC
mandated that the prospectus contain language drafted in a “clear, concise
and understandable manner.” Consider the following Securities Act rules
governing how information is presented in the statutory prospectus:

145 Rule 420—Legibility of Prospectus—Includes, among other require-
ments, that the prospectus must be in Roman type “at least as large
and as legible as 10-point modern type.”

146 Rule 421—Presentation of Information in Prospectuses—Issuers can
vary the order of information provided in the prospectus but must
ensure that the order does not “obscure any of the required informa-
tion.” Information in the prospectus must be presented in a “clear,
concise, and understandable manner” and follow “plain English” prin-
ciples. Issuers must use “short sentences,” “active voice,” and avoid
“legal and highly technical business terminology.”

147 Despite the admirable goal of more readable prose, were the SEC's
plain English reforms worth the cost? Consider the audience for the
registration statement and prospectus in a public offering. If retail inves-
tors (including individual day traders, retirees, etc.) are the primary audi-
ence for the offering documents, plain English disclosure may make those
documents more comprehensible. That assumption, however, is undercut
by the fact that sophisticated institutional investors make up by far the
largest segment of investors participating in public offerings. Even among
those individual investors who attempt to purchase in an IPO, how many
actually read the disclosure documents rather than relying on the advice of
sophisticated intermediaries (such as a broker) or their own “gut” instinct?
The SEC has forced issuers to write more clearly—but has anyone noticed?

148 Jargon is not always bad. Some forms of highly technical phrases
provide a quick and certain form of communication among those familiar
with the jargon. Consider the phrase “cash flow needs will become signifi-
cant in the second quarter of the upcoming fiscal year.” Is “cash flow”
jargon? What if we force firms to replace this language with something
more understandable, but somewhat less precise such as: “We’re spending
more than we’re taking in.” Although a larger segment of investors may
understand such a phrase, more sophisticated investors may glean less
information if “cash flow” has a commonly understood meaning. Has plain
language disclosure sacrificed depth for breadth in disclosure?

149 2. SMALL BUSINESS ISSUERS

150 The public offering process is expensive, particularly for companies going public for the first time. Their direct costs include hiring an attorney and an independent auditor, reorganizing the company, and paying the underwriters' commission. Companies doing an initial public offering also face a several month delay from the time they start drafting the registration statement to the time the securities are sold. For smaller issuers raising only a modest amount of capital, the high costs of a full-blown public offering may cause the issuers to look elsewhere for their capital needs. For example, issuers may sell to a restricted set of more sophisticated investors in a private placement (covered in Chapter 9).

151 To encourage small businesses to raise capital, the SEC provides two additional registration statement forms: Forms SB-1 and SB-2. "Small business issuers"—defined as issuers with revenues of under \$25 million for their most recent fiscal year (subject to some exclusions)—are eligible to use Form SB-2. Unlike the other registration forms, Form SB-2 references Regulation S-B, a simplified version of Regulation S-K. Regulation S-B provides "plain language" instructions. Issuers must provide only two fiscal years' worth of audited income statements and an audited balance sheet for the past year. Financial information must comport with Generally Accepted Accounting Principles but does not have to follow Regulation S-X. Form S-1, in contrast, requires three fiscal years of audited financial statements comporting with Regulation S-X. Additionally, Form SB-2 requires less extensive disclosure of the non-financial information.

152 Form SB-1 is available to small business issuers for offerings up to \$10 million in any twelve-month period. Form SB-1 also draws on Regulation S-B. Form SB-1 is even more streamlined than Form SB-2, with issuers providing disclosure in a simple question and answer format. Form SB-1 requires the same audited financial statements as Form SB-2.

153 Although reducing offering costs may stimulate the growth of small businesses, does it come at the cost of investor welfare? Consider the risks of fraud. On the one hand, larger issuers with active secondary markets for their stock have the potential, because they offer greater amounts of securities, to defraud larger numbers of investors than smaller companies. On the other hand, greater numbers of securities analysts follow larger companies and few or none follow small business issuers, increasing the opportunities for a smaller company to mislead investors.

155 **II. THE GUN-JUMPING RULES**

156 The federal securities laws tightly regulate public offerings under a regime often referred to as the gun-jumping rules. The gun-jumping rules have at least three broad goals. First, the registration process revolves around the generation of two mandatory disclosure documents: a formal registration statement and a statutory prospectus. Second, the gun-jumping

156 rules require the distribution of the statutory prospectus in connection
with the offering to the investing public and for a specified period of time
thereafter. Third, the gun-jumping rules restrict information about the
offering if it is not part of the registration statement or prospectus.

157 The public offering process is divided into three periods: the Pre-Filing
Period, the Waiting Period, and the Post-Effective Period. The Pre-Filing
Period ends and the Waiting Period begins when the issuer files the
registration statement with the SEC. The Waiting Period gives way to the
Post-Effective Period when the SEC declares the registration statement
“effective.”

160 Pre-Filing Period | Waiting Period | Post-Effective Period
162 Filing of the Registration Statement | Registration Statement Effective
163
164

166 The three period structure of the gun-jumping rules dates back to the
enactment of the Securities Act in 1933. Since then, the SEC has modified
repeatedly the actual public offering process. In 2005, the SEC adopted a
broad ranging series of reforms (“2005 Public Offering Reforms”) to take
into account the needs of large, well-followed issuers and the changing
technological environment through which investors obtain information. We
discuss the impact of the 2005 Public Offering Reforms on the gun-jumping
rules throughout this chapter. The reforms categorized issuers into four
groups:

167 *Non-Reporting Issuer*—issuer that is not required to file reports pursu-
ant to § 13 or § 15(d) of the Exchange Act and is not filing such reports
voluntarily.

168 *Unseasoned Issuer*—issuer that is required to file reports pursuant to
§ 13 or § 15(d) of the Exchange Act, but it does not satisfy the require-
ments of Form S-3 or Form F-3 for a primary offering of its securities.

169 *Seasoned Issuer*—issuer that is eligible to use Form S-3 or Form F-3
to register primary offerings of securities. Primary offerings includes secu-
rities to be sold by the issuer or on its behalf, on behalf of its subsidiary, or
on behalf of a person of which it is the subsidiary.

170 *Well-Known Seasoned Issuers (WKSI)*—More popularly known as
“wick sees,” they are defined in Rule 405. WKSI status depends on meeting
several requirements with respect to a specified “determination date.” The
determination date is the date the issuer’s most recent shelf registration
statement was filed, or its most recent § 10(a)(3) amendment to a shelf
registration statement, whichever is later. If the issuer has not filed a shelf
registration statement then the determination date is the date of the filing
of the most recent annual report on Form 10-K. The principal issuers
eligible for WKSI status are:

- 171
- the issuer is eligible to register a primary offering of its securities on
Form S-3 or Form F-3; or

- 172 ● the issuer, as of a date within 60 days of the determination date, has
either:
- 173 ● a minimum \$700 million of common equity worldwide market
value held by non-affiliates; or
- 174 ● issued \$1 billion aggregate principal amount of non-convertible
securities in registered offerings during the past three years and
either will register only “non-convertible securities, other than
common equity, and full and unconditional guarantees.” If such
an issuer has a public float of \$75 million in common equity at
the determination date, it can also issue common equity as a
WKSI.

175 Not all of these issuers are eligible for WKSI status. Issuers are disqualified
if they:

- 176 ● are not current in their Exchange Act filings or late in satisfying
those obligations for the preceding twelve months;
- 177 ● an ineligible issuer or asset-backed issuer; or
- 178 ● an investment company or business development company.

179 Ineligible issuers under Rule 405 include, among others, those issuers
that within the past three years were a blank check or shell company or
issued a registered penny stock offering are ineligible. Issuers that filed a
bankruptcy petition within the past three years also fall into the ineligible
issuer category, unless they have filed an annual report with audited
financial statements subsequent to their emergence from bankruptcy. Also
ineligible are issuers that have violated the anti-fraud provisions of the
federal securities laws during the last three years and issuers that filed a
registration statement that is the subject of any pending proceeding under
§ 8 of the Securities Act, or has been the subject of any refusal or stop
order under § 8 in the past three years. (We discuss § 8 refusal and stop
orders later in the chapter.) Issuers subject to a pending proceeding under
§ 8A in connection with an offering are also ineligible.

180 What kind of company qualifies as a WKSI? Clearly, the SEC has in
mind relatively large market capitalization companies with equity trading
in a liquid secondary market (and a corresponding following of research
analysts). Companies such as Microsoft, IBM, and McDonald’s will clearly
qualify for WKSI status, absent any prior securities law violations, but
many medium-size companies will also qualify. WKSI-eligible issuers “rep-
resented approximately 30% of listed issuers, [and] accounted for about
95% of U.S. market capitalization” in 2004.

181 A. PRE-FILING PERIOD

182 The Pre-Filing Period runs until the registration statement is filed
with the SEC. Two key provisions of § 5 of the Securities Act govern this
period. Section 5(a) prohibits all sales until the registration statement
becomes effective. Section 5(c) bans all offers prior to the filing of the

182 registration statement. Once the Waiting Period commences, § 5(c) no
longer applies:

185 Pre-Filing Period | Waiting Period | Post-Effective Period

186 § 5(a) —————>

187
188 § 5(c) —————>

189
191 1. WHAT IS AN “OFFER”

192 Key to understanding the Pre-Filing Period is § 5(c). Section 5(c)
restricts all “offers” until a registration statement is filed with the SEC.
The quiet period imposed on companies is a direct consequence of the broad
definition the securities laws give to the term “offer.” Section 2(a)(3) of the
Securities Act defines “offer,” but much of the meaning of what constitutes
an “offer” is found in SEC administrative rulings and a series of SEC
Securities Act Releases.

193 The SEC has long held the view that the term “offer” is broader than
communication including an explicit offer of securities for sale. In the
SEC’s view “offer” encompasses all communications that may “condition”
the market for the securities. The SEC in, *In the Matter of Carl M. Loeb,*
Rhoades & Co. (February 9, 1959) wrote:

194 The broad sweep of [the definition of an offer under § 2(a)(3)] is
necessary to accomplish the statutory purposes in the light of the
process of securities distribution as it exists in the United States.
Securities are distributed in this country by a complex and sensitive
machinery geared to accomplish nationwide distribution of large quan-
tities of securities with great speed. Multi-million dollar issues are
often oversubscribed on the day the securities are made available for
sale. This result is accomplished by a network of prior informal
indications of interest or offers to buy between underwriters and
dealers and between dealers and investors based upon mutual expecta-
tions that, at the moment when sales may legally be made, many prior
indications will immediately materialize as purchases. It is wholly
unrealistic to assume in this context that “offers” must take any
particular legal form. Legal formalities come at the end to record prior
understandings, but it is the procedures by which these prior under-
standings, embodying investment decisions, are obtained or generated
which the Securities Act was intended to reform. . . .

195 [W]e have made clear our position that the statute prohibits
issuers, underwriters and dealers from initiating a public sales cam-
paign prior to the filing of a registration statement by means of
publicity efforts which, even though not couched in terms of an express
offer, condition the public mind or arouse public interest in the
particular securities. . . .

196 We accordingly conclude that publicity, prior to the filing of a
registration statement by means of public media of communication,
with respect to an issuer or its securities, emanating from broker dealer

196 firms who as underwriters or prospective underwriters have negotiated
or are negotiating for a public offering of the securities of such issuer,
must be presumed to set in motion or to be a part of the distribution
process and therefore to involve an offer to sell or a solicitation of an
offer to buy such securities prohibited by Section 5(c) . . .

197 Brokers and dealers properly and commendably provide their
customers with a substantial amount of information concerning busi-
ness and financial developments of interest to investors, including
information with respect to particular securities and issuers. Section 5,
nevertheless, prohibits selling efforts in connection with a proposed
public distribution of securities prior to the filing of a registration
statement and, as we have indicated, this prohibition includes any
publicity which is in fact a part of a selling effort. Indeed, the danger to
investors from publicity amounting to a selling effort may be greater in
cases where an issue has “news value” since it may be easier to whip
up a “speculative frenzy” concerning the offering by incomplete or
misleading publicity and thus facilitate the distribution of an unsound
security at inflated prices. This is precisely the evil which the Securi-
ties Act seeks to prevent.

198 **QUESTIONS**

- 199 1. What counts as an offer?
200 2. If investors eventually will receive (or have access to) a final statutory
prospectus, why does it matter that they earlier obtain information that
“conditions” the market?

202 **Securities Act Release No. 3844**

203 Securities and Exchange Commission (Oct. 8, 1957).

204 * * *

205 A basic purpose of the Securities Act of 1933 [and] the Securities
Exchange Act of 1934 . . . is to require the dissemination of adequate and
accurate information concerning issuers and their securities in connection
with the offer and sale of securities to the public, and the publication
periodically of material business and financial facts, knowledge of which is
essential to an informed trading market in such securities.

206 There has been an increasing tendency . . . to give publicity through
many media concerning corporate affairs which goes beyond the statutory
requirements. This practice reflects a commendable and growing recogni-
tion on the part of industry and the investment community of the impor-
tance of informing security holders and the public generally with respect to
important business and financial developments.

207 This trend should be encouraged. It is necessary, however, that corpo-
rate management, counsel, underwriters, dealers and public relations firms
recognize that the Securities Acts impose certain responsibilities and limi-

207 tations upon persons engaged in the sale of securities and that publicity
and public relations activities under certain circumstances may involve
violations of the securities laws and cause serious embarrassment to issuers
and underwriters in connection with the timing and marketing of an issue
of securities. These violations not only pose enforcement and administrative
problems for the Commission, they may also give rise to civil liabilities
by the seller of securities to the purchaser. . . .

208 The terms “sale,” “sell,” “offer to sell” and “offer for sale” are
broadly defined in Section 2[a](3) of the Act and these definitions have
been liberally construed by the Commission and the courts.

209 It follows from the express language and the legislative history of the
Securities Act that an issuer, underwriter or dealer may not legally begin a
public offering or initiate a public sales campaign prior to the filing of a
registration statement. It apparently is not generally understood, however,
that the publication of information and statements, and publicity efforts,
generally, made in advance of a proposed financing, although not couched
in terms of an express offer, may in fact contribute to conditioning the
public mind or arousing public interest in the issuer or in the securities of
an issuer in a manner which raises a serious question whether the publicity
is not in fact part of the selling effort. . . .

210 **Example #1**

211 An underwriter-promoter is engaged in arranging for the public financ-
ing of a mining venture to explore for a mineral which has certain possible
potentialities for use in atomic research and power. While preparing a
registration statement for a public offering, the underwriter-promoter
distributed several thousand copies of a brochure which described in
glowing generalities the future possibilities for use of the mineral and the
profit potential to investors who would share in the growth prospects of a
new industry. The brochure made no reference to any issuer or any
security nor to any particular financing. It was sent out, however, bearing
the name of the underwriting firm and obviously was designed to awaken
an interest which later would be focused on the specific financing to be
presented in the prospectus shortly to be sent to the same mailing list.

212 The distribution of the brochure under these circumstances clearly was
the first step in a sales campaign to effect a public sale of the securities and
as such, in the view of the Commission, violated Section 5 of the Securities
Act.

213 **Example #2**

214 An issuer in the promotional stage intended to offer for public sale an
issue of securities the proceeds of which were to be employed to explore for
and develop a mineralized area. The promoters and prospective underwriter
prior to the filing of the required registration statement . . . arranged for
a series of press releases describing the activities of the company, its
proposed program of development of its properties, estimates of ore re-
serves and plans for a processing plant. This publicity campaign continued

214 after the filing of a registration statement and during the period of the
offering. The press releases, which could be easily reproduced and employed
by dealers and salesmen engaged in the sales effort, contained representa-
tions, forecasts and quotations which could not have been supported as
reliable data for inclusion in a prospectus or offering circular under the
sanctions of the Act.

215 It is the Commission's view that issuing information of this character
to the public by an issuer or underwriter through the device of the press
release and the press interview is an evasion of the requirements of the Act
governing selling procedures, a violation of Sections 5 and 17(a) of the Act,
and that such activity subjects the seller to the risk of civil and penal
sanctions and liabilities of the Act.

216 * * *

217 Example #6

218 * * *

219 The president of a company accepted, in August, an invitation to
address a meeting of a security analysts' society to be held in February of
the following year for the purpose of informing the membership concerning
the company, its plans, its record and problems. By January a speech had
been prepared together with supplemental information and data, all of
which was designed to give a fairly comprehensive picture of the company,
the industry in which it operates and various factors affecting its future
growth. Projections of demand, operations and profits for future periods
were included. The speech and the other data had been printed and it was
intended that several hundred copies would be available for distribution at
the meeting. In addition, since it was believed that stockholders, creditors,
and perhaps customers might be interested in the talk, it was intended to
mail to such persons and to a list of other selected firms and institutions
copies of the material to be used at the analysts' meeting.

220 Later in January, a public financing by the company was authorized,
preparation of a registration statement was begun and negotiation with
underwriters was commenced. It soon appeared that the coming meeting of
analysts, scheduled many months earlier, would be or about the time the
registration statement was to be filed. This presented the question wheth-
er, in the circumstances, delivery and distribution of the speech and the
supporting data to the various persons mentioned above would contravene
provisions of the Securities Act.

221 It seemed clear that the scheduling of the speech had not been
arranged in contemplation of a public offering by the issuer at or about the
time of its delivery. In the circumstances, no objection was raised to the
delivery of the speech at the analysts' meeting. However, since printed
copies of the speech might be received by a wider audience, it was
suggested that printed copies of the speech and the supporting data not be
made available at the meeting nor be transmitted to other persons.

222 * * *

Securities Act Release No. 5180

Securities and Exchange Commission (Oct. 16, 1971).

The Commission today took note of situations when issuers whose securities are “in registration” may have [to] refuse to answer legitimate inquiries from stockholders, financial analysts, the press, or other persons concerning the company or some aspect of its business. The Commission hereby emphasizes that there is no basis in the securities acts or in any policy of the Commission which would justify the practice of non-disclosure of factual information by a publicly held company on the grounds that it has securities in registration under the Securities Act of 1933. Neither a company in registration nor its representatives should instigate publicity for the purpose of facilitating the sale of securities in a proposed offering. Further, any publication of information by a company in registration other than by means of a statutory prospectus should be limited to factual information and should not include such things as predictions, projections, forecasts or opinions with respect to value.

* * *

GUIDELINES

The Commission strongly suggests that all issuers establish internal procedures designed to avoid problems relating to the release of corporate information when in registration. As stated above, issuers and their representatives should not initiate publicity when in registration, but should nevertheless respond to legitimate inquiries for factual information about the company’s financial condition and business operations. Further, care should be exercised so that, for example, predictions, projections, forecasts, estimates and opinions concerning value are not given with respect to such things, among other, as sales and earnings and value of the issuer’s securities.

It has been suggested that the Commission promulgate an all inclusive list of permissible and prohibited activities in this area. This is not feasible for the reason that determinations are based upon the particular facts of each case. However, the Commission as a matter of policy encourages the flow of factual information to shareholders and the investing public. Issuers in this regard should:

1. Continue to advertise products and services.
2. Continue to send out customary quarterly, annual and other periodic reports to stockholders.
3. Continue to publish proxy statements and send out dividend notices.
4. Continue to make announcements to the press with respect to factual business and financial development; i.e., receipt of a contract, the settlement of a strike, the opening of a plant, or similar events of interest to the community in which the business operates.
5. Answer unsolicited telephone inquiries from stockholders, financial analysts, the press and others concerning factual information.

236 6. Observe an ‘open door’ policy in responding to unsolicited inquiries concerning factual matters from securities analysts, financial analysts, security holders, and participants in the communications field who have a legitimate interest in the corporation’s affairs.

237 7. Continue to hold stockholder meetings as scheduled and to answer shareholders’ inquiries at stockholder meetings relating to factual matters.

238 In order to curtail problems in this area, issuers in this regard should avoid:

239 1. Issuance of forecasts, projections, or predictions relating but not limited to revenues, income or earnings per share.

240 2. Publishing opinions concerning values.

241 * * *

242 NOTES

243 1. “Conditioning” the market. The SEC actively polices efforts that may condition the market prior to the effective date of the registration statement. Leading up to the initial public offering of Salesforce.com, a provider of customer relationship management software, the CEO of Salesforce.com told a reporter that “the S.E.C. prohibits me from making any statements that would hype my I.P.O.,” and the statement was subsequently released in a *New York Times* article. The CEO also discussed “the software business and his competitors” in the article. The SEC deemed these communications as conditioning the market and forced Salesforce.com to delay its initial public offering. See Laurie J. Flynn and Andrew Ross Sorkin, *Salesforce.com Is Said To Delay Its Public Offering*, *New York Times*, May 19, 2004. Why is delaying the offer the usual remedy for § 5(c) violations? The SEC believes that delay will allow any conditioning of the market to subside.

244 2. *The Pre-Filing Period*. When does the Pre-Filing Period begin? This question is important because companies in the Pre-Filing Period enter into a quiet period during which a company and others associated with the offering may communicate about the offering or the company’s future prospects only at their own peril. The SEC in Release No. 5180 notes that the Pre-Filing Period begins once the company is “in registration.” But when does this occur?

245 Rule 163A provides a safe harbor for the issuer clarifying when the Pre-Filing Period begins. Communications made by the issuer, or those working on behalf of an issuer (other than an underwriter or dealer participating in the offering), prior to 30 days before the filing of the registration statement with the SEC are excluded from the definition of an “offer” for purposes of § 5(c). To be eligible for the safe harbor, the communication may not refer to the offering. In addition, the issuer must “take reasonable steps within its control to prevent further distribution or publication of the information during the 30-day period immediately before the issuer files the registration statement.” Regulation FD’s prohibition on selective disclosures (discussed in Chapter 4) applies to communications under the safe harbor. The safe harbor is not available for certain issuers, such as blank check and shell companies and penny stock issuers, and for certain types of offerings, such as business combination transactions.

246 **3. *The Internet.*** The growth of the Internet has provided issuers with a new medium through which to communicate with investors, posing new challenges for both the SEC and issuers. Information provided through the worldwide web is unique because different websites are interconnected through “hyperlinks.” An investor accessing finance.yahoo.com, for example, may learn about a particular issuer and then click on a link to go to that issuer’s homepage to continue the research. Such hyperlinks make obtaining relevant information quick and easy for investors, but do hyperlinks run afoul of the gun-jumping rules?

247 As part of the 2005 Public Offering Reforms, the SEC mandated the treatment of all non-real time electronic communication offering securities for sale as “graphic communications” and, thus, a written offer for purposes of the Securities Act. See Rule 405. Thus, emails, videotapes, CD-ROMs, and recorded electronic version of roadshow presentations that offer securities for sale are all written offers. (Roadshows and other communications distributed electronically on a “real time” basis, however, are treated as oral communications.)

248 The SEC also clarified the treatment of hyperlinks from one web page to another. Rule 433 provides that written offers includes offers of the issuer’s securities that are “contained on an issuer’s Web site or hyperlinked by the issuer from the issuer’s Web site to a third party’s Web site.” Rule 433(e)(1). For example, hyperlinks included within a written communication offering the issuer’s securities that connect to another web site or to other information are considered part of that written communication. Rule 433 excludes “historical issuer information” contained in a separate section on the issuer’s Web site from the definition of written offers unless the information was incorporated by reference, included in a prospectus of the issuer used in the offering, or otherwise used or referred to in the offering. Rule 433(e)(2).

249
250 A common theme throughout the SEC releases is the distinction between “purely factual” disclosure of information and disclosures that refer to the offering directly or make forecasts, projections, or predictions (so-called “soft” information). Although avoiding disclosures that refer to the offering is relatively straightforward, how are issuers to determine which disclosures are purely factual? Exchange Act reporting issuers face both periodic disclosure requirements and a constant stream of questions from analysts and the investing public. How can such an issuer balance these demands for information with the imposition of a quiet period for disclosures that do not meet the purely factual standard? Achieving such a balance turns on how clearly the releases define such purely factual disclosures.

251 The SEC clarified what counts as an offer under the gun-jumping rules with several new safe harbors in its 2005 Public Offering Reforms. In addition to the Rule 163A safe harbor for communications occurring prior to 30 days before the filing of the registration statement, the SEC provided two additional safe harbors for regularly released business and forward-looking information as described below.

252 *Reporting Issuer Safe Harbor*—Rule 168 of the Securities Act allows most Exchange Act reporting issuers (and those working on their behalf, other than underwriters and dealers participating in the offering) to continue the regular release of “factual business information” and “forward-looking information.” Information in periodic reports (e.g., a 10-K) and other materials filed with the SEC are included within the safe harbor. Rule 168 provides an exemption from § 5(c)’s prohibition on offers in the Pre-Filing period. By excluding communications from the definition of an offer, the Rule also exempts communications from § 2(a)(10)’s definition of “prospectus” and thereby excludes the communications from the application of § 5(b)(1) in the Waiting and Post-Effective periods.

253 Factual business information includes, among other things, factual information about the issuer and its business, advertisements of the issuer’s products or services, and factual information contained in the issuer’s periodic Exchange Act reports. Forward-looking information that is permitted includes financial projections, statements about the issuer management’s plans and the issuer’s future economic performance, and any underlying assumptions. Allowing reporting issuers the ability to publish or disseminate certain forward-looking information during a public offering is a dramatic change from the SEC’s hostile attitude toward forward-looking information set forth in the Releases above. As a condition to use Rule 168, the issuer must have “previously released or disseminated” the same type of information in the “ordinary course of its business” and the information must be “materially consistent in timing, manner and form” with the issuer’s similar past releases or disseminations of such information. Rule 168(d). The safe harbor does not cover information relating to the offering itself.

254 *Non-Reporting Issuer Safe Harbor*—Analogous to the safe harbor under Rule 168 for reporting issuers, Rule 169 of the Securities Act allows for the continuing disclosure of “factual business information” by or on behalf of non-Exchange Act reporting issuers (i.e., most IPO issuers). As with Rule 168, Rule 169 provides an exemption from § 5(c)’s prohibition on offers in the Pre-Filing Period. By excluding communications from the definition of an offer, the Rule also exempts communications from § 2(a)(10)’s definition of “prospectus” for purposes of § 5(b)(1) in the Waiting and Post-Effective periods.

255 Unlike Rule 168, however, Rule 169 does not exempt forward-looking information from the definition of an offer. (Information relating to the offering is also ineligible). Rule 169 tracks Rule 168’s requirements that the issuer have previously released or disseminated information of the same type in the ordinary course of business and in the same “timing, manner, and form.” Rule 169 also requires that the information must have been disseminated previously to “persons, such as customers and suppliers, other than in their capacities as investors or potential investors in the issuer’s securities, by the issuer’s employees or agents who regularly and historically have provided such information to such persons.” Rule 169(d)(3).

256 In addition to the safe harbors under Rules 163A, 168 and 169, the SEC also expanded the ability of well-known seasoned issuers to communicate in the Pre-Filing Period. Rule 163 exempts both oral and written communications, including offers, by or on behalf of WKSIs from § 5(c) during the Pre-Filing Period. (Certain offerings, such as mergers and other business combinations, are excluded. In addition, underwriters and dealers participating in the offering are prohibited from using Rule 163.) WKSIs that desire to use Rule 163 to exempt written communication from § 5(c) must treat such communications as “free writing prospectuses.” The issuer must file any free writing prospectuses with the SEC promptly upon filing of the registration statement. Written communications must include a legend informing the investors about the formal statutory prospectus and how to get the prospectus. Regulation FD’s prohibition on selective disclosures applies to Rule 163 communications.

257 While seemingly a radical change to the ability of WKSIs to make offers in the Pre-Filing Period, the impact of Rule 163 is overshadowed by the SEC’s reforms in 2005 to the shelf registration process. WKSIs may now file an automatic shelf registration statement that, as we discuss at the end of this chapter, allows the WKSI to register an unlimited amount of securities for an unlimited period. The Pre-Filing Period takes on a correspondingly lower (if not negligible) significance for WKSI issuers who have filed an automatic shelf registration statement.

258 HYPOTHETICAL ONE

259 Suppose that Sherry and the Smartway board of directors decide to pursue an initial public offering. Sherry and the Smartway board face a number of choices, most importantly the number of shares to sell and the price. Timing is also an issue; is the market receptive to Smartway shares now or should Smartway wait to obtain a better price for its shares? Sherry is concerned not only with executing a successful IPO for Smartway, she is worried about her own financial well-being. Much of Sherry’s compensation over the past several years has been in the form of restricted Smartway stock, generally difficult, if not impossible, to resell until after the IPO. Sherry (and the other officers of Smartway) hope to cash out some of their shares in the IPO and substantially more in a possible follow-on equity offering later the next year.

260 Consider whether the following actions raise any § 5(c) gun-jumping concerns during the Pre-Filing Period.

- 261
- 262
1. *Scenario One:* Before finding an underwriter or filing a registration statement with the SEC, Sherry telephones a number of business associates and friends from college about investing in Smartway’s IPO. Among other things Sherry says, “I can get you in on the ground floor at \$20 per share.”
 2. *Scenario Two:* Assume that Smartway is “in registration.” Sherry places a new newspaper ad in several college newspapers touting Smartway’s business (Smartway had run a similar ad a year earlier in a single college newspaper). In the ads, Sherry does not specifically mention Smartway’s IPO plans. Instead, Sherry mentions her “optimistic” view of the entire last-minute airline ticket industry. Moreover, she mentions that Smartway had a 50% increase in

262 business the prior year, as more and more flyers relied on its last-minute
airline ticket services.

263 **3. Scenario Three:** Sherry's college newspaper ad also includes financial
projections showing strong future growth in revenues and earnings for Smartway.
The projections end with the following statement: "Smartway's strong
financial future ensures that we'll be around a long time to help customers like
you!"

264 **4. Scenario Four:** Concerned about maintaining silence on the upcoming
offering during the quiet period, Sherry orders that Smartway's website make
no mention of the offering or provide any form of "soft" forward-looking
information or projections with respect to Smartway's profitability, growth
prospects, and so on. Smartway's website, nonetheless, contains a set of links
for investors interested in learning more about the last-minute airline ticket
business. One link goes to www.fool.com, an independent site with no financial
connection to Smartway. The www.fool.com website provides information on
investing. The website also includes an analysis of the value of Smartway's
upcoming offering.

265 2. PUTTING TOGETHER THE OFFERING

266 During the Pre-Filing Period, the issuer contacts and reaches a prelim-
inary understanding with the managing underwriter of the offering. Work-
ing together with the underwriter, counsel for the issuer, the underwriter's
counsel, as well as experts (including the issuer's auditors), the issuer then
drafts the registration statement during the Pre-Filing Period. Consider
how the communications among these groups of parties are exempted from
the prohibition on offers in the Pre-Filing Period.

267 HYPOTHETICAL TWO

268 **1.** One of Sherry's first decisions after deciding to take Smartway public is to
contact her friend Harold, an investment banker at Sparrow Securities. Sherry
asks Harold if Sparrow Securities will act as the managing underwriter for the
offering. Sherry discusses her concerns about pricing, the number of shares,
and the timing of the IPO with Harold over the telephone. After some
discussions, Harold agrees on behalf of Sparrow Securities to take on the
position of managing underwriter. Sherry and Harold record their tentative
agreement in a letter of intent. The offering price is left out of the letter of
intent.

269 **2.** After agreeing to act as managing underwriter for the Smartway offering,
Sparrow Securities starts putting together a syndicate of underwriters to
handle the firm commitment offering. Through a series of telephone calls,
faxes, and emails, Harold negotiates with representatives from twenty different
investment banks (fifteen of whom eventually agree in principle to participate
in the offering).

270 **3.** The five investment banks that choose not to participate as underwriters
make a counter-proposal. They ask Harold if they can participate as dealers in
the offering. As dealers, they will purchase shares from one of the underwriters
participating in the offering rather than directly from the issuer. Consequently,
they will handle far fewer shares than each of the individual underwriters

(thereby reducing their risk). The investment banks acting as dealers will earn no more than the standard dealer's commission from their sales. Harold, on behalf of Sparrow Securities, readily agrees to this arrangement from the prospective dealers' counter-proposal.

4. Sparrow Securities sends Omrī, a recent business school graduate working for Harold, to get Smartway ready for the public offering. Omrī goes over Smartway's books, corporate records, board minutes and other records. He also has extensive discussions with Smartway's auditors, Ernst & Arthur. After some thought, Omrī recommends that Smartway reincorporate in Delaware, adopt anti-takeover protections (including a classified board of directors), and convert all existing preferred shares into common stock. Are Omrī's discussions with Ernst & Arthur okay?

To reduce the tension between timely disclosure and the impact of gun-jumping rules, the SEC has promulgated a number of safe harbor rules. Rule 135, for example, provides a safe harbor for short, factual notices of a proposed registered offering.

Consider the structure of the Rule 135 safe harbor. First, Rule 135 applies only for the issuer, any other security holder selling in the offering (e.g., if the insiders are selling some of their shares in the public offering), and those working on behalf of either of these parties. Second, Rule 135 excludes notices meeting its requirements from the definition of "offer" for purposes of § 5. What legal conclusions are avoided by escaping the definition of "offer"? During the Pre-Filing Period, § 5(c) prohibits all offers. Thus, communications meeting the requirements of Rule 135 do not run afoul of § 5(c)'s prohibition. The more general ban on sales in § 5(a), however, continues in force. As we will see when we cover the Waiting Period, § 5(b) continues with a prohibition on most written offers (included within the definition of a "prospectus"). Because Rule 135 generally excludes the communications it requires from the scope of an "offer," Rule 135 also exempts them from the definition of a prospectus for purposes of § 5(b).

Rule 135 places tight limits on the information that may be disclosed. The communication may, among other things, identify the issuer, the amount and basic terms of the offered securities, the purpose of the offering, and the anticipated timing of the offering. Outside of these narrow areas, communication is not protected under Rule 135. Notably, the underwriter cannot be identified by name (which makes it difficult for the underwriter to rely on Rule 135). On the other hand, failure to meet the terms of Rule 135 does not necessarily mean that § 5(c) has been violated. Instead, the absence of the Rule 135 safe harbor means only that issuers (and others) must contend with the uncertain question of whether their communications fall within the definition of "offer."

Given the SEC's adoption of new safe harbors as part of the 2005 Public Offering Reforms under Rules 163 (for well-known seasoned issuers), 163A (prior to the 30 day period before filing of the registration

276 statement), 168 (factual and forward-looking statements by a reporting
issuer) and 169 (factual statements by a non-reporting issuer), what
function does Rule 135 continue to play? Consider the situation of a non-
WKSJ issuing a factual notice related to the offering prior to the filing of
the registration statement.

277 HYPOTHETICAL THREE

278 Excited by the prospect of Smartway's upcoming public offering, Sherry
puts out a press release on Smartway's plans for the IPO. The press release
mentions that Smartway expects to raise \$200 million for the offering and that
the proceeds will be used to expand Smartway's business through a nationwide
advertising campaign. The press release does not mention Sparrow Securities
by name, instead only stating “a well-known, national investment bank has
agreed in principle to act as our managing underwriter.” Any problems?

279 B. WAITING PERIOD

280 After filing its registration statement with the SEC, the issuer enters
into the “Waiting Period.” This refers to waiting for the SEC's Division of
Corporation Finance to declare the registration statement effective. Two
important and separate tasks take place during the Waiting Period. First,
the issuer and underwriters attempt to gauge market interest in the
offering. Second, the SEC may review the registration statement before
declaring it effective.

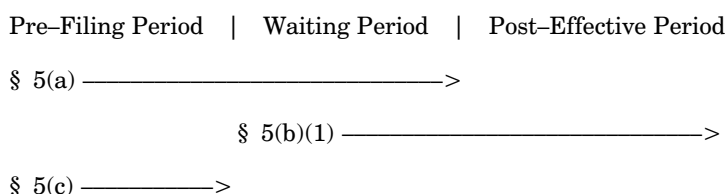
281 In this section, we consider (1) the mechanism for gauging market
sentiment, and (2) the process of becoming effective and the SEC enforce-
ment powers relating to registration. During the Waiting Period, the gun-
jumping rules continue to restrict issuers and their affiliates from condi-
tioning the market (albeit in a less intrusive fashion). For companies with
an active secondary trading market prior to the offering, however, it is
nonetheless important to allow information to flow out to investors. We
also consider here safe harbors for analyst communications of opinions on
investments to investors, which apply throughout the public offering pro-
cess.

282 1. GAUGING MARKET SENTIMENT

283 Issuers and underwriters typically promote their offering and obtain
feedback from the market during the Waiting Period. Underwriters doing a
firm commitment offering are particularly keen to learn about the market's
reaction to the prospective offering. Recall that in a firm commitment
offering, both the underwriter's own money and (indirectly) its reputation
for bringing quality, well-priced offerings to the market are on the line.
Underwriters that price an offering too high will end up holding unsold
allotments of the offered securities. Those who price the offering too low
may leave the issuer with smaller proceeds.

284 During the Pre-Filing Period, § 5(c) leaves little room to gauge market
sentiment. Section 5(c) restricts all offers prior to the filing of the registra-

tion statement. As we saw above, this restriction on offers, combined with the broad definition of offers under § 2(a)(3), leads to an almost complete prohibition on communications relating to the offering in the Pre-Filing Period for non-well known seasoned issuers. (Recall though that Rule 163 dramatically expands the ability of well-known seasoned issuers to discuss the offering in the Pre-Filing Period.) With the filing of the registration statement, however, § 5(c) no longer applies, but § 5(b)(1) steps in during the Waiting Period to restrict the transmission, through interstate commerce, of any “prospectus” not meeting the requirements of the statutory prospectus as set forth in § 10 of the Securities Act. Note also that § 5(a) still prohibits sales during the Waiting Period.



Section 5(b)(1) prohibits the transmission of prospectuses not meeting the requirements of § 10, but permits both preliminary and final prospectuses. The definition of a prospectus under § 2(a)(10) of the Securities Act is key to understanding the extent of § 5(b)(1)’s prohibition. Although generally defining a prospectus to include all “prospectuses,” § 2(a)(10) also includes 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” in the definition of a prospectus. Note two things about this definition: (a) the breadth of the types of communication included and (b) the requirement that communication must either offer the security or confirm the sale of the security to qualify as a “prospectus.” What types of communications “offer” the security for sale? Section 2(a)(3)’s definition of an offer continues to provide the answer.

Thus, § 2(a)(10)’s prospectus definition sweeps in all written and broadcast communications offering the security; § 5(b) then prohibits such communications if they do not comply with § 10. Section 10(b) authorizes a preliminary prospectus that can be used to satisfy § 5(b)(1) in the Waiting Period. Section 10(a) defines the final prospectus that must be distributed to investors in the Post-Effective Period. To understand how this works, consider the following relationships within the Securities Act:

§ 5(b)(1)	*	§ 5(a)(10)	*	§ 2(a)(3)
Prohibition of prospectuses not meeting § 10		Definition of prospectus		Definition of offer

In practice, § 5(b)(1) reintroduces the general prohibition on offers placed on all communications in the Pre-Filing Period, but because the prohibition is now limited to offers by means of a prospectus not complying with § 10, the restriction is not as broad as in the § 5(c) prohibition on all

305 offers during the Pre-Filing Period. Written offers in the form of a
preliminary prospectus under § 10(b) are explicitly permitted and only
written and broadcast communications are restricted in the Waiting Period.
By negative implication, oral communications not involving a broadcast
medium are permitted during the Waiting Period. In addition, the SEC has
provided issuers with additional latitude for gauging market sentiment
through a number of safe harbors. Consider the following forms of available
communication in the Waiting Period.

306 *a. The Preliminary Prospectus*

307 Under Securities Act Rule 430, the preliminary prospectus must con-
tain essentially the same information as the final statutory prospectus,
with the exception of price-related information. Typically, the issuer and
the managing underwriter will set the price just before the registration
statement is declared effective. (Setting the price earlier imposes large risks
on the underwriters in a firm commitment offering—what happens if the
prevailing market price turns out to be different from the price set?) The
final prospectus may reflect changes in the offering or revisions based on
the SEC's comments on the preliminary prospectus. Reporting issuers may
also use a Rule 431 summary prospectus during the Waiting Period, but
few do.

308 *b. The Roadshow*

309 Underwriters and issuers rely on their ability to make oral offers to
conduct “roadshows” across the country to pitch their offered securities to
potential investors. Typically conducted over a two-week period, the road-
show allows the issuer's top management and representatives from the
managing underwriter the chance to sell the offering in face-to-face discus-
sions with institutional investors across the country.

310 *c. The Free Writing Prospectus*

311 Rule 164 allows issuers more freedom to distribute prospectuses that
do not meet the requirements of a formal § 10(b) preliminary prospectus in
the Waiting Period (termed “free writing prospectuses”). Free writing
prospectuses (discussed in greater detail below) complying with the require-
ments of Rule 433 used after the filing of the registration statement by an
issuer and other offering participants including underwriters and dealers,
are treated as a § 10(b) prospectus. Once categorized as a § 10(b) prospec-
tus, a free writing prospectus satisfies § 5(b)(1)'s requirement that all
prospectuses in the Waiting Period meet the requirements of § 10.

312 *d. “Tombstone” advertisements*

313 Even for prospectuses that fail to meet the requirements of § 10, the
SEC provides other safe harbors. Although Rule 135 continues to apply in
the Waiting Period, the SEC provides broader safe harbors for communica-
tions during the Waiting Period. Securities Act Rule 134 provides far more

leeway for issuers seeking to disclose information on the offering and on their own business to the investing public. Moreover, not only the issuer, but also the underwriters, can use Rule 134.

What protection is afforded by coming within Rule 134's safe harbor for "tombstone" advertisements? When it applies, Rule 134 excludes communications from the definition of a prospectus under § 2(a)(10). (Note that the last clause of § 2(a)(10) allows the SEC to exclude written offers to sell from the definition of a prospectus.) Recall that § 5(b)(1) prohibits transmission of a prospectus that does not meet the requirements of § 10 (the formal statutory prospectus). By excluding written notices from the broad definition of a prospectus contained in § 2(a)(10), Rule 134 excludes those notices from the prohibition of § 5(b)(1). As long as no sales take place (still prohibited by § 5(a)), notices complying with Rule 134 are exempted from the gun-jumping rules. Communications under Rule 134 are also excluded from the definition of a "freewriting prospectus" under Rule 405.

Rule 134 offers no protection, however, in the Pre-Filing Period. Why? Recall that § 5(c) prohibits all offers in the Pre-Filing Period. Rule 134, which only excludes communications from the definitions of a prospectus and a free writing prospectus, does not limit the reach of § 5(c), which forbids all "offers," written or oral.

What kind of information is permitted under Rule 134? Among other things, Rule 134 allows the disclosure of the issuer's legal identity and business location, the amount and type of security to be offered, the business of the issuer, and the price of the security are all permitted. Other information about the issuer permitted includes "the address, phone number and e-mail address of the issuer's principal offices" as well as the "geographic areas in which it conducts business." Rule 134(a)(1). The names of all the underwriters, not just the managing underwriters, and their roles in the offering as well as a description of the marketing events, such as roadshow presentations, and a description of the procedures through which the underwriters will conduct the offering are permissible under Rule 134(a)(10), (11) and (12). Rule 134 also provides for disclosure of the identity of any selling security holders if included in the registration statement, the names of securities exchanges or other securities markets where the securities will be listed, and the ticker symbol. Rule 134(a)(18), (19), (20).

In addition to allowing these categories of information, Rule 134(b) mandates the disclosure of certain information, including a boilerplate legend indicating that securities may not be sold prior to the registration statement becoming effective. Rule 134(b) also requires the disclosure of the name and address of a person from whom an investor may obtain a § 10 statutory prospectus. These mandatory disclosures are not required if the communication is accompanied (or preceded) by a § 10 statutory prospectus (other than a free writing prospectus) or if the Rule 134 notice "does no more than state from whom a written prospectus meeting the requirements of § 10 of the Act may be obtained, identify the security,

317 state the price thereof and state by whom orders will be executed.” Rule
134(c).

318 Rule 134 does not allow the disclosure of a detailed description of the
offered securities, such as a term sheet. Issuers may, nonetheless, transmit
written details about the terms of the offering through other means in the
Waiting Period, such as a free writing prospectus.

319 *e. Solicitations of interest*

320 Rule 134 also enables issuers to obtain indications of interest from
investors. Under Rule 134(d), if a § 10 statutory prospectus (other than a
free writing prospectus) accompanies or precedes a Rule 134 communica-
tion, the communication may solicit an offer to buy or some other indica-
tion of interest. Rule 134(d) provides for a mandatory boilerplate legend
advising the investor of his or her right to revoke the offer to buy prior to
acceptance by the underwriter and that indications of interest involve no
legal obligation. (Expressions of interest that are not followed by actual
orders, however, may lead the underwriters to exclude the investor from
subsequent offerings.)

321 The requirement that a § 10 prospectus precede or accompany a
communication under Rules 134(c) and 134(d) is satisfied if the communi-
cation is electronic and contains an active hyperlink to the § 10 prospectus.
Communications relating to an investment company or business develop-
ment company are excluded from Rule 134’s safe harbor.

322 HYPOTHETICAL FOUR

323 Sherry, working closely with Harold and Sparrow Securities, filed a regis-
tration statement for Smartway’s offering with the SEC. Sherry is eager to take
Smartway’s story to investors and persuade them to purchase stock in the
upcoming IPO. Do any of the following scenarios (all during the Waiting
Period) violate the gun-jumping rules?

324 **1. Scenario One:** Sherry and Harold hold a series of meetings with large
institutional investors interested in investing in high-growth, initial public
offering stock. They fly to Boston, New York, Miami, Chicago, Los Angeles, and
other cities in a couple of weeks. In each city, they make a presentation to a
group of investors and answer questions.

325 **2. Scenario Two:** Larissa, a broker working for Sparrow Securities, learns of
the upcoming Smartway offering through internal communications within
Sparrow. She immediately calls her list of “favored” investor-clients consisting
of all recent college graduates from her alma mater which she obtains from her
school’s alumni web site. For each potential investor who takes her call (a
distressingly low percentage!), she spends about five minutes touting Smart-
way’s great growth prospects, the strength of the management team, and the
tendency of IPO stocks to rise quickly in price after the offering.

326 **3. Scenario Three:** Sherry has Smartway’s investor relations staff put together
an advertisement touting the upcoming offering for placement in the *Wall
Street Journal*. Among other things, the advertisement is directed at “investors
who want a high return” and states Smartway’s intent to sell \$200 million in

326 common stock within the next year. The ad also includes a detailed five-year
projection of future profits. The advertisement does not, however, mention
Sparrow Securities.

327 4. *Scenario Four*: Sherry has the investor relations people at Smartway put
together a “tombstone” announcement of the offering that is carried in the
Wall Street Journal. The tombstone mentions Sparrow Securities and Smart-
way and has a brief description of Smartway’s business. In addition, the
tombstone provides a summary table of the past three years audited income
statements of Smartway (including revenues, costs, and earnings). Finally, the
advertisement includes the standard legend indicating that no sales can be
made before the effective date.

328 5. *Scenario Five*: Larissa mails out a copy of the preliminary prospectus
(omitting, among other things, the pricing information on the offering) to all
the members of her college graduating class. She includes with the preliminary
prospectus a letter stating, “I think this is a good investment that might
interest you. Please call me if you want to talk further about Smartway’s
upcoming public offering. Go Bears!”

329 2. FREE WRITING PROSPECTUSES

330 Written and broadcast communications that offer to purchase or solicit
an offer to buy securities are traditionally prohibited in the Waiting Period
through the interaction of § 2(a)(10) (providing for a broad definition of
prospectus) and § 5(b)(1) (§ 10 prospectus delivery requirement). Perhaps
the biggest change in the 2005 Public Offering Reforms is the SEC’s
decision to allow free writing prior to the effective date of the registration
statement under the concept of “free writing prospectus.” The new “free
writing prospectus” expands the ability of issuers to distribute prospectuses
not meeting the requirements of a formal § 10 prospectus. Under Rule 164,
a free writing prospectus that meets the requirements of Rule 433 is
treated as § 10(b) prospectus for purposes of § 5(b)(1). Once categorized as
a § 10(b) prospectus, a free writing prospectus satisfies § 5(b)(1)’s require-
ment that prospectuses meet the requirements of § 10. As a consequence,
issuers and other offering participants, including underwriters and dealers,
may send out a wide range of written (including broadcast and electronic)
communications in the Waiting Period that raise interest in the offering.

331 a. *Definition of a Free Writing Prospectus*

332 A free writing prospectus includes any written communication that
offers to sell or solicits an offer to buy a security that is or will be subject to
a registration statement and that does not meet the requirements of a § 10
statutory final or preliminary prospectus or a § 2(a)(10)(a) form of tradi-
tional freewriting. Rule 405. Rule 405 goes on to define written communica-
tion to include written, printed, among others, broadcast and graphic
communications. Graphic communications, in turn, are defined to include
“all forms of electronic media,” such as e-mails, Web sites, CD-ROMS,
videotapes, and “substantially similar messages widely distributed” over a
variety of electronic communication networks. Significantly, the SEC ex-
cluded real-time electronic communication from the definition of graphic

332 communication, leaving real-time electronic transmissions within the
“oral” category of communication. Included in the definition of a free
writing prospectus, however, are indirect communications from the issuer
to the marketplace through media sources, including interviews given by
corporate officers that could be construed as offering a security.

333 *b. Issuer Requirements*

334 For Rule 164 to apply, the issuer or other offering participant must
meet the conditions set forth in Rule 433. Rule 433 provides for different
requirements depending on the type of issuer as set forth below. (Rules 164
and 433 exclude certain ineligible issuers and transactions.)

335 *Non-Reporting and Unseasoned Issuers*—Use of free writing prospec-
tuses is permitted only after the filing of the registration statement, so non-
reporting and unseasoned issuers cannot use Rule 433 to communicate free
writing prospectuses in the Pre-Filing Period. For free writing prospec-
tuses made by the issuer or on behalf of the issuer, including any paid
advertisement or publication, the free writing prospectus must be accompa-
nied or preceded by the most recent statutory prospectus that satisfies the
requirements of § 10, including a price range if required. If an electronic
free writing prospectus is used, Rule 433 provides that issuers may meet
the statutory prospectus delivery requirement by simply including a hyper-
link to the issuer’s most recent preliminary prospectus. For a free writing
prospectus from a media source not affiliated with nor paid by the issuer or
other offering participant, the statutory prospectus is not required to
precede or accompany the media free writing prospectus. Rule 433(b)(2)(i)

336 Issuers that have already sent a statutory prospectus to an investor
may send subsequent free writing prospectuses without any additional
information so long as there have been no material changes in the informa-
tion in the previously sent statutory prospectus. After the effective date of
the registration statement, issuers must send a § 10(a) final prospectus
either preceding or together with the free writing prospectus, even if an
earlier preliminary prospectus was sent to the recipient. Rule 433(b)(2)(i).

337 *Seasoned Issuers and Well-Known Seasoned Issuers*—Seasoned and
well-known seasoned issuers, as well as other offering participants, may use
a free writing prospectus at any time after the filing of the registration
statement. As with non-reporting and unseasoned issuers, the exemption
under Rules 164 and 433 applies only after the filing of a registration
statement. The filed registration statement must contain a statutory pro-
spectus that satisfies § 10 (including a “base prospectus” under Rule 430B
for shelf registrations as discussed at the end of the chapter). Unlike non-
reporting and unseasoned issuers, seasoned and WKSI issuers do not have
to deliver the statutory prospectus to recipients of a free writing prospec-
tus.

338 Recall that under Rule 163, a well-known seasoned issuer may also use
a free writing prospectus or make oral offers prior to the filing of the
registration statement. A WKSI and related offering participants do not

338 have to deliver a statutory prospectus with the free writing prospectus and, instead, must only provide a legend indicating where to access or hyperlink to the preliminary or base prospectus. A WSKI may therefore distribute free writing prospectuses freely throughout the public offering process, using Rule 163 in the Pre-Filing Period and Rules 164 and 433 thereafter.

339 *c. Disclosure, filing and retention requirements*

340 Rule 433 imposes two disclosure requirements. First, the free writing prospectus may not contain information that is inconsistent with information contained in either a filed statutory prospectus or a periodic or current report incorporated by reference into the registration statement. Rule 433(c)(1). Second, the free writing prospectus must include a specified legend indicating that the issuer has filed a registration statement with the SEC and where the recipient may obtain the preliminary or base prospectus. Rule 433(c)(2).

341 Rule 433 requires that certain free writing prospectuses be filed with the SEC. Once filed, the information is made available to the public through the SEC's EDGAR system. The issuer must file a free writing prospectus on or before the date of first use in two situations:

- 342 ● Any “issuer free writing prospectus” used by any person;
- 343 ● Any “issuer information” that is contained in a free writing prospectus prepared by any other person (but not information prepared by a person other than the issuer on the basis of issuer information).

344 Rule 433(d)(1). The issuer must also file “a description of the final terms of the issuer’s securities in an offering or of the offering contained in a free writing prospectus or portion thereof prepared by or on behalf of the issuer or any offering participant, after such terms have been established.” Rule 433(d)(1)(i)(C). The issuer does not need to file free writing prospectuses that contain terms that do not reflect the final terms. The issuer has until two days of the “later of the date such final terms have been established for all classes of the offering and the date of first use” to file the final terms. Rule 433(d)(5).

345 The application of the Rule 433 filing requirement is straightforward for “issuer free writing prospectuses” which are defined to encompass all information distributed by the issuer, on behalf of the issuer, or used or referred to by the issuer. Rule 433(h)(1). Such issuer free writing prospectuses must be filed with the SEC without exception. Less clear are the filing obligations resulting from free writing prospectuses of other persons, i.e., the underwriters. Rule 433(d)(1)(i)(B) requires the issuer to file free writing prospectuses prepared by other persons that contain “issuer information.” Rule 433(h)(2) defines “issuer information” as “material information about the issuer or its securities that has been provided by or on behalf of the issuer.” Issuers do not need to file the free writing prospectus of other persons if the prospectus is based on issuer information, but does not directly include such information. According to the SEC, “[e]xamples of this information would include information prepared by underwriters that

345 could be, but would not be limited to, information that is proprietary to an
underwriter.” Securities Act Release No. 8501.

346 Rule 433 imposes filing obligations on persons other than the issuer.
Other participants in the offering, including underwriters, must file free
writing prospectuses that are distributed in “a manner that was reasonably
designed to achieve broad unrestricted dissemination” unless previously
filed with the SEC. Rule 433(d)(1)(ii). What is “broad unrestricted dissemi-
nation”? The SEC tells us that “[f]ree writing prospectuses sent directly to
customers of an offering participant, without regard to number, would not
be broadly disseminated.” Securities Act Release No. 8501.

347 There are exceptions to the filing requirement. Issuers and other
participants may avoid the filing requirement of Rule 433(d)(1) if the free
writing prospectus does not contain “substantive changes from or additions
to a free writing prospectus previously filed with the Commission.” Rule
433(d)(3). Issuers do not need to file the free writing prospectus of other
persons if the issuer information was already included in a previously filed
prospectus or free writing prospectus. Rule 433(d)(4). Issuers transmitting
pre-recorded versions of an electronic roadshow (considered a graphic
communication) may qualify for free writing prospectus treatment under
Rule 433 even if they do not file the roadshow with the SEC. Non-reporting
issuers registering common equity or convertible equity securities, howev-
er, must file roadshows that qualify as written communications with the
SEC unless the issuer makes a “bona fide” version of the roadshow
available without restriction to any person. Rule 433(d)(8). To be “bona
fide,” one or more of an issuer’s officers or other management personnel
must make a presentation in the roadshow, among other requirements.
Rule 433(h)(5)

348 Media sources, in the business of disseminating written communica-
tion, that publish or distribute a free writing prospectus containing infor-
mation on the offering provided by the issuer or any person participating in
the offering (e.g., an interview of the CEO of Smartway about the upcom-
ing IPO) and who are not compensated by the issuer or other participants
in the offering are exempt from the filing and information requirements
under Rule 433. The issuer or other offering participant, however, must file
the media communication with the required Rule 433 legend within four
business days of becoming aware of the media communication. Rule
433(f)(1). Alternatively, the issuer or offering participant may file a copy of
the all the materials provided to the media including “transcripts of
interviews or similar materials.” Rule 433(f)(2)(iii). The issuer or other
offering participant may avoid filing the media communication if the
substance of the communication was already filed with the SEC. Rule
433(f)(2)(i). The issuer or other offering participant may include additional
information if the issuer or other offering participant believes it is needed
to correct information included in the communication. Rule 433(f)(2)(ii).

349 One concern with the greatly expanded filing requirements under the
free writing prospectus rules is the possibility that an issuer may inadver-
tently fail to file by the required deadline (on or before the date of first use

349 in the case of an issuer free writing prospectus). If that happens, the issuer risks a § 5 violation, exposing the issuer to potentially ruinous § 12(a)(1) liability (discussed in Chapter 8) if the issuer goes forward with the offering. To address this concern, the SEC allows issuers and other participants that immaterially or unintentionally miss the filing deadline for a free writing prospectus to cure the violation. Rule 164(b). The cure provision is only available if the issuer has acted in good faith and with reasonable care and issuer must cure the mistake by filing the free writing prospectus as soon as practicable after discovering the failure to file. Rule 164(c) also allows the issuer to cure an omission of the required legend in the free writing prospectus so long as the omission was made in good faith and after reasonable effort to comply with the requirement, the free writing prospectus is amended as soon as practicable to include the legend, and any recipients of the free writing prospectus without the legend are sent the version with the legend.

350 Finally, Rule 433(g) requires issuers and offering participants to retain any free writing prospectus that they have used for three years after the date of the initial bona fide offering of the securities. Immaterial or unintentional failure to follow the record retention requirement will not result in a violation of § 5(b)(1) so long as the issuer made a “good faith and reasonable effort” to comply with the requirement. Rule 164(d).

351 *d. Antifraud Liability and Regulation FD Implications*

352 The free writing prospectus is not considered part of the formal registration statement and thus is not subject to potential § 11 antifraud liability. Nonetheless, free writing prospectuses are considered “public” communications under Rule 433(a) for purposes of § 12(a)(2) antifraud liability (as the term “public” is used by the Supreme Court in Gustafson v. Alloyd Holdings, covered in Chapter 8).

353 Regulation FD provides an exception for communications relating to a registered public offering. For the Pre-Filing Period safe harbors contained in Rules 163 (well-known seasoned issuer Pre-Filing offers) and 163A (greater than 30-days prior to filing exclusion) described above, the SEC provided an explicit exception to this Regulation FD exception (meaning that Regulation FD *does* apply to such communications). The SEC failed to provide a similar exception to the exception for free writing prospectuses under Rules 164 and 433. Why not? The exclusion from Regulation FD may not make much practical difference. Free writing prospectuses that include new information from the issuer must be filed with the SEC on or before their first day of use. The agency posts such filings on EDGAR, thus resulting in the board public dissemination of the information even without the application of Regulation FD.

354 HYPOTHETICAL FIVE

355 Sherry, the CEO of Smartway, working closely with Harold and Sparrow Securities, has filed a registration statement for Smartway’s offering with the

355 SEC. Do any of the following scenarios (all during the Waiting Period) violate
§ 5?

356 1. *Scenario One:* Smartway mails out a glossy pamphlet containing a photo-
graph of Sherry and detailed information on the offering and how the offering
will be “rocket fuel” propelling Smartway’s growth. The pamphlets are mailed
to, among others, all the doctors and lawyers located in California and New
York.

357 2. *Scenario Two:* Sherry decides to give an interview to *Business 2.0* maga-
zine. In the interview, Sherry discusses the offering and her hope that Smart-
way’s business will rapidly expand due to the capital provided by the offering.
The *Business 2.0* article quotes the entire interview.

358 3. *Scenario Three:* Harold of Sparrow Securities sends out an information
packet on the Smartway offering, including the basic terms and its own
analysis of the valuation of the company, together with the preliminary
prospectus to potential dealers in the offering and a select group of institutional
investors that have participated in prior IPOs with Sparrow Securities. In
constructing its valuation analysis, Sparrow relied on detailed financial infor-
mation obtained from Smartway as well as discussions with Smartway’s chief
financial officer, Kumar. Sparrow Securities fails to file the information packet
with the SEC.

359 4. *Scenario Four:* To help drum up more interest in Sparrow’s upcoming IPO,
Harold has Sparrow’s brokerage department mail out the same information
packet from Scenario Three to all the individual investor-clients with accounts
at Sparrow.

360 5. *Scenario Five:* Recall that Sherry and Harold embarked on a “road show”
across the country to pitch the offering to institutional investors. Suppose that
Sherry has one of the road show presentations recorded and posted as a media
file on the investor relations section of Smartway’s website.

361 6. *Scenario Six:* Sparrow Securities sends an email to its investor clients
containing a hyperlink to a PDF version of its preliminary prospectus. The
email also contains hyperlinks to various press stories (in the *Wall Street
Journal*, *Fortune*, etc.) discussing Smartway’s upcoming offering.

362
363 To summarize, the Waiting Period increases the available means of com-
municating “offers” through four broad avenues not generally available during
the Pre-Filing Period:

- 364 (1) oral communications;
365 (2) statutory prospectuses under § 10(b) (see Rules 430, 431);
366 (3) tombstone and safe harbor statements (Rule 134, § 2(a)(10)(b)); and
367 (4) free writing prospectuses (Rules 164 and 433).

368 3. THE PROCESS OF GOING EFFECTIVE

369 While the issuer and managing underwriter busily encourage market
interest during the Waiting Period, the registration statement sits with the
SEC. The issuer must wait for the registration statement to become

369 “effective” before selling any securities to the public. Under § 8(a) of the Securities Act, a registration statement is supposed to become effective the “twentieth day after the filing thereof.” In practice, no issuer allows its registration statement to become effective automatically after twenty days. Instead, issuers commonly file a delaying amendment under Rule 473, waiting for the SEC to declare the registration statement effective. The SEC has the power under § 8(a) to accelerate the effective date of a registration statement. Typically, the issuer and the underwriters will file an acceleration request with the SEC at least two days prior to the offering’s desired effective date.

370 Rule 461 outlines the factors the SEC weighs in deciding whether to grant a request for acceleration of the effective date. Among the factors that may result in a denial of acceleration include inaccurate or inadequate information in a material respect within the preliminary prospectus, failure to make a bona fide effort to conform the prospectus to the plain English requirements of Rule 421(d), a current SEC investigation of the issuer, a controlling person of the issuer, or one of the underwriters, and an objection by the NASD to the compensation to be paid to the underwriters and other broker-dealers participating in the offering. Rule 461 also stresses the importance of the “adequacy of information respecting the registrant . . . available to the public.” Rule 460, in turn, states that one of the considerations in determining the adequacy of information is the distribution of the preliminary prospectus a reasonable time in advance of the anticipated effective date to each underwriter and dealer “reasonably anticipated” to be invited to participate in the offering. A sufficient number of copies of the preliminary prospectus should be provided to ensure “adequate distribution.”

371 Why file a delaying amendment and wait for the SEC’s approval? Why not just start selling twenty days after filing? First, under § 8(a), *any* amendment to the registration statement resets the filing date for purposes of determining when the registration statement becomes effective. Thus, issuers who intend to rely on the twenty day effective period instead of waiting for the SEC’s approval must file a complete and final registration statement twenty days prior to making their first sale. The price, of course, is one of the items that must be disclosed in the registration statement. Filing a complete registration statement would therefore require fixing the price twenty days before sale. Consider why an issuer would not want to fix the price of the offering twenty days before commencing any sales. If the price is fixed at \$20, what if the price the market is willing to pay goes up to \$25? What if the price the market is willing to pay goes down to \$15? Recall that the underwriter is using the Waiting Period to assess investor sentiment through the roadshow. Note, however, that under Rule 430A, the issuer may, under certain circumstances, file a form of the prospectus that omits price-related information as part of the registration statement.

372 Second, as we will cover in Chapter 8, stringent antifraud provisions apply to misstatements and omissions in the registration statement and prospectus. Rather than face potentially crippling antifraud lawsuits, the

372 issuer can obtain comments from the SEC identifying deficiencies and
correct them before selling to the public.

373 Third, issuers that fail to afford the SEC the time the agency deems
necessary risk a formal SEC refusal or stop order. The SEC has a number
of formal powers with which to stop a registration statement's effective-
ness. Section 8(b) of the Securities Act gives the SEC the authority to issue
a refusal order preventing a registration statement from going effective if
the registration statement is "on its face incomplete or inaccurate in any
material respect." To issue a refusal order, the SEC must give the issuer
notice within ten days of the filing of the registration statement. Moreover,
the SEC must hold a hearing within ten days of the giving of notice. The
wheels of government do not spin so fast, so the refusal authority is a
largely empty threat.

374 A more potent threat is found in § 8(d), which authorizes the SEC to
issue a stop order suspending the effectiveness of a registration statement.
Under § 8(d), the SEC may issue a stop order if the registration statement
contains "any untrue statement of a material fact or omits to state any
material fact required to be stated therein or necessary to make the
statements therein not misleading." As with the refusal order under § 8(b),
the § 8(d) stop order requires both notice and a hearing within fifteen days
of the giving of notice. To assist the SEC in determining whether to issue a
stop order, § 8(e) authorizes the SEC to investigate the issuer and under-
writers.

375
376 The SEC review process is relatively informal. If the SEC finds the
registration statement wanting during the comment period, it will typically
send the issuer a comment letter. Issuers, of course, do not have to respond
to the comment letter. But the SEC may refuse to accelerate effectiveness
or, more drastically, initiate a formal investigation leading to a refusal or
stop order. Suffice it to say that either of these events would put the issuer
in a very bad light with investors.

377 The SEC's Division of Corporation Finance reviews some, but not all,
registration statements. In 1980 the SEC adopted a policy of selective
review. The SEC reviews all IPO registration statements, but only selected
registration statements for seasoned offerings. On average, the review
process takes a little over 40 days for IPOs. Seasoned offerings are reviewed
far less frequently and for a shorter time. Non-shelf registrations on Form
S-3 are reviewed less than 15% of the time and spend on average less than
ten days with the SEC. See S.E.C., *Report of the Advisory Committee on
Capital Formation and Regulatory Processes*, app. A. (1996).

378 4. ANALYSTS

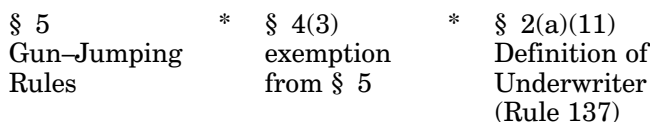
379 The gun-jumping rules restrict "offers" of securities. For non-public
companies doing an IPO, the gun-jumping rules are only an inconvenience.
Such companies typically have no audience of public investors prior to the

379 offering. On the other hand, for companies whose shares are trading in the secondary market, the gun-jumping rules may chill the flow of information to secondary market investors. Although investors cannot buy the registered shares until the effective date, investors can purchase economically similar (and often identical) shares on the secondary market.

380 The issuer is not the only source of information on companies traded in the market. Securities analysts—whether independent or associated with a brokerage firm—provide a constant stream of information on many publicly-traded companies. When a company such as Microsoft—with an active secondary market and many analysts covering the company’s stock—does a seasoned offering, should the securities laws restrict the disclosure to the secondary market of these analysts’ recommendations? The SEC’s definition of an “offer” is surely broad enough to capture such recommendations, which would put analysts and their employers at risk of violating § 5.

381 To avoid that conclusion, the SEC provides for various safe harbors for the publication or distribution of “research reports” under Rules 137, 138, and 139. Research reports are defined as a written communication that “includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security of an issuer, whether or not it provides information reasonably sufficient upon which to base an investment decision.” Rules 137(e), 138(d), 139(d). Rule 405 defines written communication to include broadcast and graphic communications (including e-mails and websites, among other forms of communication).

382 Rule 137 provides a safe harbor for broker-dealers not participating in the offering. If Rule 137 applies, the broker-dealer providing a research report on a security has not made an “offer” or “participated in an offering” within the definition of “underwriter” in § 2(a)(11). Note that Rule 137 does not exclude broker-dealers from the definition of a dealer, so broker-dealers excluded from the definition of an underwriter under Rule 137 still cannot take advantage of § 4(1). Section 4(1), recall, exempts transactions not involving any issuer, underwriter, or dealer. Broker-dealers fall within the definition of a “dealer” in § 2(a)(12) of the Securities Act, and therefore cannot rely on the § 4(1) exemption. Rule 137, instead allows unaffiliated broker-dealers making recommendations in their regular course of business to take advantage of § 4(3) (as interpreted by Rule 174, discussed below). The following diagram depicts the operation of Rule 137.



390 The availability of a § 4(3) exemption from § 5 does not flow automatically from the application of Rule 137. Dealers can rely on § 4(3) if two conditions apply: (a) the dealer is not an underwriter and (b) the publication or distribution of research does not take place during the prospectus delivery requirement period as defined in § 4(3) in conjunction with Rule

390 174. Rule 137 only removes the dealer from the definition of an underwriter. Even with Rule 137, a non-participating broker-dealer must take care not to publish or distribute research that may condition the market during the prospectus delivery period. Fortunately, this is not a great constraint for non-participating broker-dealers providing research for Exchange Act reporting companies. Rule 174 reduces the prospectus delivery period for a previously reporting company to zero days.

391 How does a non-participating broker-dealer qualify for the protections of Rule 137? Rule 137 applies only to research reports that a broker-dealer publishes or distributes “in the regular course of its business.” Rule 137 explicitly excludes from its coverage all broker-dealers who receive compensation from the issuer, selling security holder, other participants in the offering, or “any other person interested in the securities.” (Regular subscription fees for research are allowed under Rule 137.) Rule 137 also does not apply for securities of issuers who, during the past three years, were a blank check company, shell company, or issuer in a penny stock offering.

392 The SEC provides two alternative means in Rules 138 and 139 for broker-dealers participating in the distribution to provide opinions on companies during the registration process. (As with Rule 137, not all companies are eligible: blank check companies, shell companies, and penny stock issuers are excluded.) First, Rule 138 provides a limited safe harbor, exempting research reports of participating broker-dealers from the definition of an “offer for sale” or “offer to sell” for purposes of § 2(a)(10) (definition of prospectus) and 5(c) (prohibition on offers in the Pre-Filing Period). The issuer must be required to file Exchange Act periodic reports and have filed all required reports under Forms 10-K, 10-KSB, 10-Q, 10-QSB, and 20-F. Rule 138 divides securities into two groups: (a) common stock and debt and preferred securities convertible into common stock; and (b) debt and preferred securities not convertible into common stock. Rule 138 gives broker-dealers a safe harbor to provide opinions on one group of securities even though the issuer is offering securities belonging to the *other* group. In order to police attempted circumventions of § 5, any broker or dealer seeking to use Rule 138 to publish research reports on a specific type of securities must have previously published or distributed research on the same types of securities in the “regular course of business.” Rule 138(a)(3).

393 Second, Rule 139 provides a more general safe harbor for participating broker-dealers publishing research reports on Exchange Act reporting issuers. If the requirements of Rule 139 are met, the research reports are deemed not to constitute an “offer for sale” or “offer to sell” for purposes of §§ 2(a)(10) and 5(c). Rule 139 therefore directly protects broker-dealer opinions (that otherwise may be viewed as conditioning the market) from the reach of both § 5(b) and (c).

394 Rule 139 imposes differing requirements based on whether the research report is issuer-specific or covers an industry generally. For issuer-specific research reports, the SEC limits the type of issuers that may

394 qualify for a Rule 139 exemption from §§ 2(a)(10) and 5(c). Only issuers eligible for Form S-3 or F-3 pursuant to the \$75 million minimum public float or investment grade securities provisions of the Forms are eligible. Rule 139(a)(1)(i). A broker-dealer must (1) publish or distribute research reports in the “regular course of its business” and (2) not be initiating (or reinitiating after a lapse) coverage of the issuer or its securities. Rule 139(a)(1)(iii). The research reports need not, however, have been published for any minimum period of time, nor do they need to have covered the same securities being sold in the offering.

395 For “industry reports,” the SEC allows a broker-dealer to publish or disseminate research on a broader range of issuers. Eligible issuers include all reporting issuers. However, greater requirements are placed on the research itself. Rule 139(a)(2)(i). An industry report must include “similar information with respect to a substantial number of issuers in the issuer’s industry or sub-industry, or . . . a comprehensive list of securities currently recommended by the broker or dealer.” Rule 139(a)(2)(iii). The broker-dealer may not devote any “materially greater space or prominence” to the issuer compared with any other securities or companies. Rule 139(a)(2)(iv). Finally, the broker or dealer must (1) publish or distribute research reports in “the regular course of its business” and (2) “at the time of the publication or distribution of the research report, is including similar information about the issuer or its securities in similar reports.” Rule 139a(2)(v).

396 Note that broker-dealers who are participating in an offering have one additional avenue to avoid the strictures of the gun-jumping rules. Rather than look to Rules 138 or 139, the broker-dealer who is participating may attempt to treat their research report as a free writing prospectus under Rules 164 and 433. Assuming the various information, prospectus delivery (if any), filing, legending, and record retention requirements are met, participating broker-dealers may avoid the requirements of Rules 138 or 139, such as the “regular course of its business” and the “at the time of publication or distribution” requirements of Rule 139.

397 HYPOTHETICAL SIX

398 Smartway shares are not currently publicly traded, so there are no analysts following its securities. The news of its impending public offering, however, has caused some members of the investment community to take notice of Smartway. Consider whether any of these discussions of Smartway’s initial public offering run afoul of the gun-jumping rules.

399 **1. Scenario One:** Lan is a reporter for the *Wall Street Journal*. She heard of Smartway’s public offering from a friend who saw Smartway’s Rule 135 notice. After researching Smartway’s business, Lan writes a story on the offering as part of a general report on the high-flying IPO market. The story is published on page C1 of the *Journal* (the market page) and includes projections on Smartway’s future profitability.

400 **2. Scenario Two:** Lavina is a research analyst at Silverman Brothers. Silverman regularly publishes analyst opinions on companies in various sectors.

400 Silverman is not participating in the offering. Nonetheless, Lavina writes an analyst report on Smartway, giving the company a “neutral” recommendation for the IPO. Silverman publishes the analyst report, distributing it to brokers within the company as well as to its many retail and institutional investor clients. This is, however, Silverman’s first analyst report on Smartway.

401 **3. Scenario Three:** Grace is a research analyst at Sparrow Securities, the managing underwriter for Smartway’s offering. In preparation for the IPO, Grace writes a research report for Smartway, giving the company a “buy” recommendation for the IPO. Sparrow publishes a summary of the report (with the buy recommendation) in its monthly newsletter sent out prior to the effective date of the offering. Smartway has previously not been covered in the regular newsletter.

402 **4. Scenario Four:** Grace is a research analyst at Sparrow Securities. Suppose that in the past, Smartway had sold a large number of non-convertible bonds in private placements to a group of insurance companies. The insurance companies eventually resold the bonds, creating a liquid secondary market for the bonds among institutional investors well before Smartway’s decision to do an initial public offering of its common stock. Sparrow Securities decides to publish a special report covering the traded bonds. Published prior to the IPO’s effective date, the report summarizes Grace’s research into the bonds and her opinion that the bonds are a “good buy.”

403 C. POST-EFFECTIVE PERIOD

404 Just before the registration statement goes effective, the underwriters and the issuer will typically sign a formal underwriting agreement, specifying, among other things, the offering price to the public and the discount at which shares are sold to the underwriters in a firm commitment offering. After the registration statement becomes effective, § 5(a) no longer applies and the issuer and those participating in the offering can begin selling their shares. In a firm commitment offering, the underwriters then purchase the discounted securities and begin sales to investors. For many public offerings, the entire offering process is completed within the first day of the offering. The public offering may commence at 10 A.M. and underwriters may complete the sale of all firm commitment shares by the end of the trading day, if not earlier. For particularly “hot” IPO issues, the demand for the shares may outstrip the number of offered shares. The managing underwriter, or “book-running” underwriter, may have latitude in deciding to whom to allocate shares. Typically, larger institutional investors with repeat relationships with specific investment banks will be given preference in obtaining offered shares.

405 Despite the freedom to make sales in the Post-Effective Period, the issuer and others continue to face restrictions, most critically § 5(b). Section 5(b)(2) prohibits the transmission of securities “for the purpose of sale or for delivery after sale” unless accompanied or preceded by a statutory prospectus. In the Post-Effective Period, only a prospectus meeting the requirements of § 10(a) constitutes a valid statutory prospectus. The § 10(b) preliminary prospectus authorized by Rule 430 no longer meets the requirements of § 5(b).

Pre-Filing Period | Waiting Period | Post-Effective Period

§ 5(a) —————>

§ 5(b)(1) —————>

§ 5(b)(2) —————>

§ 5(c) —————>

For most purchases of securities, no actual stock certificate is transmitted, making § 5(b)(2) somewhat anachronistic. The real bite of § 5(b) lies in § 5(b)(1). Section 5(b)(1) continues to restrict written materials and broadcasts offering a security for sale unless such materials qualify as a § 10 prospectus. Can the prohibition of § 5(b)(1) be avoided by simply eschewing all written or broadcast communication offering the security? No, the definition of a prospectus in § 2(a)(10) includes written confirmations of sale. Consequently, underwriters sending confirmations fall within the prospectus delivery requirement. At the latest, a final prospectus must be sent with the confirmation of sales thereby bringing the confirmation within the § 2(a)(10)(a) “free writing” exception. (Perhaps realizing that the final prospectus does little good to an investor with the confirmation of sale, if the issuer is not already a reporting company, the SEC in Rule 15c2-8(b) requires that participating brokers must send a copy of the preliminary prospectus at least 48 hours prior to the sending of the confirmation.)

Section 2(a)(10)(a) removes “free writing” from the definition of a prospectus in the Post-Effective Period. In addition to confirmation of sales, “free writing” potentially includes all offering materials which would otherwise be a prospectus not complying with § 10(a). The free writing exception in § 2(a)(10)(a) excludes such communications from the definition of a prospectus if a formal § 10(a) statutory prospectus either accompanies or precedes the free writing after the effective date of the registration statement. Issuers and broker-dealers can therefore send confirmations and other selling documents to potential investors after the effective date as long as they also include the final statutory prospectus. The concept of “free writing” under § 2(a)(10)(a) pre-dates and is distinct from the exemption for “free writing prospectuses” under Rules 164 and 433. Post-effective communications that fit under the traditional free writing exception contained in § 2(a)(10)(a) are not treated as free writing prospectuses.

In this section we discuss: (1) the form of the statutory prospectus, (2) the prospectus delivery requirement, and (3) the updating of information contained in the statutory prospectus and registration statement.

1. FORMS OF THE FINAL PROSPECTUS

The final statutory prospectus adds price-related information (e.g., the offering price, the underwriters’ discount, etc.) to the information contained in the preliminary prospectus. Part I of the relevant registration

422 statement form (e.g., Form S-1 or S-3 for most domestic issuers) details
the required information, including information on the business, proper-
ties, management, capital stock, and audited financial statements.

423 As originally conceived, the final prospectus contained all the required
information in one physical document. Investors would receive the entire
document through the mail or directly from their broker or a dealer. Over
time, the definition of a final prospectus was relaxed. Printing a physical
document takes time, but issuers and underwriters, typically want to set
the price immediately before selling securities to the public. If the issuers
and underwriters set the offering price too high, few investors will buy the
securities. If the offering price is set too low, the issuer (and to a lesser
extent the underwriters) leave money on the table, foregoing possibly
higher proceeds.

424 Rule 430A of the Securities Act alleviates these timing concerns. Under
Rule 430A, the final prospectus filed as part of the registration statement
may omit price-related information. Rule 430A is available only for all-cash,
firm commitment offerings, so offerings for non-cash consideration (e.g., an
exchange offer for stock) and best efforts offerings cannot use Rule 430A.
(Recall that underwriters bear less risk in a best efforts offering because
the underwriters are not left holding any unwanted securities if the price is
set too high.) Rule 430A also applies to registration statements that are
immediately effective upon filing with the SEC pursuant to Rule 462(e) and
(f). Rule 462(e) deals with automatic shelf registration statements filed by a
well-known seasoned issuer (we cover shelf registration later in the chap-
ter).

425 Issuers using Rule 430A must eventually file price-related information
with the SEC. If the filing occurs within fifteen business days after the
effective date of the registration statement, then no post-effective amend-
ment is necessary. Instead, issuers must file a prospectus containing the
pricing information under Rule 424(b). After fifteen business days, the
price-related information must be filed as a post-effective amendment to
the registration statement.

426 Issuers relying on Rule 430A must also agree to the undertaking in
Item 512(i) of Regulation S-K. Item 512(i) provides that for antifraud
purposes (e.g., § 11 liability) price-related information filed after the effec-
tive date of the registration statement shall be deemed to be part of the
registration statement as of the date the registration statement was origi-
nally declared effective. If the price-related information were instead filed
as a post-effective amendment, then Item 512(i) provides for liability
purposes that “each post-effective amendment that contains a form of
prospectus shall be deemed to be a new registration statement relating to
the securities offered therein, and the offering of such securities at that
time shall be deemed to be the initial bona fide offering thereof.”

427 2. PROSPECTUS DELIVERY REQUIREMENT

428 One of the primary goals of the public offering process is the creation
of the mandatory disclosure documents: the registration statement and the

428 statutory prospectus. Creation of the documents, however, can only address
issuers' underlying informational advantage over investors if investors
429 receive, whether directly or indirectly, the information in the document. To
whom, and more critically, for how long after the offering begins, must the
430 statutory prospectus be sent?

a. The Traditional Delivery Requirement

431 Section 5(b) provides the cornerstone of the prospectus delivery re-
quirement time. Under § 5(b)(1), recall that all persons bear an obligation
to send the statutory prospectus in the Post-Effective Period either with or
preceding the written confirmations. Rule 15c2-8(h), in turn, requires the
managing underwriter to ensure that all broker-dealers “participating in
the distribution or trading in the registered security” are provided with
sufficient copies of the final prospectus in order to comply with the
prospectus delivery requirement.

432 How long does the prospectus delivery requirement last? Section 5(b)
provides no limit. Consider the cost an indefinite delivery requirement
would place on secondary market transactions. Because § 5 applies to “any
person,” even individual investors selling securities in the secondary mar-
ket (and their brokers) would have an obligation to send a statutory
prospectus to purchasing investors. How would an individual investor
obtain the statutory prospectus to send with the confirmation? What if the
sale takes place many years after the original public offering?

433 Fortunately, the prospectus delivery requirement has a more reason-
able duration. Two important exemptions from § 5 limit the reach of
§ 5(b). First, § 4(1) exempts transactions not involving any “issuer, under-
writer, or dealer” from § 5. Congress enacted § 4(1) specifically to exempt
individuals selling in ordinary secondary market transactions from the gun-
jumping requirements. Section 4(1) exempts the vast majority of secondary
market transactions. Brokers' roles in those transactions in the secondary
market, if unsolicited, are exempted by § 4(4).

Note that § 4(1) does not exempt transactions for securities dealers;
they have to find their own exemption. Section 5(b) applies broadly to all
persons, so even securities dealers who did not participate in the public
offering must deliver a statutory prospectus with the confirmation during
the prospectus delivery period. Section 4(3) provides an exemption specifi-
cally for dealers, but its availability is limited. Dealers still acting as
underwriters for the offering are not allowed to use the § 4(3) exemption
for securities that are part of an unsold allotment, so they must comply
with § 5(b)'s prospectus delivery requirements. For dealers not acting as an
underwriter (either because they are not participating in the offering or
because they have sold all of their allotment), § 4(3)—in conjunction with
Rule 174—establishes time limits for § 5(b)'s delivery requirements. The
time periods are as follows:

434 0 days—Exchange Act reporting issuer prior to the offering (i.e., an
issuer subject to the reporting requirements of § 13 or 15(d) of the
Exchange Act)

435 25 days—Issuer whose securities will be listed on a national securities
exchange or Nasdaq

436 40 days—Issuer that does not fit any of the above categories *not* doing
an initial public offering

437 90 days—Issuer that does not fit any of the above categories doing an
initial public offering

438 *b. Access Equals Delivery*

439 When the Securities Act was enacted in 1933, paper documents were
the primary means of communication. Although the telegraph and tele-
phone did exist, neither instrument provided a convenient medium to
transmit a large amount of information. Investors interested in learning
directly about a particular public offering had to read the paper version of
the statutory prospectus.

440 Even in the 1930s, however, the benefit to the investors from the
prospectus delivery requirement was less than clear. The SEC can mandate
that the prospectus be delivered to the door of many individual investors,
but it cannot make them read it. (And recycling was less prevalent in the
1930s than it is today!) Why would an investor ignore the prospectus? For
individual investors making only a small investment, the cost of reading
and deciphering the prospectus—shrouded in legalese and dense with
accounting figures—outweighs the potential benefit of doing so.

441 Even with a readership well below 100%, mandatory disclosure none-
theless may protect retail investors in one of three ways. First, the mere
drafting of a disclosure document that the SEC may review encourages
issuers to be truthful in their disclosures. That incentive is bolstered by the
possibility of an antifraud suit under the generous standards of §§ 11 and
12(a)(2).

442 Second, retail investors may obtain information indirectly. Retail inves-
tors may never read the prospectus, but they may read analyst reports on
the company and/or obtain advice from their brokers before investing. Both
of these sources may be enlightened by the disclosures in the prospectus.
To be sure, recent scandals in the United States involving analyst opinions
from many prominent investment banks call into question the value of
analyst and broker recommendations. This problem seems most acute when
the analyst and broker are associated with a brokerage firm that also
provides investment banking advice and underwriting services to issuers.

443 Finally, even if the retail investors make no effort to digest the
information, disclosure may influence the market for the offering. Most
public offerings are purchased primarily by institutional investors. If these
investors are not willing to purchase the securities (at least at the price

443 range initially contemplated), the issuer and underwriters may need to
reduce the price to sell out the entire offering.

444 What is the best way to distribute the mandatory disclosure? As part of
the SEC's 2005 Public Offering Reforms, the SEC promulgated Rule 172,
under which "access equals delivery" for the prospectus delivery require-
ment. (certain issuers and transactions are excluded.) Rule 172(c) imposes
several conditions to qualify for an exemption. Most importantly, the issuer
must file a final § 10(a) statutory prospectus with the SEC (with the
possible omission of certain information as provided by Rule 430A) or
"make a good faith and reasonable effort to file such prospectus within the
time required under Rule 424 and in the event that the issuer fails to file
timely such a prospectus, the issuer files the prospectus as soon as
practicable thereafter." Rule 172(c)(3). The filing condition is not required
for dealers to take advantage of Rule 172 who would otherwise face a
prospectus delivery requirement due to the operation of §§ 5 and 4(3). Rule
172(c)(4). If Rule 172(c) is satisfied, Rule 172(a) exempts written confirma-
tions of sales from the reach of § 5(b)(1), obviating the need for broker-
dealers to mail out a final prospectus together with the confirmation of
sales. Similarly, Rule 172(b) deems the requirement that a prospectus
precede or accompany a security transmitted for sale as met for purposes of
§ 5(b)(2). General free writing other than the written confirmation of sales
is not covered under Rule 172 and therefore falls under the traditional
prospectus delivery requirement discussed above (although a seasoned
issuer or WKSI may avoid prospectus delivery if they instead comply with
the free writing prospectus requirements under Rule 164 and 433).

445 Underwriters, brokers and dealers are not completely freed from the
requirement to transmit additional information along with the confirma-
tion of sales. Rule 173 requires that for transactions in which the final
prospectus delivery requirement applies under Rule 174 and § 4(3), partici-
pating underwriters, brokers, and dealers (or issuer if sold directly by the
issuer) must send to each purchasing investor, who purchased directly from
the respective underwriter, broker, dealer, or issuer, notice that the sale
took place under an effective registration statement or a final prospectus
pursuant to an effective registration statement, thereby informing the
purchaser that they may have rights under §§ 11 and 12(a)(2). The notice
must be provided not later than two business days following the completion
of the sale. Purchasers may request a copy of the final prospectus from the
person sending out the notice. After the effective date of the registration
statement, notices mailed under Rule 173 are exempt from § 5(b)(1) (and
thus avoid the prospectus delivery requirement). Compliance with Rule
173's notice requirement is not a prerequisite for the application of the
Rule 172 access-as-delivery safe harbor from the prospectus delivery re-
quirement.

446 HYPOTHETICAL SEVEN

447 Suppose Smartway and Sparrow Securities commence sales of the initial
public offering on June 1st. Among the underwriters in the offering are

447 Sparrow Securities (with the largest allotment of shares) and Villagebank, a
large investment bank based in New York City. Villagebank was allocated
400,000 Smartway shares for sale. Assume that by June 3rd, Villagebank has
sold 300,000 shares from its allotment leaving 100,000 more shares to sell. Do
any of the following run afoul of § 5?

448 1. *Scenario One:* Villagebank sells shares out of its remaining allotment to
Kevin, an investor based in New York City. Together with the confirmation of
sales, Villagebank mails out a copy of the final prospectus.

449 2. *Scenario Two:* Simultaneously with the commencement of the offering,
Smartway's shares are listed on Nasdaq. Secondary market trading quickly
follows. Marx Securities, a securities dealer not participating in Smartway's
offering decides to sell some of its Smartway common stock inventory into the
market one week after the start of Smartway's IPO. Marx Securities mails the
stock certificates for the shares it sells to purchasing investors but does not
send a statutory prospectus to the investors.

450 3. *Scenario Three:* Suppose instead that Marx Securities simply pitches
Smartway securities through cold calls to retail investors who then purchase
Smartway shares. Marx Securities acts as their broker in placing the investors'
orders with a market maker in Sparrow stock. Marx Securities sends each
purchasing investor a written confirmation, but not the statutory prospectus.

451 4. *Scenario Four:* Suppose that Villagebank issues an analyst report on
Smartway on June 10. At that time, Villagebank still holds 50,000 shares from
its allotment. The report covers a number of high-growth companies, including
Smartway. The report recommends Smartway as a "buy" and talks glowingly
about Smartway's future growth prospects. The analyst report is sent to all of
Villagebank's customers.

452 5. *Scenario Five:* Suppose that Jack, a coffee importer from Brazil, decides to
purchase some Smartway stock on the secondary market. He contacts his
broker, Joel, at Villagebank and instructs him to purchase 1,000 shares at the
prevailing market price. Joel executes the order for Jack on June 10, sending
him a written confirmation two days later, but does not include the statutory
prospectus.

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4. UPDATING THE PROSPECTUS AND REGISTRATION STATEMENT

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Not all public offerings sell out on the first day of the offering. Less desirable offerings may take some time to sell. As we discuss below issuers may also register an offering to take place over an extended period of time (a “shelf registration”). Even after the offering is initially sold, we saw in the prospectus delivery section above that under certain circumstances § 5(b) imposes a continuing obligation on dealers to send the final prospectus along with any written confirmation of sales (or afford access through filing under Rule 172).

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Information about the issuer may change after the effective date of the registration statement. The CEO of the issuer may resign. The issuer may decide to shift into a different line of business. The issuer may terminate its auditor and hire a new independent accountant. A company may become the target of a new lawsuit that, while unrelated to the public offering, may pose a significant contingent financial liability. For investors contemplating whether to buy the issuer’s offered securities, either directly from the underwriters or through later secondary market trading, should it matter that the final prospectus and registration statement have become outdated?

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The concept of materiality helps answer this question. Recall that materiality is defined by reference to the “total mix of information.” Information that in isolation may seem important to reasonable investors loses its materiality if the market already has the information. For companies whose securities trade in an informationally efficient capital market, “new” information on the company may already be incorporated in the stock market price, making updating the prospectus and registration statement unnecessary. Indeed, most investors would never read an updated prospectus. As a practical matter, the market price is the *only* way such new information will (indirectly) reach the investors. Consider the extent to which the efficient capital market hypothesis informs the requirements for updating the prospectus and registration statement.

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a. Updating the Prospectus

Depending on the type of issuer, the prospectus delivery requirement may extend up to 90 days after the start of the public offering for securities dealers who are not part of the underwriting syndicate. Underwriters selling their allotment are required to deliver a prospectus until their allotment is entirely sold. Most updates to the prospectus take place through a process known as “stickering” under which new information is added to the relevant page of the prospectus. Rule 424(b)(3)-(5) sets forth the procedure for stickering.

Three basic duties require updating of the final prospectus:

Section 10(a)(3) of the Securities Act. Under § 10(a)(3), if a prospectus is used more than nine months after the effective date of the registration statement, the information used in the prospectus may not be more than sixteen months old to the extent that the information is known to the

461 “user of the prospectus” or can be provided without unreasonable effort or
expense.

462 *Antifraud Liability.* No explicit updating duty is specified in § 12(a)(2)
or Rule 10b–5 antifraud liability. Instead, the prospect of antifraud liability
indirectly imposes an incentive for issuers to update the prospectus. If the
information in a prospectus is no longer accurate, the issuer and others
involved with the prospectus are potentially liable for both § 12(a)(2) and
Rule 10b–5 liability.

463 *Shelf Registration.* Issuers doing a shelf registration under Rule 415
must update the prospectus to reflect any “fundamental” change to the
information set forth in the registration statement pursuant to Item 512(a)
of Regulation S–K. As we discuss below, Item 512(a) also requires the filing
of a post-effective amendment to the registration statement.

464 For non-shelf registration offerings, does § 10(a)(3) provide an ade-
quate incentive for issuers to update the prospectus? Since the prospectus
delivery requirement for non-shelf public offerings may continue at most
for 90 days after the commencement of the offering, § 10(a)(3)’s nine-
month updating requirement has little effect. Only underwriters still sell-
ing an unsold allotment of securities are subject to the updating require-
ment. (The SEC takes a dim view of a non-shelf registration that continues
for an extended period after the effective date of the registration state-
ment.) Thus, § 10(a)(3) is generally important only for shelf registration
offerings.

465 Instead, antifraud liability provides the major incentive for updating
the prospectus. Antifraud liability, however, may impose a number of
different requirements on investor-plaintiffs as well as provide possible
defenses for the defendants. Rule 10b–5, for example, requires plaintiffs to
demonstrate that the defendants had scienter (whether intentional or
reckless) with respect to the fraud. Section 12(a)(2) has no scienter require-
ment, but defendants can avoid antifraud liability so long as they did not
know (nor could have known with “reasonable care”) about the materially
misleading misstatement or omission.

466 Another potential source of liability is § 12(a)(1). In SEC v. Manor
Nursing Centers, Inc., 458 F.2d 1082 (2d Cir. 1972), the Second Circuit held
that a grossly misleading prospectus would violate the prospectus delivery
violations of § 5, thus potentially giving rise to a cause of action under § 12
(a)(1).

467 The Second Circuit’s opinion in Manor Nursing has not attracted
broad support. The Fifth Circuit in SEC v. Southwest Coal & Energy Co.,
624 F.2d 1312, 1318–19 (5th Cir. 1980), wrote:

468 The Manor Nursing thesis of fraud as a basis for § 5 violations has
been roundly criticized . . . § 12[a](1) provides strict liability for one
who offers or sells a security in violation of § 5. Sections 11 and
12[a](2) similarly provide liability for offers or sales of securities upon
misrepresentation or misleading nondisclosure of material facts, but
only if the offeror cannot demonstrate that he did not know, and could

468 not reasonably have been expected to know, of the untruth or omission. Under the *Manor Nursing* construct, however, one who proves a misrepresentation actionable under § 11 or § 12[a](2) has also proved a violation of § 5, thus automatically establishing liability per se under § 12[a](1). Not only does this interpretation render § 11 and 12[a](2) essentially superfluous as remedial mechanisms, but it also obliterates the due diligence defense contained in these sections, plainly intended to be available to defendants in actions under the 1933 Act based on such misrepresentations or nondisclosures. Such a result could not possibly have been intended by the drafters of these provisions.

469 *b. Updating the Registration Statement*

470 The registration statement must be accurate as of its effective date because antifraud liability under § 11 and Rule 10b-5 is measured as of that time. In addition, the SEC may issue a stop order pursuant to § 8(d), as discussed above, if the registration statement contains misrepresentations. The SEC's authority under § 8(d), however, only reaches registration statements that contain a material misstatement at the time of the effective date. See *Charles A. Howard*, 1 S.E.C. 6 (1933). Although issuers (and other associated parties) may have a duty to correct materially false or misleading information in the registration statement at the time of the effective date, no duty exists to update previously accurate information. Thus, there is no general duty to update the registration statement.

471 There are two major exceptions to the general rule that there is no duty to update the registration statement. First, issuers using a Rule 415 shelf registration, as we will see below, must include an Item 512(a) undertaking pursuant to Regulation S-K. The Item 512(a) undertaking requires the issuer to make a post-effective amendment to the registration statement for certain events, including any § 10(a)(3) change to the prospectus, any “fundamental” change to the information set forth in the registration statement, or any material change to the plan of distribution. Rule 412 allows issuers to use incorporation-by-reference of Exchange Act filings instead of a post-effective amendment to meet the updating requirement of Item 512(a).

472 Second, in certain circumstances, if the issuer updates the prospectus, the issuer also must file that updated prospectus as a post-effective amendment to the registration statement. Recall that the statutory prospectus is Part I of the registration statement. Rule 424(a) requires that “substantive changes from or additions to” a previously filed prospectus must be filed as part of the registration statement (technically as an amendment to the registration statement). Non-substantive changes may be made by “sticker-ing” the prospectus without a new filing.

473 What counts as a “substantive” change or addition is unclear. The SEC felt it necessary to require shelf registration issuers to include an undertaking under Item 512(a) for “fundamental” changes to the registration statement, implying that a *mere* “fundamental” change would normally not warrant an amendment to the registration statement without the

473 undertaking. On the other hand, the SEC has expressed the view that even
without an Item 512(a) undertaking for non-shelf registration offerings,
“the staff generally requires that post-effective amendments be filed to
reflect material changes.” See Securities Act Release No. 6276 (Dec. 23,
1980).

474 Updating the registration statement (through an amendment) has far
greater negative consequences than does stickering the prospectus for
developments occurring during Post-Effective Period. A post-effective
amendment to the registration statement under § 8(c) of the Securities Act
becomes effective only at the discretion of the SEC. When the amendment
becomes effective, all the information in the registration statement is
assessed at the new effective date for purposes of § 11 antifraud liability.
Issuers filing a post-effective amendment to the registration statement
therefore open themselves up to additional possible antifraud liability if
they have not updated all of the information in the registration statement.

475 HYPOTHETICAL EIGHT

476 Smartway’s IPO registration statement has been declared effective by the
SEC. In the registration statement and final prospectus, Smartway disclosed
that it is in the midst of negotiating a contract with the Law Professors
Association of America, Inc. (LPAA) to obtain rights to use the likenesses of
well-known law professors as a marketing tool to help sell more airline tickets.
(Sherry believes, perhaps wrongly, that law students are a great target custom-
er base because they have a great respect and regard for their professors.) The
registration statement did not include a risk factor mentioning the possibility
that the LPAA contract may not come through. Two weeks after the effective
date of the registration statement, the LPAA has gone bankrupt and, conse-
quently, all of the contract talks with LPAA have fallen through. Moreover, all
the big-name law professors have broken ranks and signed with Smartway’s
major competitors. Is there any duty to update either the final prospectus or
the registration statement and why?

478 III. PUBLIC OFFERING TRADING PRACTICES

479 During and immediately after a public offering, underwriters have a lot
at stake in maintaining (or better yet, increasing) the market price of the
offered securities. If the securities price drops precipitously during an
offering, the underwriter may have trouble selling unsold allotments of
securities. In a firm commitment offering, the underwriter bears the risk of
selling the securities and thus suffers in the case of any unsold allotment.
In addition, most public offerings include an overallotment option for
underwriters to expand the size of the offering. This “Green Shoe” option
allows the underwriters to purchase up to an additional 15% of the offered
securities at the discounted price for resale to investors at the offering
price. If the price holds up, the overallotment option can mean additional
profits for the underwriters.

480 A price drop after an offering commences may harm underwriters indirectly as well. Part of the service underwriters offer to issuers (and a principal justification for the large underwriter's discount) derives from the relationships the underwriters enjoy with large institutional investors. These investors depend on the underwriters to bring them fairly priced—or better still, underpriced—securities. If the price drops, the institutional investors that purchased initially in the offering will lose money and the underwriters will lose face (and, potentially, customers for future offerings).

481 Underwriters may attempt to affect artificially the secondary market price of a security through fraud. For example, the underwriters may disclose false information after the start of the offering that the company's profits are projected to climb sharply. Antifraud liability limits such she-nanigans.

482 Left unregulated, underwriters might purchase shares in the market in an attempt to inflate secondary market price. Large volume purchases may push the market price higher for at least two possible reasons. First, increased demand could exhaust the supply of securities that investors are willing to sell at a particular price. Investors may have a range of beliefs on the value of the security or, alternatively, face different tax consequences from the sale of securities. To induce more investors to sell in the face of increased demand, the market price must increase. Second, the presence of a large volume of purchase orders may signal to the market that informed investors have non-public information that the company is undervalued (and are acting on this information by purchasing securities). This signal will also cause the market price to rise.

483 Regulation M supplements the general antifraud and anti-manipulation provisions of the securities laws, such as §§ 9(a), 10(b), and 15(c) of the Exchange Act, focusing in particular on manipulation that may take place in connection with securities offerings. The SEC explains the purpose of Regulation M:

484 As a prophylactic, anti-manipulation measure, Regulation M is designed to prohibit activities that could artificially influence the market for the offered security, including, for example, supporting the offering price by creating the exaggerated perception of scarcity of the offered security or creating the misleading appearance of active trading in the market for the security.

485 Securities Act Release No. 8511 (Dec. 9, 2004). No explicit private cause of action exists for Regulation M violations. Instead, the SEC may bring an enforcement action for a violation.

486 A. IPO ALLOCATIONS

487 On December 6, 2000 the *Wall Street Journal* ran a front-page story exposing abuses in the market for initial public offerings. See Susan Pulliam & Randall Smith, *Seeking IPO Shares, Investors Offer to Buy More in After-Market*, Wall St. J. A1 (Dec. 6, 2000). The story revealed “tie-in”

487 agreements between investment banks and initial investors seeking to participate in “hot” offerings. Under those agreements, initial investors would commit to buy additional shares of the offering company’s stock in secondary market trading in return for allocations of shares in the IPO. As the *Wall Street Journal* related, those “[c]ommitments to buy in the aftermarket lock in demand for additional stock at levels above the IPO price. As such, they provide the rocket fuel that sometimes boosts IPO prices into orbit on the first trading day.” This process of encouraging purchases in the aftermarket at ever-higher prices has come to be known as “laddering.” The *Journal*’s account of the practice essentially lays out a conspiracy between underwriters and their favored investor-customers to engage in a scheme of market manipulation. Retail investors—who end up purchasing the stock after the IPO at inflated prices—systematically lose from the manipulation.

488 What benefits do underwriters receive from boosting the aftermarket price? At first glance, the clear winners from a hot IPO are those initial investors who purchase at the IPO offering price, typically large institutional investors. Underwriters may then benefit in a number of indirect ways. First, underwriters in a firm commitment offerings (under which the underwriters bear the risk of failing to sell out the offering) reduce their risk. Investors are more willing to purchase IPO shares if they expect immediate gains in the stock price in the secondary market. Second, underwriters gain a reputational benefit. By elevating the aftermarket price above the IPO price, underwriters allow their customers—the institutional IPO investors—to sell their overvalued stock to retail investors in the aftermarket. A drop in stock price before the institutional investors sell their IPO allotments into the secondary market would damage the underwriters’ IPO reputation among the institutional investors. Among the services underwriters provide to issuers is their ability, which is based on the underwriters’ reputation, to bring investors willing to buy the IPO stock. Laddering therefore may enhance the underwriters’ reputation with future issuers as well. Third—and less benign from the issuer’s perspective—underwriters may obtain under-the-table commissions from favored investor-clients. In a follow-up story on the laddering scheme, the *Journal* reported a joint investigation into the allegations by the SEC and the U.S. Attorney for the Southern District of New York. That story pointed to underwriters demanding commissions from investors favored with hot IPO allocations: “Wall Street dealers may have sought and obtained larger-than-typical trading commissions in return for giving coveted allocations of IPOs to certain investors.” See Randall Smith & Susan Pulliam, *U.S. Probes Inflated Commissions for Hot IPOs*, Wall St. J. C1 (Dec. 7, 2000).

489 Not surprisingly, the fallout from these revelations has been severe for the investment banking industry. The SEC’s investigation into the practice has led to substantial settlements with many of the best known investment banks. For example, CS First Boston settled for \$100 million with the SEC and, as is customary, neither admitted nor denied guilt in the matter. The magnitude of these fines suggests that the SEC was able to uncover hard evidence of the laddering scheme. The NASD has proposed rules to try and

489 dampen the frothy IPO aftermarket that makes such abuses possible. The
ruler would, among other things, ban market orders on the first day of
trading after the IPO.

490 If market purchases on behalf of underwriters artificially raise the
price of securities, these purchases distort the true value of the securities,
causing investors purchasing the securities to pay too much. One possible
regulatory response to the problem of underwriter trading practices de-
signed to maintain or increase the secondary market price of an offered
security would be a flat ban. The SEC, however, did not take such an
approach. Instead, the SEC adopted a more nuanced approach in Regula-
tion M under the Exchange Act to regulate trading practices surrounding a
distribution of securities.

491 Regulation M balances three disparate considerations. First, not all
purchases (or bids) on the part of underwriters and others associated with
an offering are intended to manipulate the secondary market price. Invest-
ment banks acting as underwriters may also act as market makers for the
stock. (To serve as market makers, the banks must have the ability to
purchase the stock at prevailing market prices to maintain market liquidi-
ty.) In addition, investment banks acting as underwriters may also have a
brokerage division that purchases securities on behalf of clients in unsolic-
ited transactions.

492 Second, attempts to affect artificially the market price through pur-
chases are much less likely to work for companies with a “deep” secondary
market with large volumes of unrelated, independent trades. An underwrit-
er purchasing 100,000 shares is much more likely to affect the market price
for a company with an average daily trading volume of 200,000 shares than
a company with an average daily trading volume of 10 million shares.

493 Regulation M also distinguishes between efforts to raise the market
price above its current level (banned market manipulation) and efforts
simply to maintain the market price at the offering price (regulated
stabilization). Although both distort the market price, the potential for
distortion is greater with efforts to raise the market price. For example,
consider where the market price for Smartway immediately after the public
offering is \$20 per share. Information then reaches that market that the
true value of Smartway is only \$17 per share. Efforts to manipulate the
price upwards (if successful) can result in a price of above \$20 (say \$25 per
share)—resulting in an overvaluation of \$8 per share. With stabilization,
the maximum price permitted is \$20 per share (the public offering price).
Thus, the potential overvaluation is only \$3 per share.

494 B. MARKET MANIPULATION

495 Regulation M regulates efforts to manipulate the market price of a
company’s securities during a public offering of “covered” securities. Cov-
ered securities include “any security that is the subject of a distribution, or
any reference security.” Regulation M defines a reference security as “a
security into which a security that is the subject of a distribution . . . may

495 be converted, exchanged, or exercised or which, under the terms of the
subject security, may in whole or in significant part determine the value of
the subject security.” Rule 100, Regulation M. Thus, if a company is issuing
convertible bonds then the reference security is the class of common shares
into which the bonds could be converted. The common shares, as reference
securities, would also come under the restrictions of Regulation M as
covered securities.

496 In order to curb market manipulation, Rules 101 and 102 limit certain
types of trading during the “restricted period.” The restricted period is
defined under Rule 100 and depends in part on the worldwide average daily
trading volume (the “ADTV”) for the two months, among other possible
time periods, preceding the filing of the registration statement. The differ-
ent possible restricted periods are as follows:

- 497 1. For any security with an ADTV value of \$100,000 or more of an
issuer whose common equity securities have a public float value of
\$25 million or more, the period beginning on the later of one
business day prior to the determination of the offering price or
such time that a person becomes a distribution participant, and
ending upon such person’s completion of participation in the
distribution; and
- 498 2. For all other securities, the period beginning on the later of five
business days prior to the determination of the offering price or
such time that a person becomes a distribution participant, and
ending upon such person’s completion of participation in the
distribution.
- 499 3. In the case of a distribution involving a merger, acquisition, or
exchange offer, the period beginning on the day proxy solicitation
or offering materials are first disseminated to security holders, and
ending upon the completion of the distribution.

500 “Distribution participant” is defined to include an “underwriter, prospec-
tive underwriter, broker, dealer, or other person who has agreed to partici-
pate or is participating in a distribution.” Rule 100.

501 Rule 101(a) prohibits the underwriters and their affiliated purchasers
from bidding for, purchasing, or inducing another to bid for or purchase a
covered security during the restricted period. Exceptions are provided,
however, including offers to sell or solicitations of offers to buy the
securities being distributed. Rule 101(b)(9). The underwriters must be able
to sell the offering, even if Rule 101 prohibits them from purchasing shares
or inducing others to purchase covered securities other than the actual
securities being distributed. Other notable exceptions include:

- 502 ● Research falling under the safe harbors of Rule 138 or 139, even if
considered an “attempt to induce any person to bid or purchase.”
Rule 101(b)(1).
- 503 ● Stabilization transactions under Rule 104. Rule 101(b)(2).

- Bids and purchases relating to transactions in connection with the distribution not effected on a securities exchange, inter-dealer quotation system, or electronic communications network (i.e., when the underwriters purchase directly from the issuer in a firm commitment offering). Rule 101(b)(8).
- De minimis transactions, defined as purchases “during the restricted period, other than by a passive market maker, that total less than 2% of the ADTV of the security being purchased, or unaccepted bids.” Persons relying on the de minimis exception must maintain and enforce “written policies and procedures reasonably designed to achieve compliance with the other provisions of this section.” Rule 101(b)(7).

Rule 101(c)(1) provides that the restrictions of Rule 101 do not apply to certain “actively-traded securities,” defined as securities with an average daily trading volume at least \$1 million, issued by a company with a public float of common equity of at least \$150 million. Rule 101(c)(1) reflects the view that market manipulation in a distribution of securities is less effective (and less likely) if the securities already enjoy a liquid secondary market prior to the offering.

Rule 102 provides similar bid and purchase restrictions for issuers (and selling security holders) and purchasers affiliated with them. Rule 102 parallels Rule 101 in prohibiting bids, purchases, or inducements of bids or purchases by another person of covered securities during the restricted period. Rule 102, however, provides fewer exceptions to issuers than Rule 101 affords distribution participants. Most importantly, issuers and their affiliates are not permitted to engage in stabilization transactions under Rule 104.

As part of an overhaul of Regulation M proposed in late 2004, the SEC proposed a new Rule 106. Proposed Rule 106 would prohibit the issuer and other distribution participants from, among other things, accepting additional consideration from investors to participate in the offering. The SEC takes a broad view of “consideration,” intending Rule 106 to focus on abuses where the underwriters required or induced “customers to pay excessive commissions on transactions in other securities, to purchase ‘cold’ IPO shares, and to make purchases in the aftermarket of the offered security.” Securities Act Release No. 8511 (Dec. 9, 2004). The proposed prohibition on investors offering to purchase shares in the aftermarket in return for an allocation of shares in a public offering goes directly to the heart of the IPO laddering scandal described above.

HYPOTHETICAL NINE

Smartway and its underwriter Sparrow Securities have commenced the initial public offering of 10 million shares at \$20 per share. The IPO is a firm commitment underwriting with Sparrow Securities and the other underwriters purchasing the securities from Smartway at a 7% underwriters’ discount. In addition, the underwriters enjoy an overallotment option of 1 million shares.

510 The underwriters agree to purchase the firm commitment shares from Smartway
511 on the day the registration statement becomes effective. The price of the
offering initially jumps up to \$30 per share but then starts falling down to \$25
per share on the first day of trading. Consider whether the following market
activities run afoul of Regulation M.

512 1. *Scenario One:* During the course of the public offering, Sparrow Securities
initiates market research for Smartway, issuing a “buy” recommendation for
Smartway securities.

513 2. *Scenario Two:* Suppose that Sparrow Securities promises to allocate 100,
000 additional shares of Smartway’s IPO to the Million Dollar Hedge Fund.
Million Dollar, in turn, promises to purchase 10,000 shares of Smartway in the
secondary market at prices above the offering price in the first day of trading.

514 3. *Scenario Three:* Sparrow Securities completes its sales of allotted Smartway
IPO shares two days after the offering. The shares of Smartway start to sag in
the secondary market to a price below the offering price. On day three, Sparrow
starts buying shares in a successful attempt to raise the market price back to a
level above the offering price. On day four, Sparrow exercises its overallotment
option and then sells additional quantities of IPO shares to the market.

514 C. STABILIZATION

515 Rule 104 of Regulation M regulates efforts on the part of any person
(including the issuer, underwriters, and others) to stabilize the market
price. Stabilization is defined to include bids and purchases with the
“purpose of pegging, fixing, or maintaining the price of a security” (Rule
100). Rule 104 stabilization is the principal exception to the prohibition of
Rule 101.

516 What types of stabilization in connection with a public offering of a
security qualify under Rule 104? First, stabilization is only permitted to
prevent or retard a drop in the secondary market price of a security.
Purchases intended to increase the market price are not permitted under
Rule 104(b).

517 Second, Rule 104 requires that stabilization bids must give way to
“any independent bid” at the same price regardless of the size of the
independent bid at the time it is entered (Rule 104(c)).

518 Third, Rule 104 requires notice to the market of stabilization. Those
seeking to stabilize must give prior notice to the market and disclose the
purpose of the bid to the person with whom the bid is entered. In addition,
the prospectus must contain a statement notifying investors of the stabili-
zation. To facilitate monitoring of stabilization, a group attempting stabili-
zation may also only have one stabilizing bid in a market at any one time
(Rule 104(d)).

519 Finally, the stabilization price cannot be greater than the offering price
(Rule 104(f)). In addition, stabilization is not allowed for “at-the-market”
offerings where the price is not fixed. Rule 104 then distinguishes between
initiating and maintaining stabilization. Initiation of stabilization that
occurs when the principal market for the securities is open must take place
at a price no higher than the last independent transaction price if the

519 security has traded in the principal market on that day. Similar formula-
tions apply if the security has not traded on that day; the rule looks instead
at the previous day's transaction price and the last current asking price for
the stock. Persons seeking to continue with stabilization after initiation
may maintain the initial stabilization price in the principal and other
markets. Persons may also reduce the stabilizing price at any time regard-
less of changes to the independent bids and transaction prices for the
security. Persons may increase the stabilization price—while staying below
the offering price—only to the extent of the highest current independent
bid for the security in the principal market (if the market is open).

520 HYPOTHETICAL TEN

521 Sparrow Securities decides that maintaining the market price at near the
offering price (\$20 per share) after the start of the public offering would assist
the efforts of the underwriters to sell out the entire offering and provide an
orderly secondary market for investors. Assume that Smartway securities are
listed for trading on the Nasdaq after the offering (and thus Nasdaq is the
“principal” market for Smartway shares). Are any of the following permissible
under the federal securities laws?

522 1. *Scenario One:* After the Smartway IPO commences, the market price sinks
immediately to \$15 per share (the last transaction price on Nasdaq). Sparrow
Securities commences stabilization, putting in a bid to purchase 1,000 shares of
Smartway at \$20 per share, the IPO offering price.

523 2. *Scenario Two:* After the Smartway IPO commences, the market price
increases dramatically to \$50 per share (the last transaction price on Nasdaq).
Happy, but worried that this price will not last, Sparrow Securities puts in a
stabilization bid for 1,000 shares at \$50 per share.

525 IV. SHELF REGISTRATION

526 The public offering process imposes both large costs and significant
delays on issuers. Issuers must not only pay the direct expense of drafting
the registration statement and submitting it for SEC review, but also worry
that their communications may run afoul of the quiet period imposed
through the gun-jumping rules.

527 How can issuers reduce the cost of the registration process? Suppose
Smartway registers an enormous number of shares at the time of the initial
public offering. May Smartway then draw from this reserve of registered
shares indefinitely into the future to sell additional securities into the
market while avoiding the expense of a new registration? If the registration
statement and prospectus are kept current, investors may already have
adequate information to assess any newly-offered securities.

528 There are barriers, however, standing in the way of continuous regis-
tration for Smartway. Section 6(a) of the Securities Act states that a
“registration statement shall be deemed effective only as to the securities
specified therein as proposed to be offered.” The SEC in *Shawnee Chiles*

528 *Syndicate*, 10 S.E.C. 109, 113 (1941), interpreted § 6(a) as prohibiting
issuers from registering securities not intended to be offered immediately
or in the near future. Although the precise time limit on sale is not clear,
sales continuing for over a month after the effective date pose a problem.

529 For little-known issuers seeking to sell stock indefinitely into the
future, the SEC's prohibition of indefinite registration of securities protects
investors from unwise purchases of securities. Investors also enjoy other
legal protections. If an issuer sells securities using an out-of-date or
otherwise misleading prospectus, the issuer and those soliciting purchases
on its behalf potentially face § 12(a)(2) antifraud liability.

530 Consider the following situations. Why should these issuers face a time
limit on the effectiveness of their registration statement?

531 *Situation 1*

532 Smartway sells 1 million convertible bonds for a total of \$100 million.
Each bond is convertible at any time, at the option of the bondholder, into
one share of Smartway common stock. At the time the bonds are sold they
are priced at \$100 per bond while Smartway's common stock trades at \$80
per share. No rational bondholder would convert at these prices. Should
Smartway's business take off, however, the conversion feature of the bond
allows the bondholder to take advantage of the upside. For example, if
Smartway's common stock rises to \$120 per share (assume that the bond
price remains constant), the bondholder will convert to obtain the higher
priced shares.

533 The offering of convertible bonds involves two securities: (a) the bond
and (b) the security into which the bonds may be converted (common stock
in the case of Smartway). Section 2(a)(3) of the Securities Act states
(emphasis supplied):

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

535 Smartway's sale of convertible bonds implicates the offer and sale of the
bonds as well as the common stock into which they can be converted. It is a
current offer for purposes of § 5 of the Securities Act because it can be
exercised immediately even though it would be economically irrational to
do so. But because the conversion is likely to occur on a delayed basis (if at
all), the information in the registration statement is likely to be stale when
the "sale" actually takes place.

Situation 2

Consider seasoned and well-known seasoned issuers. For many (but perhaps not all) Form S-3 issuers, large numbers of analysts and investors follow the stock of the company. Over ten different analysts, for example, provide ongoing opinions and recommendations for Yahoo! Inc., a likely WKSJ. By definition, seasoned issuers and WKSJs also must comply with the Exchange Act reporting requirements (and remain current in their filings), providing a periodic flow of company-specific information to the capital markets. The informational benefit to investors of forcing such issuers to go through the registration process for any one issuance of securities is therefore reduced. If a large supply of information relevant to investors (both from mandatory periodic filings and outside analyst reports) already exists in the market, additional mandatory disclosure contained in the registration statement is unlikely to provide investors with much additional protection. Indeed, under the integrated disclosure system, much of the information contained in the registration statement will simply be incorporated by reference from the existing periodic disclosure filings (i.e., Forms 10-K, 10-Q and 8-K filings).

To address these situations, among others, the SEC promulgated Rule 415 of the Securities Act to allow for shelf registration. Under shelf registration, issuers (and others) are able to sell registered securities for an extended period of time after the initial effective date of the registration statement, avoiding the time limitation imposed by the SEC's interpretation of § 6(a).

Rule 415 provides that offerings meeting its requirements may be offered on a “continuous or delayed basis in the future.” Rule 415 imposes five basic requirements. First, only certain types of offerings may qualify. These include:

- Securities which are to be offered or sold solely by or on behalf of a person or persons *other than the registrant*, a subsidiary of the registrant or a person of which the registrant is a subsidiary (Rule 415(a)(1)(i))
- Securities which are to be issued upon *conversion* of other outstanding securities (Rule 415(a)(1)(iv))
- Securities the offering of which will be *commenced promptly*, will be made on a continuous basis and may continue for a period in excess of 30 days from the date of initial effectiveness (Rule 415(a)(1)(ix))
- Securities registered (or qualified to be registered) on *Form S-3* or *Form F-3* which are to be offered and sold on an immediate, continuous or delayed basis by or on behalf of the registrant, a subsidiary of the registrant or a person of which the registrant is a subsidiary (Rule 415(a)(1)(x))

Second, for non-S-3 issuers, Rule 415(a)(2) imposes a two-year time limit for shelf registration offerings falling under Rules 415(a)(1)(viii) (business combinations) and (ix) (continuous offerings to be commenced promptly). The rule leaves some wiggle room; securities for such offerings

544 must be “reasonably expected to be offered and sold” within two years
from the effective date of the registration statement. Note that offerings on
behalf of persons other than the registrant (e.g., a large pre-existing
shareholder of the registrant) or issued upon conversion are not subject to
this two-year time limit. Nor are securities sold by Form S-3 issuers under
Rule 415(a)(1)(ix) or (x) subject to the two-year limitation.

545 Third, Rule 415 requires updating of the prospectus and registration
statement. Rule 415(a)(3) requires that the issuer “furnish the undertak-
ings required by Item 512(a) of Regulation S-K” for all shelf registration
offerings. Item 512(a)(1)(i) of Regulation S-K provides that the issuer will
file any prospectus required under § 10(a)(3) as a post-effective amend-
ment. Thus, if an issuer updates a prospectus used more than nine months
after the effective date of the registration statement with more current
information under § 10(a)(3), the issuer pursuant to Item 512(a) must file
the prospectus as an amendment to the registration statement.

546 Item 512(a)(1)(ii) also requires an issuer to reflect in the prospectus
any “fundamental” changes in the registration statement. The issuer must
file the new prospectus with the “fundamental” changes as an amendment
to the registration statement. In addition, Item 512(a)(1)(iii) requires that
issuers file a post-effective amendment containing any “material” change
to the plan for distribution of the offering (e.g., the number of shares). For
Form S-3 issuers, however, Item 512(a) excuses companies from making a
post-effective amendment if the information is contained in any Exchange
Act filing that is incorporated by reference into the registration statement
or the information is included in a filed prospectus supplement under Rule
424(b).

547 The filing of a post-effective amendment to the registration statement
includes the information in the registration statement for purposes of § 11
antifraud liability. Moreover, the amendment resets the effective date of
the registration statement. As we discuss in Chapter 8, § 11 measures the
accuracy of information in the registration statement as of the effective
date, so all of the information in the registration statement must be
accurate as of that date.

548 Can the issuer avoid the additional exposure to § 11 liability created by
an amendment by opting instead for a prospectus supplement or incorpo-
ration-by-reference of the required Item 512(a) information? No—regard-
less of the method with which an issuer chooses to satisfy the Item 512(a)
updating requirements, the issuer will still face potential § 11 liability for
that information. “Information included in a base prospectus or in an
Exchange Act periodic report incorporated into a prospectus is included in
the registration statement.” Securities Act Release No. 8591 (July 19,
2005). Item 512(a)(5) makes clear that the prospectus supplements author-
ized by Rule 430B and 430C (discussed below) are also deemed to be part of
the registration statement and therefore subject to § 11 liability. Only the
Rule 430B prospectus supplement (for shelf registration), however, resets
the registration date for the entire registration statement, and even then,

548 only for the issuer and underwriters (thereby excluding the officers, di-
rectors and experts from new liability exposure). Rule 430B(f)(2).

549 Fourth, Rule 415(a)(4) provides that in an “at the market” equity
offering by or on behalf of the issuer, the issuer may only make use of Rule
415(a)(1)(x) to qualify for a shelf registration. Rule 415(a)(4) defines an “at
the market” equity offering as “an offering of equity securities into an
existing trading market for outstanding shares of the same class at other
than a fixed price.”

550 Fifth, Rule 415(a)(5) imposes a three-year limit to shelf offerings
registered under Rules 415(a)(1)(vii), (ix) (if registered on Form S-3 or F-
3), and (x). Although issuers falling under Rule 415(a)(5) must re-register
every three years, the SEC eased the burden of doing so. The issuer must
file a new registration statement for those offerings, but securities regis-
tered under a prior shelf registration statement may continue to be sold
until the “earlier of the effective date of the new registration statement or
180 days after the third anniversary of the initial effective date of the prior
registration statement.” Rule 415(a)(5)(ii)(A). In the case of a continuous
offering of securities, the issuer may continue selling the securities until
the effective date of the new registration statement. Rule 415(a)(5)(ii)(B).
Under Rule 415(a)(6), issuers may include in a new registration statement
any unsold securities covered in an earlier shelf registration statement
falling under Rule 415(a)(5). Rule 415(a)(6) also allows the issuer to roll
over any previously paid and unused filing fees with regard to the unsold
securities to offset filing fees for the new registration statement.

551 In addition to the basic requirements for a Rule 415 shelf registration,
the SEC provides special rules for (A) automatic shelf registrations and (B)
the use of a minimal “base” prospectus.

552 A. AUTOMATIC SHELF REGISTRATION

553 The SEC eases the restrictions on shelf offerings for well-known
seasoned issuers. Well-known seasoned issuers can file an automatic shelf
registration for most types of offerings filed on Form S-3. See Rule 405.
Rule 462 treats an automatic shelf registration statement, as well as any
post-effective amendment, as becoming effective upon filing with the SEC,
even without the opportunity for SEC review. Rule 401(g)(2) provides that
an automatic shelf registration statement and any post-effective amend-
ment are “deemed filed on the proper registration form unless and until
the Commission notifies the issuer of its objection.” The presumption of
proper form allows an issuer certainty that it is using the proper form in
filing an automatic shelf registration statement unless it hears otherwise
from the SEC. Well-known seasoned issuers may register an unspecified
amount of securities on an automatic shelf registration statement. The
automatic shelf registration need only indicate the name or class of the
securities. Rule 430B(a).

554 Well-known seasoned issuers using an automatic shelf registration
statement can also add additional classes of securities to the offering

554 without filing a new registration statement. (Rule 413 requires the filing of
a new registration statement to cover additional securities for most other
types of offerings.) Under Rule 413(b), additional classes of securities may
be added to an automatic shelf registration statement through a post-
effective amendment. Drafting a post-effective amendment is a much
simpler task than drafting an entire new registration statement. The
ability to add an additional class of securities at a later time gives WKSIs
“significant latitude” to determine the precise types and amount of securi-
ties to register, including securities of their eligible subsidiaries and second-
ary offerings of their securities (in the hands of insiders, for example).

555 Rather than pay filing fees based on the amount of securities registered
up front, a WKSI can “pay-as-you-go,” paying filing fees only when the
securities are actually sold. Rule 456(b). The SEC also allows WKSIs using
the automatic shelf registration process to exclude more information from
the base prospectus filed with the registration statement, as discussed
below. WKSIs may then include the omitted information with the prospec-
tus supplement.

556 Rule 415(a)(5) imposes a time limit of three years from the initial
effective date for automatic shelf registration statements. In the case of an
automatic shelf registration statement, the three-year re-registration re-
quirement serves primarily a house-keeping purpose (aggregating all up-
dates into one document) for WKSIs. A WKSI using an automatic shelf
registration statement may simply file a new registration statement that
becomes effective immediately upon filing under Rule 462(e). Under Rule
415(a)(6), any unsold securities and filing fees paid in connection with the
unsold securities are transferred to the new automatic shelf registration
statement. The three-year time limit therefore does not limit delay the
ability of a WKSI to sell securities under an initial shelf registration
statement. The ability to register an unspecified amount of a class of
securities for, essentially, an unlimited time combined with the ability to
add on new classes of securities under Rule 413(b) means that WKSIs may
seamlessly sell any amount of securities off the shelf without delay after
the filing the initial shelf registration statement.

557 B. THE BASE PROSPECTUS

558 A shelf registration issuer could simply file a complete prospectus,
including price-related information, with the initial registration statement.
The issuer’s only obligation would then be to update the registration
statement pursuant to Item 512(a) as well as to file any required prospec-
tus supplements, such as under § 10(a)(3) of the Securities Act. In practice,
issuers will often file only a minimal “base” prospectus with the initial
registration statement in a shelf offering. The base prospectus omits
information related to the public offering price and the underwriters,
among other information. Instead, the issuer will include any omitted
information from the base prospectus as part of a prospectus supplement.
Rule 424(b)(2) requires that the issuer file such a prospectus supplement
with the SEC “no later than the second business day following the earlier

558 of the date of the determination of the offering price or the date it is first
used after effectiveness in connection with a public offering or sales.” The
prospectus supplement that is filed under Rule 424(b)(2) may disclose
“public offering price, description of securities, specific method of distribu-
tion or similar matters.”

559 In the 2005 Public Offering Reforms, the SEC adopted Rule 430B,
bringing much needed clarity to what information an issuer may omit from
the base prospectus. Rule 430B represents a shelf registration corollary to
Rule 430A. (Rule 430C provides a “catch all” prospectis supplement
provision for offerings not covered by Rules 430A and B). Rule 430B
provides that the following information may be omitted from the base
prospectus filed with a registration statement at the initial effective date.

- 560
- Shelf offerings pursuant to Rule 415(a)(1) (vii)(mortgage-related securities) or (x) may omit “information that is unknown or not reasonably available to the issuer pursuant to Rule 409.” Rule 430B(a). What exactly constitutes information that is “unknown” or “not reasonably available”? Information omitted generally includes the public offering price and other price-related information, such as the underwriting discount. In addition, to the extent the issuer does not know the specific characteristics of securities to be offered on the shelf at the time of the initial filing of the registration statement, the issuer may omit such information, providing only general terms. The issuer may then include more specific details for offered securities later as part of a prospectus supplement. Other information may also qualify for omission, such as the identities of the underwriters for future takedowns off the shelf, if unknown at the time of filing of the initial registration statement.
 - 561 ● Shelf offerings under an automatic shelf registration statement and pursuant to Rule 415(a)(1), other than Rule 415(a)(1)(vii) or (viii), may omit “whether the offering is a primary offering or an offering on behalf of persons other than the issuer or a combination thereof, the plan of distribution for the securities, a description of the securities registered other than an identification of the name or class of such securities, and the identification of other issuers.” Rule 430B(a). Thus, a WKSI making use of an automatic shelf registration statement may omit information on the plan of distribution and on whether the shelf is a primary or secondary offering even if the issuer knows the information or the information is otherwise reasonably available. The issuer may not know in advance which of its investors in a private placement, for example, will want to take advantage of a registered offering to resell their securities.
 - 562 ● Shelf offerings pursuant to Rule 415(a)(1)(i) conducted by an issuer eligible for Form S-3 or F-3 may omit the information specified in Rule 430B(a) as well as “the identities of selling security holders and amounts of securities to be registered on their behalf.” This exclusion applies only for (1) an automatic shelf registration statement or (2) situations where “(i) The initial offering transaction of the

562 securities . . . the resale of which are being registered on behalf of
each of the selling security holders, was completed; (ii) The securities
. . . were issued and outstanding prior to the original date of filing
the registration statement covering the resale of the securities; (iii)
The registration statement refers to any unnamed selling security
holders in a generic manner by identifying the initial offering
transaction in which the securities were sold.” A fourth requirement
(iv), is that the issuer cannot have been, in the past three years, a
blank check or shell company or an issuer in a penny stock offering.
Rule 430(b)(2).

563 Under Rule 430B, a base prospectus omitting information pursuant to
the Rule would meet the requirements of § 10 for purposes of § 5(b)(1) of
the Securities Act. Rule 430B does not, however, allow the omission of such
information for a prospectus to satisfy § 10(a) for purposes of § 5(b)(2) or
for the free writing exception contained in § 2(a)(10)(a). Thus, the issuer
must eventually include the omitted information to transmit securities for
sale (under § 5(b)(2)) or to engage in traditional free writing under
§ 2(a)(10)(a).

564 What is the mechanism for later including the omitted information in
the prospectus? Rule 430B gives issuers flexibility in how to file the
additional information through either a prospectus supplement, Exchange
Act report (incorporated by reference), or a post-effective amendment. Rule
430B(d). Item 512(A)(5) and Rule 430B(e) and (f) make clear that any
additional information filed later, regardless of whether through incorpo-
ration-by-reference, a prospectus supplement, or a post-effective amend-
ment, is deemed part of the registration statement. For the issuer and the
underwriters, this creates a new effective date for the registration state-
ment for § 11 antifraud liability purposes. For certain other defendants,
including officers, directors, and experts, the effective date is unchanged for
the other portions of the registration statement.

565 NOTES

566 1. *Underwriters.* Rule 415 creates a dilemma for underwriters. On the one
hand, the shelf registration process is designed to allow issuers to sell securities
quickly by incorporating by reference their prior Exchange Act filings. Speed,
however, undercuts the ability of underwriters to perform adequate due dili-
gence on the offering, necessary if they are to avoid § 11 liability for any
misstatements in the registration statement. The problems created for under-
writers by this accelerated pace are explored in the *WorldCom* case, excerpted
in Chapter 8.

567 2. *Overhang.* When a company registers securities for sale through a shelf
registration, the stock price of the company typically drops. The price drop is
known as the shelf registration overhang. One explanation for shelf overhang is
that the presence of a large supply hanging over the market results in a fear of
substantial dilution among present stockholders, lowering the stock price. The
potential sale of securities in and of itself, however, will not necessarily dilute
pre-existing security holders. If a company sells common stock at a premium to

567 the market price, the sale should increase the per share value of the pre-existing common stock. (But who would buy at a premium to the market price?) Dilution will occur only where the shares are sold at a price *lower* than the market price. But why would managers ever choose to sell for less than the market price? Only a company with serious cash flow problems would dilute shareholders this way.

568 An alternative explanation for market overhang is that managers can time stock sales to coincide with market overvaluation of the stock. Imagine that pre-existing shareholders cannot tell whether the market under or overvalues the stock (but managers do know this). First, consider when the stock is overvalued. Those who own pre-existing stock will be less likely to obtain the benefit from selling overvalued stock (as the company will flood the market with new stock in this case). Second, consider when the stock is undervalued. The owners of pre-existing stock will then bear the entire cost of selling undervalued stock. Pre-existing shareholders, therefore, will systematically bear the cost of selling undervalued stock but miss out on selling overvalued stock—reducing their expected returns and therefore lowering the price of stock in the marketplace.

569 HYPOTHETICAL ELEVEN

570 Two years have passed since Smartway's initial public offering (in which Smartway issued eleven million shares of common at \$20 per share). Smartway's shares now trade on Nasdaq at around \$80 per share. Assume that no affiliates of Smartway own any of the publicly traded shares and that Smartway has been current in its Exchange Act filings over the past two years. Smartway has occasional cash flow problems and wants to be able to raise additional funds quickly to cover its cash shortfalls. Consider the following options for raising more capital.

571 1. *Scenario One:* Smartway will issue \$500 million of non-convertible bonds. Sherry does not know when Smartway will need this capital, but she hopes to be able to sell the bonds over the next six years as dictated by Smartway's cash flow needs. Can Smartway structure its bond offering to achieve Sherry's goal?

572 2. *Scenario Two:* Suppose that six months after the initial effective date of the shelf registration described in Scenario One, Sherry is indicted for insider trading and jailed; she is replaced with a new CEO. If this were not a shelf registration and Smartway had not yet completed its offering, what updating would Smartway have to do? What about with Rule 415(a)(3)? What difference does it make?

573 3. *Scenario Three:* Can Smartway issue \$500 million of voting common stock through sales directly into Nasdaq over the next two years? Smartway would prefer not to pay an underwriter's commission for the offering.

574 4. *Scenario Four:* Smartway moves forward with its shelf registration offering of common stock through Nasdaq with the assistance of Sparrow Securities as an advisor. On February 1, Smartway files a Form S-3 registration statement, including a "base prospectus." The base prospectus excludes information on the offering price, underwriters, underwriting discount, and on the securities offered (referring only to an "unspecified" amount of "common stock"). Later, on June 1, Smartway sells \$200 million of common off the shelf. The common stock is sold at the prevailing market price of \$80 per share and sold through

574 the assistance of Sparrow Securities as underwriter. On June 2, Smartway files
a prospectus supplement containing the previously omitted information with
the SEC. Has Smartway complied with Rule 415?

575 **5. Scenario Five:** Smartway will issue \$250 million of convertible bonds on a
delayed basis over the next two years. Each bond (principal amount of \$100)
can be converted at any time into one share of voting common (assume that if
all the bonds were converted into common today they would result in \$100
million of common). The bonds' term is ten years; the conversion therefore may
take place up to ten years after the bonds are sold.

576 **6. Scenario Six:** Many Smartway officers purchased shares prior to Smart-
way's initial public offering. These shares are "restricted" in the sense that the
securities laws prohibit the officers from freely reselling the shares into the
public markets absent a registration statement. (We explain why in Chapter
10.) May the officers use a shelf registration for these shares covering a ten-
year period?