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Current and Recurrent Section 5 Gun-Jumping Problems

Morton A. Pierce*

This article analyzes the section 5 prohibition against offers to sell securities prior to the effective date of the registration statement. It traces the factors which initially led to the regulation and details the development thereof. It then explores what problems were solved and what new problems were engendered by the ban on pre-effective offers, while evaluating the effectiveness of and the necessity for the prohibition.

I. BACKGROUND

THE SECURITIES ACT of 1933¹ (Securities Act) was designed “[t]o provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof.”² The rationale was to provide investors with enough information to make an informed investment decision.³ This disclosure philosophy was a direct result of abusive investment banking practices which had developed prior to 1933.⁴

Prior to 1900, securities sales were conducted by selling agents on a commission basis with the issuer bearing the risks of distribution.⁵ In 1906, a change occurred in the marketing of securities when Goldman, Sachs & Co., a major brokerage house, seeking to underwrite an issue by United Cigar Manufacturers, but unable to undertake the entire commitment, asked Lehman Brothers, another large brokerage house, to participate in the underwriting. This coopera-

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1. 15 U.S.C. §§ 77a *et seq.* (1970).

2. 48 Stat. 74 (1933).

3. S. REP. NO. 47, 73d Cong., 1st Sess., (1933). *See generally*, L. BRANDEIS, *OTHER PEOPLE'S MONEY, AND HOW THE BANKERS USE IT* (1914).

4. Gourrich, *Investment Banking Methods Prior to and Since the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 44 (1937).

5. This summary of investment banking history is taken primarily from U.S. v. Morgan, 118 F. Supp. 621, 635-55 (S.D.N.Y. 1953); E. MILLER, *Background and Structure of the Industry in INVESTMENT BANKING AND THE NEW ISSUES MARKET* Ch. 2 (I. Friend *et al.* eds. 1967); Gourrich, *supra* note 4. *See* Douglas, *Protecting the Investor*, 23 YALE REV. 508 (1933).

tion set the precedent for future underwriting syndicates. The syndicate system, which became the normal method of marketing securities, was the result of the need to spread the economic risk and to distribute an issue as quickly as possible.

As issues became larger, syndication expanded beyond the formation of underwriting groups and selling groups were established. The selling group members were dealers who received allotments from the underwriting group and were responsible for a rapid public sale.⁶ Issues were sometimes sold within twenty-four hours.⁷

This emphasis on speed and the resultant absence of public information concerning an issue prior to the offering date created a securities market in which buyers had little knowledge of what they were purchasing. This system was successful in large part because participants in the syndication and ultimate buyers placed much reliance on the originating and participating bankers, the members of the underwriting syndicate, and their judgment in choosing new issues.⁸ But as syndicates grew larger and the primary concerns of the originating bankers became profit and pleasing the syndicate dealers by providing a constant flow of work, reliance on their judgment became misplaced.

II. SECTION 5 AND GUN-JUMPING

Against this background, the Securities Act was designed to provide investors with information concerning new issues so that reliance on the tacit or express approval of underwriters was not necessary to making an investment decision.⁹ The Act required that material information relevant to a proposed offering be contained in

6. The life of a syndicate in the late 1920's was about 30 days, as compared with one year in 1906. *U.S. v. Morgan*, 118 F. Supp. 621, 638, 644 (S.D.N.Y. 1953).

7. Gourrich, *supra* note 4, at 51.

8. Judge Medina, in *U.S. v. Morgan*, 118 F. Supp. 621, 639 (S.D.N.Y. 1953), noted that the early investment bankers, whose companies bore their names, felt a moral obligation to their customers. Consequently, they thoroughly investigated a company's financial situation and often were made directors and officers of a corporation as a sign of their endorsement of the corporation.

9. There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of caveat emptor, the further doctrine, "Let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.

MESSAGE FROM THE PRESIDENT—REGULATION OF SECURITY ISSUES, 97 CONG. REC. 937 (1933), reprinted in LEGISLATIVE HISTORY OF THE SECURITIES ACT OF 1933 AND SECURITIES EXCHANGE ACT OF 1934, Vol. 1, Item 3 (J. Ellenberger & E. Mahar eds. 1973).

a registration statement filed with the Federal Trade Commission.¹⁰ Twenty days after filing, the registration statement became effective.¹¹ In order to insure that the investor was making an informed choice, section 5(a) of the Act¹² prohibited sales or offers to sell¹³ prior to the effective date of the registration statement. Section 5(b)(1)¹⁴ required that all information concerning a security sent to a prospective purchaser after the effective date be in the form of a statutory prospectus.¹⁵ Additionally, section 5(b)(2)¹⁶ prohibited the delivery after sale of a security unless accompanied or preceded by a statutory prospectus.¹⁷

As originally written, section 5 thus created a contradictory situation which is still largely unresolved. Specifically, the Securities Act was written to promote full and honest disclosure to all potential investors. In order to effectuate that purpose, the language of section 5 limited disclosure until the effective date of the registration statement and then tightly controlled post-effective disclosures. The period between the filing of the registration statement and its effective date was, in theory, to be used by the investor to educate himself about the proposed issue. This purpose, however, was frustrated because any written communication to an investor by an issuer or an underwriter could be construed as an illegal offer to sell the securities for which the registration statement was pending.¹⁸

10. Securities Act §§ 6, 7, 15 U.S.C. §§ 77f, g (1970). The Federal Trade Commission was the regulatory agency charged with oversight of the securities industry until the creation of the Securities and Exchange Commission in 1934. See 1934 FTC ANNUAL REPORT 37-42.

11. Securities Act § 8, 15 U.S.C. § 77h (1970).

12. 15 U.S.C. § 77e(a) (1970).

13. Defined in § 2(3), 15 U.S.C. § 77b(3) (1970).

14. 15 U.S.C. § 77e(b)(1) (1970).

15. See *id.* § 10, 15 U.S.C. § 77j (1970).

16. 15 U.S.C. § 77e(b)(2) (1970).

17. Section 5(b) stated:

It shall be unlawful for any person directly or indirectly—

- (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security registered under this title, unless such prospectus meets the requirements of section 10. . . .

This would appear to permit an oral sale without the use of a statutory prospectus. For this reason, section 5(b)(2) required that a prospectus accompany the delivery of a security after a sale if the buyer had not received a prospectus previously. For a discussion of the oral loophole, see L. LOSS, 1 SECURITIES REGULATION 225-26 (2d ed. 1961) [hereinafter cited as LOSS].

18. The two aims of prohibiting solicitation and encouraging dissemination of information are not wholly compatible. See Note, *Prohibition Against Sales of New Security Issues Prior to Effective Date of Registration Statement*, 56 YALE L.J. 156, 158 (1946).

In attempting to foster dissemination of information by prohibiting solicitations until the investor was afforded the chance to become informed, the Act created a solicitation-dissemination tension, the solution to which issuers, underwriters, and investors had difficulty grasping.¹⁹

A. *Section 5—Pre-1954*

The immediate result of this uncertainty generated by section 5 was the fostering of illegal offers, known as "gun-jumping" or "beating the gun." As one commentator stated:

"Beating the gun," although not a new practice, has probably increased materially under the Act and in the current market. Since the "firm inquiries" of customers, or understandings between customers and salesmen as to retail allotments prior to the effective date, violate the spirit if not the letter of the waiting period provision, dealers find this one of the harassing features of the Act. They have little sympathy with the waiting period, for experience does not indicate that it is utilized by investors for study of new issues, while dealers are placed in the uncomfortable position of being "bootleggers" of popular issues when customers insist on being "kept in mind" for specific amounts of such new securities.²⁰

Constituting a breach of the typical syndicate agreement by disposing of securities before the date of the public offering, the gun-jumping problem also existed prior to the passage of the Securities Act.²¹ The problem was controllable, however, because the sanctions were self-imposed and the underwriters formulated a timetable to suit their needs. The Securities Act was intended to effect a basic change in the way in which securities were marketed²² by substituting a standardized marketing timetable suited to the imputed needs of the investor, not the underwriter. However, pressure on underwriters and dealers to unload the securities as rapidly

19. For discussions of the solicitation-dissemination problem, see Byse & Bradley, *Proposals to Amend the Registration and the Prospectus Requirements of the Securities Act of 1933*, U. PA. L. REV. 609 (1948); Forer, *A Comment on the Amendments to the Federal Securities Acts*, 103 U. PA. L. REV. 1020 (1954); Lobell, *Revision of the Securities Act*, 48 COLUM. L. REV. 313 (1948).

20. Bates, *Some Effects of the Securities Act Upon Investment Banking Practices*, 4 LAW & CONTEMP. PROB. 72, 73 (1937). See also Bates, *The Waiting Period Under the Securities Act*, 15 HARV. BUS. REV. 203 (1937).

The term "gun-jumping," as used throughout this paper, will refer to the making of illegal offers prior to the effective date of the registration statement.

21. Byse & Bradley, *supra* note 19, at 621-22.

22. *Id.* at 624. The authors compare the Securities Act to Prohibition.

as possible continued.²³ There was a strong temptation, therefore, to make offers during the statutorily created waiting period in which offers were illegal.

The ambiguous requirements of section 5 also placed pressure on those who wished to comply with the law. As a former chairman of the Securities and Exchange Commission noted:

[T]here was much concern over the seeming inconsistency between the fundamental theses of the act, first, that during the period between the filing date and the effective date the public should have an opportunity to become informed about an issue and, then, that during the same period no offer could be made. Every responsible member of the industry was anxious to comply with the law and yet was fearful lest, in distributing information about an issuer during the waiting period, he might be considered to be engaged in making an offer contrary to the statute.²⁴

1. *Initial Responses to the Problem*

The initial administrative response to these restrictive requirements of section 5 tended to create confusion and uncertainty, as indicated by Federal Trade Commission (FTC) Release No. 70.²⁵ In responding to the question whether there could be any written communication between underwriters and dealers during the waiting period, this release first recognized that the public would not become informed about a security merely because a registration statement had been filed.²⁶ To correct this deficiency, the FTC authorized the use of a "red herring" prospectus, a circular which would describe a security in accordance with the descriptive method required of prospectuses conforming to section 10 and which would be clearly marked in red ink to indicate that it was informative only and was not an offer to sell.²⁷

Release No. 70 pinpointed another recurring problem generated by the language of section 5. In describing the theory of the waiting period, the release stated that it was unlawful to make an

23. Lobell, *supra* note 19, at 320.

24. Gadsby, *Current Problems Under Section 5 of the Securities Act of 1933 and Release No. 3844*, 13 BUS. LAWYER 358, 359 (1958).

25. FTC Release No. 70 (Nov. 6, 1933), reprinted in 1 CCH FED. SEC. L. REP. ¶¶ 3150-54 (1973).

26. *Id.* ¶ 3152: "Obviously, this purpose [dissemination of information] cannot be accomplished merely by filing a registration statement with the Federal Trade Commission, even though a copy of such statement is open to public inspection"

27. *Id.* ¶ 3154. The "red herring" prospectus was eventually to become the present summary prospectus.

offer to buy or sell a security “[d]uring the waiting period, as well as prior thereto”²⁸ The latter clause emphasized the plain meaning of section 5(a) that offers prior to the effective date were illegal. Although the statute created a waiting period between the filing and effective dates, its prohibitions became applicable significantly before the filing date. The release, however, failed to indicate what standards were to be applied in determining when section 5 had been violated. To date, this important omission has not been completely remedied.

Subsequent Securities and Exchange Commission (SEC) releases acknowledged that FTC Release No. 70 was not helpful in resolving the solicitation-dissemination dilemma. In Release No. 464,²⁹ for example, the SEC attempted to define when bulletins of summarized information about particular securities, including ratings and other expressions of opinion as to their investment value, could be distributed without constituting an illegal offer to sell. The release first dealt with the statistical bureau which compiled the bulletins. It indicated that as long as the company received no consideration from anyone involved in the distribution and was not interested in the sale of the securities, it could distribute the bulletins during the pre-effective period.³⁰ Thus, the apparent conclusion to be drawn from Release No. 464 was that a distribution would not be considered illegal if it was part of the normal course of business of the noninterested distributor.

The initial part of the release also noted two concerns which, to a lesser degree, still persist. First, it recognized that certain people disinterested in a securities offering could distribute information when an interested party could not. As written, section 5 applied to any person, and Release No. 464 indicated that this language was troublesome. Second, this section of the release also suggested that in certain circumstances, activity which was part of the normal course of one's business need not be interrupted merely because a registration statement covering a certain security had been filed.

From the standpoint of distributors of new issues, the latter part of Release No. 464 was especially unclear. It stated explicitly that the circulation by dealers to their customers of bulletins with opinions as to the investment value of a security during registration would constitute a violation of section 5.³¹ Having disposed of these

28. *Id.* ¶ 3151.

29. SEC Securities Act Release No. 464 (Aug. 19, 1935), *reprinted in* 1 CCH FED. SEC. L. REP. ¶¶ 3165-69 (1973).

30. *Id.* ¶ 3166.

31. *Id.* ¶ 3168.

opinions, the release referred to FTC Release No. 70 and indicated that a bulletin, similar to a red herring prospectus, could be distributed by dealers and underwriters who had an interest in the offering. However, it went on to warn:

[A]ny circulation by underwriters or dealers of a bulletin descriptive of a particular security, which is in furtherance of an offering of such security for sale prior to the effective date of registration, or of a solicitation during that period of an offer to buy the security, would fall within the prohibitions of section 5 of the Act.³²

This language, coupled with Release No. 70, indicated that while it was not a violation to circulate a red herring prospectus, such circulation might be considered a violation if the circulation was part of an offering of the security before the effective date of the registration statement.

Release No. 802³³ was further evidence that the solicitation-dissemination distinction was easier to describe than define. A letter had been sent to the SEC asking if an underwriter could, during the waiting period, prepare a summary of certain information contained in the registration statement and distribute it to clients. Such a summary would contain no opinion concerning the security and would bear the red ink legend stating that no offer to sell the security was being made therein. Thus, the letter asked the same question that the SEC had assumed Releases No. 70 and No. 464 had answered.

In an attempt at further clarification, the SEC responded:

[T]his and similar summaries of information contained in a registration statement may, without violation of Section 5 of the Act, be circulated through the mails and in interstate commerce prior to the effective date of the registration statement covering the described securities, provided that the summary does not itself constitute an offer of the securities described and is not circulated or used under such circumstances as might in fact involve its use in connection with any sale of the described securities.³⁴

These releases confirmed the fears of issuers and investment bankers that, in practice, the philosophy of disclosure conflicted with the prohibitions against offers and sales prior to the effective date of the registration statement, the means by which disclosure

32. *Id.* ¶ 3166.

33. SEC Securities Act Release No. 802 (May 23, 1936), *reprinted in* 1 CCH FED. SEC. L. REP. ¶¶ 3175-78 (1973).

34. *Id.* ¶ 3177.

was to be implemented.³⁵ The releases seemed to offer only the circular guidance that the red herring prospectus would not be considered an illegal offer unless it were an illegal offer.

2. *The Van Alstyne Case*

In 1941, the securities industry made proposals to clarify the status of the red herring prospectus by amending section 2(3) to separate the definition of the term "sale" from that of the phrase "offer to sell," and to allow offers through the use of a limited prospectus during the waiting period.³⁶ These proposals were perceived as a means to end the solicitation-dissemination confusion, inform the prospective investor and allow the underwriter to assess how the offering would be received.³⁷

Nonetheless, the SEC perceived little reason to relax the standards. Although it thought that adequate information was not in fact reaching the investor, it feared that relaxation of standards would risk making matters worse.³⁸ Cases such as *Van Alstyne*,

35. See REPRESENTATIVES OF INVESTMENT BANKERS ASS'N OF AMERICA, NAT'L ASS'N OF SECURITIES DEALERS, INC., NEW YORK CURB EXCH., AND NEW YORK STOCK EXCH., REPORT ON THE CONFERENCE WITH THE SECURITIES AND EXCHANGE COMM'N AND ITS STAFF ON PROPOSALS FOR AMENDING THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 (1941).

The *Report* stated:

The distinction between an "offer to sell," "an attempt or offer to dispose of a security" or a "solicitation of an offer to buy" (Section 2(3)) on the one hand and discussion during the waiting period with potential buyers on the other hand is a tenuous one, difficult to grasp and understand, for lawyers as well as for laymen. As a practical matter, in ordinary conversation, it is a difficult if not impossible distinction for laymen to make and for laymen to understand. A prospective purchaser having been given information by a prospective seller certainly thinks he has been asked to "buy" and that the person who approached him "offered to sell." Otherwise why was he approached?

Id. at 88.

36. *Id.* at 9-12, 19-21.

37. "If information concerning a security is to be disseminated to the public, and if information concerning the likely reception is to be relayed back to the banker, it would be impractical as well as undesirable to prohibit all efforts to dispose of a security during the waiting period." Byse & Bradley, *supra* note 19, at 633.

38. Although the voluminous registration statement is available for inspection at the offices of the Commission and copies are distributed upon request, few investors directly utilize that information in the appraisal of a new security. It is true that Section 5 requires that on or after the effective date, written offers to sell must be accompanied by a detailed prospectus. But if the offer to sell is made orally, no prospectus need be supplied a purchaser until the security is delivered. Hence, despite the disclosures demanded by the Act, it is not certain that a buyer will receive any direct information before the consummation of a sale. For a time the Commission permitted underwriters to distribute the so-called "red herring" prospectus during the cooling period subject to the limitation that the prospectus not be used as an offer to sell. Unfortunately the effective use of

*Noel & Co.*³⁹ increased fears of abuse. In that case, the Commission found that the firm of Van Alstyne, Noel & Co. made arrangements with Andrew J. Higgins, president of Higgins Industries, Inc., for the underwriting of 900,000 shares of common stock of the then-unorganized Higgins, Inc. Publicity of the proposed offering was disseminated throughout the country via the Dow-Jones ticker on January 4, 1946, by which time the firm had contacted other underwriters to inquire whether they wished to participate. Upon completion of these arrangements, a senior member of the firm informed Higgins that the underwriting was a success. On January 10, 1946, the formation of the selling group, about 160 dealers, was completed. Other dealers, not part of the selling group, requested and were allotted 104,500 shares. The Van Alstyne firm itself entered on its books "buy" order tickets for its customers totalling 2,600 shares. A registration statement was then filed on January 30, 1946.

Although the SEC considered these actions a willful violation of section 5(a)(1),⁴⁰ it decided that the public interest required only that Van Alstyne, Noel & Co. be suspended from membership in the National Association of Securities Dealers for ten days, and not that the registration of the firm be revoked. The Commission specifically noted that although it had not instituted proceedings against the dealers involved, such inaction was not to be taken as an indication that those dealers had not violated section 5.⁴¹

3. *Rules 131 and 132—The Commission's Response*

The mild penalty imposed in the *Van Alstyne* case may have been due to the recognition that confusion persisted as to the implementation and bounds of the disclosure philosophy and the use of the red herring prospectus. In a renewed effort at clarification and as a belated response to the industry proposals of 1941, the SEC enacted rule 131,⁴² which formally authorized the use of the red herring prospectus. The Commission explained:

It [rule 131] provides that sending or giving to any person, before a registration statement becomes effective, a copy

this device was severely reduced by the Commission's subsequent requirement that distributors distribute to all recipients any amendments to the original prospectus.

Note, *Prohibition Against Sales of New Security Issues prior to Effective Date of Registration Statement*, 56 YALE L.J. 156, 158 (1946).

39. 22 S.E.C. 176 (1946).

40. *Id.* at 180.

41. *Id.* at 180 n.3.

42. SEC Securities Act Release No. 3177 (Dec. 5, 1946).

of the proposed form of prospectus filed as part of such registration statement, shall not in itself constitute an "offer to sell," "offer for sale," "attempt or offer to dispose of," or "solicitation of an offer to buy" within the meaning of section 2(3) of the Act, if the proposed form of prospectus contains substantially the information required by the Act and the rules and regulations thereunder to be included in a prospectus for registered securities, or substantially that information with certain exceptions. The copy must also contain the required legend.⁴³

Despite the promulgation of rule 131, efforts were renewed to implement the suggested 1941 amendments.⁴⁴ The SEC, acknowledging the conflict between full disclosure and structured disclosure but still wary of allowing pre-effective offers, responded that it would not be justified in recommending new legislation to the Congress until all avenues for achieving greater dissemination under the existing rules had been exhausted.⁴⁵ In furtherance of this policy, the Commission enacted rule 132.⁴⁶ The SEC explained:

The proposed Rule 132 is designed to permit, under certain circumstances, the use of a brief "identifying statement" which would set forth generally the nature of the security to be offered. . . . Among other things, the identifying statement would set forth "the general type of business of the issuer" The identifying statement would be intended for use as a screening device to locate persons who might be interested in receiving a red herring prospectus or final prospectus and not to facilitate solicitations in advance of the effective date.⁴⁷

43. *Id.*

44. See Byse & Bradley, *supra* note 19, at 626-30; Lobell, *supra* note 19.

45. SEC Securities Act Release No. 3447 (July 10, 1952).

46. *Id.*

47. *Id.* Rule 132(b) specified the following twelve categories of information, the first six of which had to be included in the identifying statement, if applicable:

- (1) the title of the security;
- (2) the name of the issuer;
- (3) the general type of business of the issuer;
- (4) the price of the security;
- (5) the price at which, the conditions upon which, and the time when, the security may be redeemed or converted or exchanged or, if the security is a right or warrant or is offered by means of a right or warrant, the terms of such right or warrant with respect to price and the conditions and time of exercise;
- (6) whether the security is being offered in connection with a financing by the issuer or a distribution by a person directly or indirectly controlling or controlled by the issuer, or under direct or indirect common control with the issuer;
- (7) the stated rate of return or the yield or both if the security has a fixed interest or dividend provision and if the issuer's earnings for the past three full fiscal years will reasonably support a conclusion as to yield;
- (8) whether the security is listed on any securities exchange;

Apparently, the Commission believed that publication of such identifying statements in media such as newspapers would promote public awareness of the proposed offering and thereby satisfy industry demands.

The result, after promulgation of these various rules and after twenty years of attempting to differentiate between illegal solicitations and proper information dissemination, was still confusion. One could have reached the conclusion that, under certain conditions, the information which appeared in the registration statement could be disseminated before the effective date. Nonetheless, the six-year hiatus between the promulgation of rules 131 and 132 indicated that people were so unsure of the status of the law that little use was made of rule 131. The tension created by section 5 and its progeny was illustrated by the Commission's warning that it would not grant acceleration of the effective date of the registration statement unless there had been adequate information dissemination through the use of the red herring and identifying statements.⁴⁸ Such encouragements to the use of these communications, however, were contradictory to the view of the law held by underwriters and dealers. SEC Chairman Demmler summarized that view:

The securities industry has contended for many years that, in practice, the free flow of information concerning a new issue during the waiting period has been restrained because of the fear of underwriters and dealers that their communication to prospective customers might be construed to be illegal offers⁴⁹

B. *Section 5—Post-1954*

In a continuing effort to foster information dissemination and reduce the related fears of underwriters, dealers, and issuers, the gun-jumping provisions were amended in 1954 in accordance with the 1941 industry proposals. Thus, written offers during the waiting

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- (9) whether, in the opinion of counsel, the security is a legal investment for savings banks, fiduciaries, insurance companies, or other similar investors under the laws of any State or Territory or the District of Columbia;
 - (10) the extent to which the issuer has agreed to pay any tax with respect to the security or measured by the income therefrom;
 - (11) whether the issue represents new financing or a refunding operation;
 - (12) the title and number of shares or other units or (in the case of debt securities) principal amount of each class of outstanding securities.

48. SEC Securities Act Release No. 3447 (July 10, 1952).

49. *Hearings on S. 2046 Before a Subcomm. of the Senate Comm. on Banking & Currency*, 83d Cong., 2d Sess. at 23 (1954). See also Demmler & Armstrong, *The Federal Securities Laws: Scope and Effect of the New Amendments*, 41 A.B.A.J. 133 (1954).

period by means of a prospectus filed with the Commission were authorized. Specifically, section 2(3)⁵⁰ was amended to define separately the terms "offer" and "sale" so that under section 5(a)(1)⁵¹ sales, but not offers to sell, prior to the effective date would still be unlawful. Since the use of statutory prospectuses was legalized during the waiting period, section 5(b)(1)⁵² was amended to allow the transmission of these prospectuses in interstate commerce. Also, a new section 5(c)⁵³ was added to make unlawful offers prior to the filing of a registration statement. The result of these changes was the advancement of the actual organization of the selling group from the effective date to the filing date of the registration statement.⁵⁴

Obviously, the amendments, which are still operative to date,

50. 15 U.S.C. § 77b(3) (1970).

51. 15 U.S.C. § 77e(a)(1) (1970).

52. 15 U.S.C. § 77e(b)(1) (1970).

The use during the waiting period of the preliminary prospectus pursuant to section 10(a) and rule 433 and the summary prospectus pursuant to section 10(b) and rules 434 and 434a was legalized. It is not necessary to distinguish between the two for purposes of discussing pre-effective offers and gun-jumping. These prospectuses will be referred to as section 10 or statutory prospectuses.

53. 15 U.S.C. § 77e(c) (1970). Section 5 now reads in full:

Sec. 5.

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

- (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or
- (2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

- (1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or
- (2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use of the medium of any prospectus or otherwise any security, unless the registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

54. For a discussion of the 1954 amendments, see Forer, *supra* note 19.

did not significantly change anything from the viewpoint of disclosure but merely elevated rule 131 to the status of a statute.⁵⁵ Instead of maintaining the fiction that pre-effective offers were illegal although the use of red herring prospectuses was encouraged, the status of the red herring prospectus as an offer was recognized and codified. Implicit in this change was the belief that nothing was inherently wrong with the basic statutory scheme, so long as the industry was confident enough to utilize the informative communications the law allowed.⁵⁶ The amendments appeared to assume that the only confusion which existed was the superficial one of whether a red herring prospectus could be used without penalty. Unfortunately, the amendments failed to set forth the factors that differentiated dissemination from solicitation. The amendments, thus, were insensitive to the fact that the limited and reluctant use of the red herring prospectus stemmed from a more basic confusion about the dissemination-solicitation distinction.

1. *Rules 134 and 135*

Acknowledgement that the amendments had not solved the problems came quickly, as the Commission adopted rules 134 and 135.⁵⁷ Rule 134 was enacted pursuant to section 2(10)(b),⁵⁸ which exempts from the definition of prospectus certain identifying notices. The rule specified twelve categories of information which could be included in a notice or communication transmitted to any person after a registration statement had been filed and prior to the delivery of a statutory prospectus.⁵⁹ Similarly, rule 135 provided that an issuer could send its present security holders notice of a proposed issuance of rights to subscribe to its securities. The rule was amended three years later to authorize the sending of notices when (a) an issuer proposed to offer securities to its own security holders, or to the security holders of another issuer, in exchange for securi-

55. See text accompanying notes 68-70 *infra*.

56. "This fear [of using the red herring prospectuses] springs from the criminal penalties provided for violation of the statute and also from the fact that a violation of section 5, based on a strict construction of the term 'offer,' might give the purchaser a right of rescission for one year under section 12(1) of the Act." Demmler & Armstrong, *supra* note 49, at 134. See also Demmler, *Problems Inherent in Pre-Filing Publicity*, 15 BUS. LAWYER 132 (1959).

57. SEC Securities Act Release No. 3568 (Aug. 29, 1955) (Rule 134). SEC Securities Act Release No. 4099 (June 16, 1959).

58. 15 U.S.C. § 77b(10)(b) (1970).

59. The categories of information were similar to those enumerated in former rule 132. See note 47 *supra*.

ties presently held by them, or (b) when an issuer proposed to make an offering of securities to its employees.⁶⁰

These rules added little to the unraveling of the dissemination-solicitation mystery. They provided for a notice of a proposed offering along with certain information contained in a statutory prospectus. As so structured, they were designed to do what the red herring prospectus had been designed to do, namely, notify investors that there was to be a public offering and that offers were to be made only by means of a statutory prospectus. In essence, the post-1954 structure paralleled closely the pre-1954 structure in that the rules were intended to foster widespread dissemination of notice that there was to be a public offering of securities, sanctioned the use of information appearing in the registration statement if properly presented, but shed little light on which activities beyond the distribution of a preliminary prospectus would be considered an illegal offer to sell a security.

2. Release No. 3844

In an attempt to confront the problems posed by the gun-jumping prohibitions, the Commission published Release No. 3844 entitled *Publication of Information Prior to or After Effective Date of Registration Statement*.⁶¹ The release contained ten examples of common gun-jumping problems and the Commission's solution to them.

Example 5 of the release⁶² was instructive because it gave an insight into how the Commission decided whether the dissemination of information was an illegal offer to sell. The example involved the lack of awareness on the part of the research department of an investment banking firm as to a pending offer of its underwriting department. Prior to the filing of the registration statement, the research department had distributed to many of the firm's customers a brochure which referred specifically to the securities in question and described the business and prospects of the parent company of the prospective issuer. On these facts, the release warned:

The Commission advised the representatives of the issuer and the prospective underwriters that *under all the circumstances, including the content, timing, and distribution*

60. SEC Securities Act Release No. 4099 (June 16, 1959).

61. SEC Securities Act Release No. 3844 (Oct. 8, 1957), *reprinted in* 1 CCH FED. SEC. L. REP. ¶¶ 3250-56 (1975).

62. *Id.* ¶ 3256.14.

given to the brochure, participation of the firm in the distribution of the securities would pose difficulties from the point of view of the enforcement of the provisions of section 5 of the Securities Act.⁶³

This reply suggested that in the Commission's view the standard determining the line between proper dissemination and illegal solicitation was an "all the circumstances" test.

The release also attempted to deal with aspects of the gun-jumping question other than the dissemination-solicitation issue. Example 9⁶⁴ involved an issuer about to file a registration statement on behalf of a controlling person. The timing of the registration was to coincide with the usual distribution of the company's annual report. The issuer was advised by the Commission "that, if the annual report was of the character and content normally published by the company and did not contain material designed to assist in the proposed offering, no question would be raised [under section 5]."⁶⁵

The significance of this example was that certain activity which might otherwise have constituted an illegal offer to sell would not be so characterized if it was undertaken as part of normal business activity. The release recognized this exception without providing guidelines for determining when it applied.

The release also addressed the problem of identifying the time at which the gun-jumping restrictions begin to operate. It stated:

It apparently is not generally understood . . . 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.⁶⁶

Example 1 served to illustrate this timing problem by positing the following hypothetical:⁶⁷ While preparing a registration statement for a public offering, the underwriter distributed several thousand copies of a brochure which described in glowing generalities the future of the issuer's industry. The brochure did not refer to an issuer, to any security, or to any particular financing. The Commission,

63. *Id.* (Emphasis added).

64. *Id.* ¶ 3256.18.

65. *Id.*

66. *Id.* ¶ 3254.

67. *Id.* ¶ 3256.10.

nonetheless, characterized the use of the brochure as the first step in a sales campaign. Since the pre-filing period had no fixed starting point, this example gave no indication of the point in time at which such a brochure could have been distributed without penalty. Again, the Commission's hypothetical suggested recognition of a problem but failed to provide general guidelines for its solution.

Commenting generally on Release No. 3844, SEC Chairman Gadsby stated:

[T]he problem of determining what constitutes pre-effective or pre-filing offerings of securities has always been with us. . . . [I]n publishing Release No. 3844, we have not embarked upon some new adventure in statutory construction or of administrative policy. . . . Early releases [Nos. 70 and 464] were published for the same purpose for which we published Release No. 3844, namely, to make generally public the Commission's views concerning the type of activity which, in its opinion, might constitute a violation of the statutory prohibitions against pre-filing offerings by issuers and underwriters.⁶⁸

These remarks were made just four years after the previous Chairman had stated that the 1954 amendments had been passed to allay industry fears and foster information dissemination.⁶⁹ However, if, as Chairman Gadsby stated, the Commission's policy had not changed from 1933 to 1958, then the only certainty in the gun-jumping area was that preliminary prospectuses could be employed with impunity. This knowledge had comforted few in the past.

In continuing his theme that the Commission's attitude towards the issue of gun-jumping had remained consistent, Chairman Gadsby stated further:

The fact is that all through the history of the rulings of the Commission in dealings with this question runs a consistent and simple logic. If the material submitted is reasonably to be considered as a part of the selling effort, it comes within the purview of the statute The ultimate determination must be made on an *ad hoc* basis⁷⁰

This statement reiterated the "all the circumstances" approach reflected in Release No. 3844. The fallacy of this approach was that it hindered dissemination of information before 1954 because

68. Gadsby, *Current Problems Under Section 5 of the Securities Act of 1933 and Release No. 3844*, 13 BUS. LAWYER 358, 360 (1958) (Address by Chairman Gadsby before Central States Group of the Investment Bankers Ass'n, at Chicago, Ill., March 20, 1958).

69. Demmler & Armstrong, *supra* note 49.

70. Gadsby, *supra* note 68, at 367-68.

there was a reluctance on the part of the industry to take it upon itself to decide whether under "all the circumstances" a particular activity was proper or whether it constituted illegal gun-jumping. Chairman Gadsby's remarks indicated that the reluctance would continue.

3. *The Loeb, Rhoades Case*

The gun-jumping problem and the Commission's approach to it were further confused by its decision in *Carl M. Loeb, Rhoades & Co.*⁷¹ In that case, Arthur Vining Davis placed certain of his Florida properties into a new corporation which was to be financed through a public offering of securities. Loeb, Rhoades was to be the managing underwriter. A press release was issued on July 8, 1958, announcing the formation of Davis' corporation (Arvida), and that new capital would be sought to develop the land now held by the corporation. On September 18, 1958, after the financing arrangements had been formalized, Loeb, Rhoades issued a press release which stated that Arvida would be provided with 25 to 30 million dollars by a stock offering, increasing the corporation's assets to over 100 million dollars. In order to insure adequate press coverage, reporters were invited to Loeb, Rhoades' offices where it was disclosed that the offering price of the stock would be in the vicinity of 10 or 11 dollars per share. The Loeb, Rhoades officer would not disclose additional information such as the extent of the mortgage indebtedness or the capitalization of Arvida. Thus, until publication of the statutory prospectus, the public was not informed that much of the money raised would be used to pay the mortgage debt of which over 20 million dollars would fall due within five years, and that much of the land was rural and inaccessible and that 50 per cent of it was below the "flood criteria" established by local authorities, requiring substantial fill and damming expenditures before development could begin. In any event, buying interest attributable to the press release was estimated by the SEC to be at least \$500,000.

On these facts, the Commission found that Loeb, Rhoades had violated the section 5(c) gun-jumping prohibition against "initiating a public sales campaign 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."⁷² It arrived at this conclusion by pointing out that whether the publicity constituted

71. 38 S.E.C. 843 (1959).

72. *Id.* at 850.

an illegal offer depended upon all the facts and circumstances "including the nature, course, distribution, timing, and apparent purpose and effect of the published material."⁷³ The Commission also stated that publicity emanating from underwriters or prospective underwriters would be presumed to be an offer to sell in violation of section 5(c).⁷⁴

The Commission's statements in *Loeb, Rhoades* gave rise to at least four different interpretations of how it would proceed in identifying gun-jumping violations: the Commission would look to the effect of the publicity on the public;⁷⁵ the Commission would consider both the intent of the disseminator and the effect on the public;⁷⁶ the Commission would consider only the intent of the disseminator;⁷⁷ or subjective tests had been abandoned and replaced with the presumption that pre-filing publicity was an offer.⁷⁸

Thus, rather than elucidating the "all the circumstances" approach to determining infractions of the gun-jumping rules which the Commission reaffirmed in Release 3844, the *Loeb, Rhoades* decision muddied understanding by failing to specify what exactly the "all the circumstances" test would be used to determine. The decision restated the Commission's policy against a conditioning of the market but did not indicate how the fact of proscribed conditioning would be established. One conclusion which issuers and underwriters might well have drawn from these omissions was that the less said, the better. Of course, this conclusion discouraged the dissemination of legitimate pre-filing information.⁷⁹

73. *Id.* at 853 n.20.

74. *Id.* at 851.

75. Note, *An Offer to Sell Under the Securities Act of 1933*, 54 NW. U. L. REV. 131 (1959).

76. *Id.*; *id.* at 131 n.3.

77. Note, *Pre-Registration Publicity of New Securities Offering Enjoined by Stipulation*, 59 COLUM. L. REV. 517, 519-21 (1959). The Note viewed this approach favorably.

Although this practical and flexible approach may not provide the securities industries with a perfectly predictable test, it would seem to offer maximum protection to the investor without unduly impinging on freedom of communication or otherwise unduly restricting the activities of the financial community.

Id. at 521.

78. Note, *Arvida and the SEC: Prefiling Publicity*, 1959 DUKE L.J. 460, 466. The Note points out that if publicity were given its broadest meaning, any statement by an underwriter with respect to an issuer would be an illegal offer. See also *First Maine Corp.*, 38 S.E.C. 882 (1959), decided one month after *Loeb, Rhoades*, which adhered to the presumptive offer approach.

79. Note, *Arvida and the SEC: Prefiling Publicity*, *supra* note 78, at 467-68.

That this was in fact the result was indicated by Charles E. Shreve of the SEC in a telephone conversation with Eric H. Hager of the New York law firm of Shearman and Sterling:

Another conclusion that might have been drawn from the *Loeb, Rhoades* decision was that the Commission was ignoring all its various, vague pronouncements on gun-jumping and would take action against only the most flagrant violator. In *Loeb, Rhoades*, for example, the Commission noted that the press release contained serious omissions but did not go so far as to say that the release was fraudulent.⁸⁰ In fact, the press release probably was fraudulent under the anti-fraud provisions of the securities laws.⁸¹ Thus, the *Loeb, Rhoades* decision could have been read as a statement by the Commission that, in order to foster dissemination, it would invoke the gun-jumping prohibitions only if the gun-jumping statements were fraudulent or very close to being so.

The application of the "all the circumstances" test of gun-jumping in *Loeb, Rhoades* mentioned, but failed to clarify, how the defense of normal business practice fit into the calculation of a gun-jumping violation. As part of the defense raised in the case, it was argued that the press release was necessary and normal as a matter of sound business judgment to dispel rumors. The Commission rejected this argument as spurious but reasserted its position that announcements in the normal course of business were allowed and encouraged:

In the normal conduct of its business a corporation may continue to . . . make routine announcements to the press. This flow of normal corporate news, unrelated to a selling effort for an issue of securities, is natural, desirable and entirely consistent with the objective of disclosure to the public⁸²

However, under the "presumptive offer" interpretation of the *Loeb, Rhoades* case, a corporation would not issue a press release to dispel a rumor and educate the prospective investor for fear of violating the gun-jumping prohibition.

In sum, by attempting to articulate gun-jumping standards in Release No. 3844 and the *Loeb, Rhoades* case, the Commission

Mr. Hager asked whether this meant it would be improper to publish any news release in connection with the filing of a registration statement. I advised that as a practical matter I believed this to be true. He stated that this interpretation of the Act and rules was not generally understood by the New York law firms and underwriting houses. I agreed that it would be advisable for us to make this interpretation clearly understood.

Memorandum of telephone conversation between Charles Shreve and Eric H. Hager on file with the SEC (May 15, 1959) [unpublished].

80. 38 S.E.C. at 851-55.

81. See Rule 10b-5, 17 C.F.R. § 240.10b-5 (1974), of the Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.* (1970).

82. 38 S.E.C. at 853.

merely accentuated that it could do no better than to state an amorphous "conditioning the public mind" standard without adequately explaining what that meant.⁸³ Realistically, since even permitted communications are disseminated in the hope that the potential investor will purchase the security involved and are meant to condition the public mind, the only logical conclusion is that a gun-jumping violation is whatever the Commission, in retrospect, decides has conditioned the public mind adversely. Such a situation, similar to that which existed prior to the 1954 amendments, can only serve to discourage the dissemination of information.⁸⁴

C. *The Current Rules*

1. *Areas of Continuing Concern*

Although the Commission continued to refer to Release No. 3844 and the *Loeb, Rhoades* case as indications that the gun-jumping problem had been resolved,⁸⁵ increased interest and participation in the securities market in the 1960's resulted in indications to the contrary. As corporations began publishing more information and brokerage houses increased the publication of market letters and similar material, renewed awareness of the gun-jumping problem surfaced.⁸⁶ For example, the *Wheat Report*⁸⁷ stated that a need existed for clearer standards which would "differentiate between helpful and informative publicity and publicity primarily designed to 'condition' the market in such a way that the disclosure in the prospectus would be rendered ineffective."⁸⁸ In its chapter on gun-jumping,⁸⁹ the Report also pinpointed other specific areas of confusion. It noted that inconsistent statements had been made by the Commission as to whether an issuer contemplating a public offering could announce that fact. The Report also found that there was

83. Note, *Arvida and the SEC: Prefiling Publicity*, *supra* note 78, at 468-69.

84. It seems fair to conclude that the *Arvida* cases have produced an amorphous standard to regulate an activity of vital concern to the financial institutions of this country. Since SEC sanctions compel respect of this standard, the result, whether or not intended, is to stifle, without discrimination, the publication of both legitimate and illegitimate pre-filing information—an effect of dubious legitimacy.

Id. at 469.

85. See *American Television and Radio Co.*, 40 S.E.C. 641 (1961); SEC Securities Act Release No. 5009 (Oct. 7, 1969); SEC Securities Act Release No. 4697 (June 5, 1964).

86. See Comment, *The Wheat Report Proposals*, 35 Mo. L. Rev. 188 (1970).

87. SECURITIES AND EXCHANGE 'COMM'N, DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 and '34 ACTS (1969) [hereinafter cited as *WHEAT REPORT*].

88. *Id.* at 127.

89. *Id.* ch. 5.

general uncertainty among brokers as to when the gun-jumping restrictions began and to whom they applied.⁹⁰

2. Adoption of the Current Rules

a. *Rule 135.* The SEC responded with amendments to rule 135 and new rules 137, 138 and 139,⁹¹ all of which are operative today. Rule 135 was amended to permit the publishing of a notice that an issuer proposed to make an offering of securities and a notice of offerings related to certain forms of business combinations. The requirement that such notices be sent sixty days prior to the proposed date of the offering, formerly embodied in rule 135(a), was deleted.

The Commission rejected suggestions that the content of the notice allowed under rule 135(a)(1), which permits revelation of only the name of the issuer, should be expanded to permit an indication of the issuer's general type of business and the name of the managing underwriter.⁹² The Commission explained:

We do not feel an indication of the issuer's general type of business would be consistent with the restraint needed in such notices. Similarly, we feel naming the managing underwriter would stimulate public interest, and invoke public response during the pre-filing period.⁹³

These recommendations for changes in the rule and their rejection sharply defined the gun-jumping tension. Urging their implementation, the suggestions noted that they would increase investor knowledge and also facilitate dissemination of the prospectus. A prospective investor could thus better assess his interest and would know from whom he could obtain a prospectus.⁹⁴ Yet, the Com-

90. *Id.* at 135-38. The *Wheat Report* cited an example of one brokerage firm that indicated it would not publish a recommendation for any security of an issuer in registration. This confusion was fostered by statements by the Commission that merely continuing an existing practice would not preclude a finding that the literature used involved an offer to sell. See G. J. Mitchell, Jr., Co., 40 S.E.C. 409 (1960).

91. SEC Securities Act Release No. 5101 (Nov. 19, 1970).

92. Memorandum to the SEC from Charles E. Shreve of the SEC's Division of Corporate Finance, May 5, 1970 (The comments to which Shreve was responding had come from the New York law firm of Sullivan and Cromwell, the Association of the Bar of the City of New York, and the Investment Bankers Ass'n of America) [hereinafter cited as Shreve Memorandum] [unpublished]. Naming the managing underwriter was also advocated in FEDERAL BAR ASS'N, CONFERENCE ON NEW ERA IN SEC DISCLOSURE: THE WHEAT REPORT 86-87 (1970).

93. Shreve Memorandum, *supra* note 92, at 3.

94. The identification of the managing underwriter would place the announcement in a proper context. It would make the public aware that the issuer has the capability to market its securities. For this very reason, perhaps the announcement of a proposed public offering should be required

mission did not accept these recommendations because they might lead to practices and discussions designed to do more than merely provide information.⁹⁵ However, since all statements in this context are ultimately made with a view towards sale, and since the intent of the securities laws is to inform the investor, it seems arbitrary for the Commission to have refused to expand rule 135 because it felt that the additional information, although factual, might lead to an illegal conditioning of the market. In structuring the rule as it did, the Commission was again designating certain categories of information safe from the gun-jumping restriction without explaining why it chose to draw the line where it did.

b. *Rule 137.* Rule 137 was proposed to clarify the status of persons not participating in a distribution. Specifically, it attempts to answer the question noted by the Wheat Report of whether a nonparticipating dealer was subject to the gun-jumping prohibitions.⁹⁶ To this end, the rule permits publication and distribution, in the regular course of business by a nonparticipating dealer, of information, opinions, or recommendations regarding the securities of an issuer subject to the reporting requirements of the 1934 Act who files or proposes to file a registration statement under the 1933 Act. To qualify under this rule, a dealer must receive no consideration from, and have no special arrangements with, either the issuer or the underwriter.

One suggested change the Commission considered prior to the adoption of the rule was the expansion of the rule's coverage beyond issuers reporting under the 1934 Act.⁹⁷ Assuming, as the rule requires, that the broker has no interest in the new issue, no reason is apparent for prohibiting nonparticipating brokers from issuing statements on any new issue.

In rejecting this suggestion, the Commission explained:

Rule 137 is an attempt to reconcile the need for information about traded securities with the 1933 Act's prohibition against unregistered distributions. This rule is based upon

to state that no agreement or understanding has been reached with any underwriter, if that is the case. An incidental advantage to announcing the name of the proposed managing underwriter would be that it would permit people who wanted to write for the preliminary prospectus to have a firm to which they could direct their inquiries. Very often an issuer is not equipped to respond to a large number of requests for preliminary prospectuses.

FEDERAL BAR ASS'N, CONFERENCE ON NEW ERA IN SEC DISCLOSURE: THE WHEAT REPORT, *supra* note 92, at 57.

95. *Id.* at 63.

96. See note 90 *supra*.

97. See Shreve Memorandum, *supra* note 92.

a presumption there is greater trading interest in the stock of reporting companies than in nonreporting issuers. There is also an assumption that publications by nonparticipants about reporting issuers relate to the trading interest in the security rather than distribution.⁹⁸

The Commission's response indicates that, in the interests of disclosure as to already issued securities, a gun-jumping exception was being created. Moreover, it suggests that the Commission was not focusing on the dissemination-solicitation distinction when it formulated the rule, although the last sentence of the response reveals a fear that information about companies which had previously not issued securities would somehow be used to create a demand that might otherwise not exist.

Additionally, this response, coupled with the Commission's statement explaining why it was rejecting the recommended amendments to rule 135, indicates that the Commission was leaning toward the "effect of the communication" as the test of a gun-jumping violation. Espousal of this criterion, however, was undertaken without explaining why and how the Commission determined that the effect of one communication, innocuous on its face, was more or less harmful than another. Thus, the rules worked to perpetuate the pattern of designating certain communications in certain situations as immune from the gun-jumping restrictions, without adequate explanation of the distinctions which were being made.

Another recommended change to rule 137 called for the abolition of the requirement that the information be published in the regular course of business.⁹⁹ Again assuming, as the rule requires, that the dealer had no interest in the distribution, no reason appeared for banning even isolated opinions.

The Commission responded that no language in the rule prohibited an isolated opinion.¹⁰⁰ Since the rule is explicit that a nonparticipating dealer can publish or distribute information and opinions only if they are published and distributed "in the regular course of business," the Commission's response reflects its belief that isolated opinions are published in the normal course of business. If this interpretation of the Commission's response is correct, the Commission would be departing from the "normal course of business" standard employed in the *Loeb, Rhoades* decision.¹⁰¹

98. *Id.* at 4.

99. *Id.*

100. *Id.* at 5.

101. See Note, *Arvida and the SEC: Prefiling Publicity*, *supra* note 78.

Such a response is also in conflict with the "normal business activity" definition set forth in rule 139.

Rule 137 is not very helpful in determining who is covered by the gun-jumping prohibitions. By failing to define the phrase "normal business activity" as used in the rule 137 context, the Commission allowed freer reign to nonparticipating dealers, but reserved the right to sanction those who do not act in accordance with their normal activities. Although the rule answers the question of whether nonparticipating dealers will be held to the same gun-jumping standards as participating dealers, it substitutes the question, possibly as onerous, of what constitutes normal business activity for the nonparticipating dealer.

This definitional ambiguity might be unimportant, given other failings of the rule which have the potential of impeding disclosure of information, the paramount goal of the securities laws. Since a dealer cannot be contacted to join in a distribution of securities until the filing of the registration statement,¹⁰² a strong inducement exists on the part of a dealer not to distribute information once he learns of a proposed offering, because there is nothing in rule 137 exempting from the gun-jumping sanctions a dealer who publishes opinions when he does not expect to participate in an offering but who later becomes a participant.¹⁰³ If enough dealers withhold publishable information on the chance that they might become involved in the underwriting, rule 137 would become academic.

Additionally, rule 137 contains the proviso that "nothing herein shall forbid payment of the regular subscription or purchase price of the document or other written communication in which such information, opinions or recommendations appear." One comment on the rule when it was proposed suggested that the type of consideration which could be received by the dealer should be more precisely described.¹⁰⁴ It was suggested that the phrase "customary compensation" be substituted for the phrase "regular subscription or purchase price."

The Commission responded to this recommendation by stating that it saw no reason to enlarge the scope of compensation beyond

102. Contacting anyone, including a dealer, prior to the filing of a registration statement with a view towards sale of the securities to be registered would constitute a violation of section 5(c).

103. Kohn, *Problems Under the New "Gun-Jumping" Rules and Interpretations of the SEC*, in NEW YORK CITY PRACTICING LAW INSTITUTE, 3RD ANNUAL INSTITUTE ON SECURITIES REGULATION 160-61 (Mundheim & Fleischer eds. 1972).

104. Comments of Sullivan & Cromwell, *reprinted in* Shreve Memorandum, *supra* note 92.

that already permitted.¹⁰⁵ By authorizing the receipt of the regular subscription or purchase price, the Commission remained consistent with its authorization of publications in the regular course of business. Nonetheless, the suggestion and the Commission's response indicated that there might be further confusion in the area of regular business activity stemming from problems of definition of the term "regular subscription or purchase price."

c. *Rule 138.* Rule 138 was enacted to permit a dealer participating in an offering of nonconvertible debt securities or nonconvertible, nonparticipating preferred stock which is registered on Form S-7 or S-9 to publish opinions or recommendations concerning the common stock or the debt or preferred stock convertible into common stock of the issuer.¹⁰⁶ Conversely, a dealer participating in an offering of common stock or debt or preferred stock convertible into common stock, which is registered on Form S-7, can publish opinions or recommendations concerning the issuer's nonconvertible debt securities or nonconvertible, nonparticipating preferred stock.

The rationale underlying the change is in the nature of the securities involved. As the Commission noted:

Existing restrictions on such recommendations have proved troublesome, particularly with respect to public utilities which are continuously seeking debt financing. However, investment conditions with respect to the common stock and the senior securities of established corporations are significantly different, and the market for senior securities is largely institutional. Accordingly, since the danger of creating unwarranted interest in the offering is reduced, the Commission believes that restrictions may be relaxed, subject to a qualification: The proposed rule would apply only with respect to offerings of nonconvertible or debt or preferred stock which are registered on Form S-7 or S-9.

For similar reasons, the proposed rule would also permit a broker-dealer participating in a distribution of common stock registered on Form S-7 to publish opinions or recommendations concerning the issuer's nonconvertible senior securities.¹⁰⁷

105. *Id.* at 5.

106. Form S-7 is designed for the registration of securities, subject to certain conditions, only where the securities to be registered are to be offered for cash. The Commission will waive the cash requirement upon conversion of Eurobonds by companies which otherwise meet the requirements of the form. *See* 2 CCH FED. SEC. L. REP. ¶¶ 7190-96A (1975). Form S-9 is designed for the registration, subject to certain conditions, of nonconvertible, fixed-interest debt securities of an issuer which is required to file reports pursuant to sections 13 or 15(d) of the Securities Exchange Act of 1934. *See* 2 CCH FED. SEC. L. REP. ¶¶ 7206-13(1975).

107. SEC Securities Act Release No. 5010 (Oct. 7, 1969), at 3, 4.

One suggested amendment to the rule was that the opinions should not be limited solely to the securities which they described but should be allowed to discuss the issuer and its business.¹⁰⁸ The Commission, in rejecting the proposal, stated that it did not agree that the word "solely" as used in rule 138 meant that the opinion could not discuss the issuer or its business.¹⁰⁹ The Commission also stated its fear that if the word "solely" were deleted, dealers might consider the deletion an indication that it was proper to print opinions concerning securities they were offering if these opinions appeared in a publication ostensibly concerned with an issuer's other securities.¹¹⁰ The suggestion and the Commission's response indicated there would be future debate over the meaning of "solely."

The reasoning underlying rule 138 provides another example of coping with a specific gun-jumping situation by labeling a communication a permissible dissemination without explaining why it qualifies as such. If the Commission is to be taken at its word, a dealer could publish an opinion concerning an issuer's debt security and could then proceed to discuss the issuer and its business, even though the dealer is involved in the distribution of the issuer's common stock. By contrast, the Commission thought that to allow discussion of the issuer's business in rule 135 notices would not be consistent with the restraint dictated by the gun-jumping prohibitions. Thus, given the Commission's interpretation of rule 138, a dealer could convey the same information to a prospective customer, at the exact time that he would be forbidden to do so by rule 135, by publishing an opinion concerning another security of the same issuer. Perhaps the Commission felt that because the dealers were not commenting directly on securities in which they had a direct distribution interest and because disclosure should be restricted only where absolutely necessary, the possibility of circumvention of rule 135 provided by rule 138 should be tolerated. The effective result is to designate another safe area without indicating what characteristics the Commission relied on in awarding immunity from the gun-jumping restrictions.

d. *Rule 139.* As succinctly stated in Release No. 5101:

Rule 139 permits a broker-dealer participating in an offering to publish at regular intervals, as part of a comprehensive list of securities, opinions or recommendations concerning the issuer provided it is a reporting company.

108. Shreve Memorandum, *supra* note 92.

109. *Id.* at 5.

110. *Id.*

The opinion or recommendation, however, must not be given special prominence, and must not be more favorable than the last previous opinion distributed before the broker-dealer became a participant.¹¹¹

This rule was an attempt to codify the belief of the Commission that the gun-jumping rules were compatible with the normal business activity of a dealer publishing opinions, even though the dealer was involved in the distribution of a security about which he was publishing an opinion.

Specifically, clause (c) of rule 139 stipulates that the opinion published by the participating dealer can be no more favorable than the dealer's previously published opinion. It was suggested that the Commission adopt a standard based on extensiveness rather than favorableness.¹¹² Because it felt that such a substitution would create an amorphous standard which would be too difficult to enforce, the Commission rejected that approach.¹¹³ Regardless of the merits of the Commission's belief, the meaning of the "no more favorable" standard has itself proved to be the subject of uncertainty and debate.

Clause (a) of the rule requires that the recommendation be contained in a publication which has been distributed annually or more often for at least the preceding two years. It was suggested that a period of six months should be substituted for the two-year period if the publication was issued weekly or monthly.¹¹⁴ This, the argument went, would allow a new publication, or a new broker starting in the business, to take advantage of the rule sooner. The Commission rejected this argument, stating that the two-year requirement was necessary to prevent erosion of the purpose of the rule.¹¹⁵

The Commission's rejection of this shortened time period proposal indicates its belief that, for the purposes of rule 139, something is not normal business activity unless it has been done regularly for two years. This view contrasts with the Commission's position that, for the purposes of rule 137, normal business activity could encompass isolated opinions. Although an obvious justification exists for not allowing isolated opinions by a dealer involved in the distribution, there is no clear explanation as to why the two-year requirement was chosen.

111. SEC Securities Act Release No. 5101 (Nov. 19, 1970).

112. Shreve Memorandum, *supra* note 92.

113. *Id.* at 6.

114. *Id.*

115. *Id.*

Clause (a) of rule 139 also requires that each regularly produced publication contain a comprehensive list of securities currently recommended by the dealer. The term "comprehensive list" was left undefined, even though the Commission was informed that the omission would generate uncertainty.¹¹⁶ One practitioner, after speaking with the Commission about the problem, stated:

I understand that the staff has informally advised brokers that lists which contain information only as to a small handful of issuers do not constitute comprehensive lists under Rule 139. While I have been informed that the staff apparently has not directly passed on the question as to whether a list confined to one or a few industries can be a comprehensive list, the emphasis appears to be on the number of securities rather than the number of industries. Therefore, a list which covers a large number of securities in one industry might pass muster, while a list which contains very few securities in more than one industry might not qualify.¹¹⁷

Nonetheless, by leaving the phrase undefined, the Commission created another ambiguity in the gun-jumping area.

A different problem with clause (c) of rule 139 was spotlighted by a no-action letter (the Bache letter) released by the Commission as an example of the way in which the rule was designed to operate.¹¹⁸ In his letter to the Commission, a broker indicated that he sometimes recommended that a security be sold solely because, in the opinion of the broker, the market price was significantly higher than a carefully appraised investment value. A situation could arise, the letter continued, in which, subsequent to the published recommendation, the market price might decline appreciably and the broker might become a participating dealer in the security at the reduced price. The broker concluded that under these circumstances it would be contrary to the public interest to prohibit publishing a revised estimate if justified by the new price-to-value ratio.

The Commission replied, somewhat mechanistically, that if the broker's previous recommendation had been a "switch" or "hold," a firm could not publish a "buy" recommendation after it became or knew it would become a member of the underwriting syndicate or dealer group participating in a distribution of the securities covered by the recommendation.

The letter pinpointed the problem of what actions would be per-

116. FEDERAL BAR ASS'N, CONFERENCE ON NEW ERA IN SEC DISCLOSURE: THE WHEAT REPORT, *supra* note 92, at 55.

117. Kohn, *supra* note 103, at 159.

118. Bache & Co., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,459.

missible if a material event occurred in the period between the publication of the opinion and the broker's involvement in the underwriting. With regard to such a situation, the Commission had stated in Release No. 5009:

After a particular security is "in registration," broker-dealers often do not know the extent to which they may follow up recommendations concerning the security made before the security was "in registration." If a broker-dealer is a participant in a proposed underwriting and material events occur during the "pre-filing" period, the broker should be able to make a brief, strictly factual report of these events to his customers.¹¹⁹

This statement was not totally believed when made¹²⁰ and became more suspect after the Commission's response to the Bache letter.

Once again, the Commission's statement in Release No. 5009 and its response to the Bache letter indicates its inability to articulate what differentiates proper dissemination from improper solicitation. In the rule 139 context, the result of this inability is the failure to define the parameters of normal business activity. Rule 139 is a recognition on the part of the Commission that brokers should continue normal activity while involved in an underwriting. The Bache letter indicates that normal activity encompasses changing the recommendation on a security when market conditions change or when more facts are made available to the market. The wording of the rule suggests that the Commission recognizes this to be true since nothing in the rule would prohibit a broker from changing the recommendation of a security which he is involved in distributing if the recommendation is less favorable than his previous one. The conclusion to be drawn regarding the gun-jumping standard in the realm of normal business activity is that normal business publications are permitted if they do not give the appearance of being an attempt to sell. Favorable utterances would be a presumptive attempt to sell.

Besides the policy confusion embodied in clause (c) of the rule, the notice or publication to which the rule refers may prove to be another problem in interpretation. Clause (c) provides that while involved in the distribution of a security, a dealer can publish an opinion about that security if "[a]n opinion or recommendation at least as favorable to the security was published by the dealer in either the last publication of the same character or in a subsequent

119. SEC Securities Act Release No. 5009 (Oct. 7, 1969), *reprinted in* 1 CCH FED. SEC. L. REP. ¶ 1465, at 2135 (1973).

120. Kohn, *supra* note 103, at 150-51.

publication of a different character, which was previously distributed by such dealer." Under one interpretation of this language, a broker could decide to participate in a distribution and print a more favorable recommendation of the security in question, not in the publication in which the last recommendation appeared (publication A), but in another publication which meets the rule 139 criteria (publication B). He could then include the favorable recommendation which appeared in publication B in A, the publication in which opinions concerning that security had appeared in the past. Since such an interpretation would seem to violate the spirit of the gun-jumping prohibitions, it appears unlikely that such an interpretation is what the Commission intended. Obviously, this part of clause (c) creates another definitional ambiguity which will require explanation.¹²¹

e. *Release 5180: When the Restrictions Begin.* One problem not addressed directly by the new rules is the difficulty in determining the point at which the gun-jumping prohibitions become operative. In exempting a dealer from the gun-jumping prohibitions if he is not or does not propose to be a member of the underwriting syndicate or dealer group, rule 137 suggests that the prohibitions take effect at the point at which the dealer proposes to become a part of the underwriting. This formulation is deficient in practical value because it does not reach the problem of determining exactly when this decision is made.

Regarding the issuer, the Commission has attempted to define when the registration process and, thus, the gun-jumping restrictions begin. In a release issued shortly after the adoption of the rules,¹²² the Commission stated:

"In registration" is used herein to refer to the entire process of registration, at least from the time an issuer reaches an understanding with the broker-dealer which is to act as managing underwriter prior to the filing of the registration statement and the period of 40 to 90 days during which dealers must deliver a prospectus.¹²³

The crucial wording in the release is the use of "at least," implying that there is no one definite point at which the restrictions begin to apply. This interpretation has, in fact, been confirmed by a staff

121. In an [unpublished] interview, Mr. Rowland Cook, a member of the General Counsel's staff at the SEC, admitted confusion as to the meaning of this part of rule 139.

122. SEC Securities Act Release No. 5180 (Aug. 16, 1971), reprinted in 1 CCH FED. SEC. L. REP. ¶ 3056 (1973).

123. *Id.* n.1.

member of the Commission who has stated that the activity of an issuer prior to its contacting of an underwriter would be scrutinized to determine if the activity was normal.¹²⁴

The problems presented by this type of vague standard are similar to those that arise when the phrase "normal activity" is utilized in the gun-jumping context. Suppose, for example, that an issuer decided one year in advance of its decision to market a new security that it would market a new product.¹²⁵ Consequently, just prior to contacting an underwriter, the issuer commenced an advertising campaign designed to condition the public mind to purchase the new product. Under the various interpretations of the gun-jumping standard, such an advertising campaign could be considered a veiled attempt to sell the securities about to be marketed since a public mind favorably disposed to the issuer's new product might also view favorably the security to be offered. Moreover, the product advertising might not be strictly limited to the merits of the product but might also tout the merits of the producer. It is arguable that the mere announcement of the new product, without additional advertising, could be aimed at displaying to the securities market the financial strengths and prospects of the issuer, despite similar marketing and advertising of new products which in the past were part of the issuer's normal activity.

The problem posed by these facts was confronted in Release No. 3844.¹²⁶ Example No. 9 of the release¹²⁷ posited a registration coinciding with the normal distribution by the issuer of its annual report to security holders. The Commission advised the issuer "that, if the annual report was of the character and content normally published by the company and did not contain material designed by the company to assist in the proposed offering, no question would be raised."¹²⁸ The Commission's position was that normal business activity was proper so long as such activity was not an illegal offer to sell. The new rules contain no indication that this circular standard has been modified.

The result of this circular characterization of the standard is that it is difficult to determine when the gun-jumping restrictions begin to apply. This difficulty is caused by the nebulous standards of

124. Interview with Mr. Rowland Cook of the SEC staff [unpublished].

125. A similar problem was discussed in Note, *Arvida and the SEC: Prefiling Publicity*, *supra* note 78.

126. SEC Securities Act Release No. 3844 (Oct. 8, 1957), *reprinted in* 1 CCH FED. SEC. L. REP. ¶¶ 3250-56 (1975).

127. *Id.* ¶ 3256.18.

128. *Id.*

“conditioning the public mind” and “normal business activity” used when discussing behavior prior to registration. Since these phrases have not been adequately defined in a dissemination-solicitation framework, it is difficult to predict when an issuer or dealer will be deemed to have begun the process of distribution of securities.

3. *Analysis of the Current Rules*

Amended rule 135 and rules 137, 138, and 139 were the products of an effort by the SEC to define clearer standards in the gun-jumping context to help differentiate between informative publicity and publicity designed to condition the market.¹²⁹ Specifically, the rules, along with follow-up Release No. 5180, were supposed to answer those questions which had plagued the gun-jumping restrictions since their inception, namely: (1) When does the prohibition against offers begin? (2) In what situations does the normal business activity exception to the gun-jumping prohibition apply, and what is the definition of that exception? (3) To whom does the prohibition apply? and (4) What is the distinction between valid dissemination of information and dissemination which constitutes improper solicitation? The answer to this last question is, of course, fundamental to answering the others.

The effort was unsuccessful because, instead of confronting these basic questions, the rules merely added categories of behavior which are deemed not to violate the gun-jumping prohibition.¹³⁰ The rules thus fit into the pattern which has developed in the interpretation of the gun-jumping rules since the immunity they confer upon certain categories of communications is not explained by accompanying statements of policy and fact.

It is also arguable that the rules accomplish little in the way of

129. The Wheat Report noted the need for clarifying the gun-jumping standards. WHEAT REPORT, *supra* note 87, at 127.

130. The mechanical nature with which the gun-jumping rules have been expanded is well illustrated by mutual fund advertising, which poses a special gun-jumping problem because the funds are constantly in registration and are, therefore, limited in what they can communicate to the public. Mutual funds have argued that the advertising restrictions upon them are unfair when compared with the relative lack of restrictions placed on other types of financial advertising undertaken by their competitors, such as bank trust departments and savings and loan associations. The Commission's response to the problem has been to amend rule 134 and to adopt new rule 135a, in effect merely adding categories of information whose publication is permissible under the gun-jumping rules, without explaining why this information so qualifies. Thus, the Commission has not departed from its prior practice in coping with the gun-jumping confusion by creating exceptions to it. See SEC Rules 134, 135a, 17 C.F.R. §§ 230.134, 230.135a (1974), *as amended*, 40 Fed. Reg. 27442 (1975) [Rule 134 only].

expansion of safe categories. Since rules 137, 138, and 139 apply only to issuers subject to the reporting requirements of the 1934 Act, the gun-jumping prohibitions are altered only for this limited class of issuers. Since the rules contain a number of definitional problems whose resolutions are largely dependent on an understanding of what distinguishes an illegal offer from a legal publication, the result may be a reluctance on the part of issuers and underwriters to rely on the rules even if the issuer is a 1934 Act reporting company. A member of the Commission staff has stated that the rules are expansive in the limited sense of giving comfort to those who fall strictly within their language.¹³¹ However, since in some instances it is even difficult to determine the meaning of the rules' exact language, the group of persons who will gain comfort from them is small.¹³²

Possibly, the Commission sensed that the same basic problems still remained after promulgation of the rules. In Release No. 5180,¹³³ issued soon after the rules were adopted, the Commission attempted to clarify what an issuer could say while in registration:

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 nondisclosure of *factual* information by a publicly held company on the grounds that it has securities in registration under the Securities Act of 1933 ("Act"). 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.¹³⁴

The Commission in this release seemed to be espousing a "fact as opposed to opinion" standard. However, this standard seems inconsistent with the Commission's rejection of various recommendations to amend the rules to allow more factual statements. These

131. Interview with Mr. Rowland Cook of the SEC staff [unpublished].

132. Interviews indicate that brokers and lawyers who are involved in underwriting are not too familiar with the exact wording of rules 134, 135, 137, 138, and 139. These brokers and lawyers generally stated that attempts were made to assess all the circumstances surrounding the registration process and act as conservatively as possible in the dissemination of information, for to do otherwise might jeopardize the effective date of the registration statement.

133. SEC Securities Act Release No. 5180 (Aug. 16, 1971), *reprinted in* 1 CCH FED. SEC. L. REP. ¶ 3056 (1973).

134. *Id.*

suggestions were rejected on the grounds that either the suggested speech was itself a solicitation or carried with it a high probability that it would lead to a solicitation. Thus, describing the gun-jumping standard as allowing statements of fact as opposed to statements of opinion was not wholly accurate. Such a description was simply one way to characterize the standard, similar to the use of the phrase "conditioning the public mind," without actually explaining what it meant.

Release No. 5180 may have been prompted by the Commission's perception that even after the adoption of the 1970 rules there was still confusion about where information dissemination ended and gun-jumping began. The confusion produced a reluctance by underwriters and brokers to release any information that might be construed as an offer. It will be recalled that a similar situation arose after the enactment of section 5 of the Securities Act. To prompt greater disclosure of information to investors the Commission authorized and encouraged the use of the red herring prospectus. Release No. 5180 appears to encourage the release of factual as distinguished from opinion information to keep investors informed. It is questionable that the creation of a fact-opinion dichotomy has helped eliminate gun-jumping confusion.

III. A PROPOSED SOLUTION

A. A "Free-Writing" System

The history of the gun-jumping prohibition has been characterized by a lack of development of its underlying premise: dissemination may be distinguished from solicitation. This uneven history stems from the contradiction between the gun-jumping prohibition and the full disclosure goal. As a means of ending the high-pressure, minimum-risk underwriting practices of the 1920's and of allowing investors sufficient time to gather information, the prohibition was instituted to prevent underwriters from pressuring dealers who, in turn, pressured customers. Selective nondisclosure via the gun-jumping prohibition was seen as a necessary means of eliminating pressure sales tactics.

Other means, however, were developing to combat these fraudulent practices, notably the disclosure requirements of the 1934 Act.¹³⁵

135. See rule 10b-5 of the 1934 Securities Act, which makes it unlawful for any person "to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading" For the application of that rule, see *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968).

The gun-jumping prohibition developed and grew without regard to the rights, duties, and obligations imposed by these disclosure requirements. The result of this lack of coordination has been confusion and conflict between the goals of full disclosure and investor protection and the gun-jumping restriction which was devised as a means of obtaining these goals. Adding new rules to the gun-jumping prohibition, rather than eliminating its inherent tension, only heightens the awareness of the essential conflict. New rules will not solve the problems because all communications are both solicitations and disseminations, and, thus, there is no adequate way to distinguish between the two.

The best method to eliminate the gun-jumping confusion and to eliminate the conflicts necessarily generated with other aspects of the disclosure system is to remove the gun-jumping prohibition altogether. Implementation of this suggestion would not require major changes in the present rule structure. First, in order to insure that investors have sufficient time to inform themselves about a new issue, the registration provisions and the waiting period now in effect must be retained. This would preclude the high-pressure, hard-sell tactics involved in the *Van Alstyne* case.

Second, the requirement of the delivery of a prospectus to the investor should also be retained. Although some commentators have questioned whether the requirement enables the average investor to obtain comprehensible information upon which to base an investment decision,¹³⁶ the absence of such a requirement would leave a vacuum. It is unrealistic to assume that the investing public will be protected if the basis for information disclosure during a public offering consists of documents filed with the SEC, regardless of the comprehensiveness of the documents filed. The average investor will not seek out this information, may not ask his broker the proper questions, and will probably be told as little factually as is consistent with law. It should not matter that most investors do not read the prospectus, for the law most properly should concern itself with extending the opportunity for equal and complete information to all investors. Whether or not investors choose to pursue this opportunity is beyond the scope of the law. Thus, in any offering of a security, there should be a basic document, the prospectus, containing essential facts about that offering.

136. See Cohen, *Truth in Securities Revisited*, 79 HARV. L. REV. 1340 (1966); Kripke, *The SEC, The Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151 (1970); Mann, *Prospectuses: Unreadable or Just Unread? A Proposal to Reexamine Policies Against Permitting Projections*, 40 GEO. WASH. L. REV. 22 (1970).

Some commentators have indicated that, because of the oral loophole in the statutory scheme, many investors do not receive a prospectus until after a security has been purchased.¹³⁷ The oral loophole should be plugged, and the investor should receive a prospectus while it can play some part in his investment decision. Again, it may be that most investors would not look at the prospectus, but the law should insure that information is available if desired.

Finally, the one major change proposed is to allow issuers and brokers to say and write whatever they please during the registration process. This system of "free writing" would be similar to the one which now exists in the post-effective period. Such a system would insure that whenever a material item should be disclosed it can be, without fear of incurring liability under section 5. "Free writing" in this context would eliminate the contradiction that:

[S]omething less than "full" disclosure is deemed adequate in conveying an offer before or after effectiveness of the registration statement, and thus also adequate as a basis for investment decision, but is deemed inadequate as the final, exalted communication still required after investment decision, at the moment of consummation of sale.¹³⁸

B. *Obsolescence of the Gun-Jumping Restriction*

A "free writing" system is possible, in part, because of the continuous disclosure system of the 1934 Act. Issuers and brokers should be able to inundate the market with any and all manner of advertisements because this freedom does not pose the threat it did in 1933 when the only information available to an investor was that contained in the registration statement and prospectus. The situation has changed significantly since then because of the continuous reporting requirements of sections 12, 13, and 15(d) of the 1934 Act.¹³⁹ These rules insure that the investor and analyst have access

137. An oral offer can be made during the waiting period and an oral sale consummated after the effective date. Under these circumstances, all that section 5(b) presently requires is that a statutory prospectus be delivered with the confirmation of sale or delivery of the security, whichever occurs first.

This oral loophole has been much debated since the inception of the Act. See Byse & Bradley, *Proposals to Amend the Registration and the Prospectus Requirements of the Securities Act of 1933*, 96 U. PA. L. REV. 609 (1948); Dean, *Book Review*, 50 MICH. L. REV. 1388 (1952). See also note 17 *supra*.

138. Cohen, *supra* note 136, at 1389.

139. 15 U.S.C. §§ 78l, 78m, 78o(d) (1970).

See Kripke, *supra* note 136. See also Anderson, *The Disclosure Process in Federal Securities Regulation: A Brief Review*, 25 HASTINGS L.J. 311 (1974).

to detailed facts, on file with the SEC, about the issuer, in addition to the other facts reported in the registration statement.

A "free writing" system is also made possible because of the expanding concepts of fraud under the 1933 and 1934 Acts.¹⁴⁰ As one commentator has stated: "[T]he law now contains . . . sweeping prohibitions against all forms of fraud and misrepresentations, applicable to *all* communications in connection with registered and unregistered offerings alike."¹⁴¹ Given the expanded scope of the fraud provisions, it is safe to allow issuers and brokers to say whatever they wish. If there are misstatements or omissions in connection with a public offering, the wronged parties are adequately protected by the various remedies for fraud available. The substantial liabilities imposed by these remedies serve as a deterrent to fraudulent behavior. For these reasons, it is safe to allow even a new issuer, with no reporting history under the 1934 Act, as in the *Van Alstyne* case, to be free of gun-jumping restrictions.

An examination of the history of the gun-jumping prohibitions provides further justification for concluding that the prohibitions are obsolete. The major cases and releases on the subject have focused not so much on the fact that there was impermissible communication which pressured the investor as on the fact that the communication was probably incomplete or fraudulent. For instance, in Release No. 3844,¹⁴² ten examples were given of situations in which the gun-jumping problem might arise. Example No. 2¹⁴³ involved the issuance of a press release prior to the filing of a registration statement. The Commission stated: "The press release, which could be easily reproduced and employed by dealers and salesmen engaged in the sales effort, contained representations, 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."¹⁴⁴

The SEC's emphasis on the fact that something communicated to the investor during the registration process might be unreliable or misleading appeared again in the *Loeb, Rhoades* case.¹⁴⁵ There, the Commission stated:

140. Rule 10b-5 is not the only anti-fraud provision which can be invoked by the Commission. The fraud concepts are also embodied in sections 11, 12, and 17 of the Securities Act, as well as in sections 14(a), (d), and (e) and in rules 14a-9(a) and 14d-1(a) of the Securities Exchange Act of 1934.

141. Cohen, *supra* note 136, at 1392.

142. SEC Securities Act Release No. 3844 (Oct. 8, 1957), *reprinted in* 1 CCH FED. SEC. L. REP. ¶¶ 3250-56 (1975).

143. *Id.* ¶ 3256.11.

144. *Id.*

145. 38 S.E.C. 843 (1959).

Wholly omitted from the release and withheld from reporters were the essential financial facts of capitalization, indebtedness, and operating results which are so material to any informed investment decision. . . . Obscured also was the probable use of much of the proceeds of the financing, not to develop the properties but rather to discharge mortgage debt. . . . From the publicity, investors could, and no doubt many did, derive the impression that the risk and financing requirements of this real estate venture had been substantially satisfied by Davis and that the public was being invited to participate in reaping the fruits through early development.¹⁴⁶

The Commission was concerned with the failure to disclose material information and the creation of a false impression, rather than with the fact that the communication had taken place.

IV. CONCLUSION

Although the gun-jumping prohibition may have been necessary in 1933 to insure adequate disclosure and investor protection, it now hinders the accomplishment of these objectives. The expanding fraud and disclosure concepts permit the repeal of the prohibition without a loss of investor protection.

The hindrance arises in two fundamental ways. First, the SEC and case law have failed to generate adequate guidelines to permit a before-the-fact determination of whether a particular communication constitutes gun-jumping. Issuers in registration are, therefore, reluctant to disclose information for fear that such disclosure will be called an illegal solicitation. The history of section 5 has been one of unsuccessful attempts on the part of the SEC to coax the industry into information dissemination in the face of such reluctance. This failure has not been due to a lack of effort to define the terms "dissemination" and "solicitation." Rather, as the history of section 5 indicates, the effort has been misplaced because these terms cannot be distinguished since all disseminations are, at least indirectly, intended to be solicitations. What has resulted is an ad hoc process of allowing certain communications and forbidding others with no adequate explanation for the different treatment. The expanded requirements of disclosure dictate that the barrier to the free flow of information posed by the dissemination-solicitation tension be removed.

Second, the gun-jumping prohibition inhibits disclosure on a more theoretical level since its purpose of protecting offerees in a

146. *Id.* at 854.

public offering now conflicts with the general philosophy of disclosure. Over the last forty years, the disclosure concept has developed pursuant to concern not only for protecting offerees in a public offering but also for protecting investors in the trading markets via a continuous flow of material information:

Offerees in public offerings were special proteges of the 1933 Act, and an elaborate disclosure system, with emphasis on delivery of a prospectus was created for their particular benefit. But the 1934 Act says that all "investors" (potential buyers or sellers) in actively traded securities need the protection of a disclosure system.¹⁴⁷

Because of the development of the 1934 Act reporting system and the growing scope of the concept of fraud in the securities laws, the danger which existed when the gun-jumping prohibition was adopted—that an investor would purchase newly issued securities on the basis of inadequate or inaccurate information—has been reduced significantly. Consequently, it is no longer dangerous to allow free writing during the entire registration process. By retaining the waiting period, the law would still insure that the investor has enough time to gather information and to make an informed investment decision.

147. Cohen, *supra* note 136, at 1384-85.