FROM THE PODIUM

Reforming the Securities Act of 1933: A Conceptual Framework

At the fall meeting of the American Bar Association's Federal Regulation of Securities Committee meeting, Linda Quinn, the director of the SEC's Division of Corporation Finance, gave a thought-provoking talk on adapting the Securities Act of 1933 to the markets of the 1990s and beyond. In view of the importance of this speech, we have reprinted it in full below.

By Linda C. Quinn

This is certainly a time of intellectual ferment and questioning of what many have viewed as immutable truths. Nowhere is this more true than with respect to the laws governing capital formation. I am delighted to join you today to share with you some thoughts and observations on efforts to adapt the Securities Act of 1933 (Securities Act) to the markets of the '90s and next century.

The current discussion and debate recall the fundamental rethinking of the securities laws in the 1960s with the Special Study,[1] Milton Cohen's seminal article "Truth in Securities Revisited,"[2] and the Wheat Report,[3] all of which laid the intellectual foundation for the integrated disclosure system used for the last fifteen years.

Today's reassessment is wide ranging and has provoked a broad spectrum of initiatives, including legislation introduced by Congressman Fields,[4] the Commission's Advisory Committee on Capital Formation[5] headed by Commissioner Wallman, the NASAA Blue Ribbon Panel;[6] and the Commission's recently proposed initiatives to allow "testing the waters" in advance of a registered initial public offering[7] and to reconsider the prohibition on general solicitation and general advertising for private placements.[8]

Background

When I spoke to this assembly nine years ago,[9] key issues and concerns confronting the Commission under the Securities Act centered principally around issues of exempt offerings: (1) what constituted a good private placement; (2) when could restricted securities be resold outside of Rule 144; (3) integration; and (4) offshore sales.

At that time, I suggested that we step back from individual issues and questions of specific procedural detail and articulate a definition of public offering that would provide a conceptual framework for interpretation of, and rulemaking under, the Securities Act. The framework proposed was quite simple—to require registration only of those offerings made in the United States to persons who require the protections of the disclosures mandated by the registration process. This conceptual definition underlies Rule 144A[10] and Regulation S,[11] as well as the integration analysis set forth in the *Black Box* letter.[12]

With the new freedoms introduced into the unregistered market by these regulatory initiatives, public offering distribution techniques have been introduced and are common in the unregistered securities markets. International equity offerings are sold into the U.S. market through investment banks under Rule 144A using the same underwriting techniques as in registered transactions so long as the buyers are qualifying institutions. Domestic debt can be similarly distributed. Not only have public distribution practices migrated to the private market, so too have expectations of enhanced liquidity—both that of offshore markets made available under Rule 904 of Regulation S and the domestic institutional market under Rule 144A.

The success of the Rule 144A market is evident in the more than $165 billion of securities sold by over 1,100 issuers (almost half foreign) since adoption of the rule in 1990. With the success and visibility of this market, news of these exempt transactions is anything but private. Reports of ongoing transactions appear not only in services like the Private Placement Letter—but also in the business section of the general press. Rule 144A tranches of global public offerings, as well as

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the size of Rule 144A domestic placements, have assured that information about transactions is widely known and public. Keeping news of a placement private is, in a number of cases, not in the interests of investors and in many cases, simply not possible.

Participants in the public registered market increasingly have sought to introduce private market speed and flexibility into the registered offering process.

It was the former point—the need for disclosure of material issuances—that led the Commission to adopt Rule 135c to allow announcements of unregistered transactions prior to completion.[13] Recognition of offshore publicity practices, as well as the increasing newsworthiness of information about financings, is reflected in the preliminary note to Regulation S that sanctions news coverage of offerings under the Regulation[14] and the recent *Deutsche Telekom* letter.[15]

While public offering distribution techniques and enhanced liquidity were being introduced to the private market, participants in the public registered market increasingly have sought to introduce private market speed and flexibility into the registered offering process. Sellers have sought to engage in preregistration private solicitations as well as to use customized written documentation for institutional purchasers in registered deals. Shelf registration, introduced in the early '80s, and enhanced with the introduction of the unallocated shelf process in 1992,[16] greatly facilitated this osmosis.

Accelerating this trend to introduce private placement techniques in the registered market was the Commission's adoption of Rule 3a-7 under the Investment Company Act of 1940 (1940 Act) that exempted investment grade asset-backed securities from the 1940 Act.[17] Highly structured and negotiated transactions, previously relegated to the private or offshore markets, have moved to the registered public market—bringing with them a culture of ongoing negotiation and structuring of the product through active communication with purchasers—neither of which fits neatly within a statutory framework that restricts written documentation generally to a statutory prospectus and requires full offering documentation to be delivered prior to or with the confirmation or delivery of the securities.

At the same time, purchasers, even those qualifying for private placements, increasingly want unrestricted, freely saleable securities. Notwithstanding the enhanced efficiency of the unregistered market, purchasers want registered securities. Therefore, issuers have undertaken to register even those offerings that could rely on the private placement exemption. This led to the introduction of PIPEs (Private Investment, Public Equity transactions)[18] and Exxon Capital Exchange Offers.[19]

Thus, unlike nine years ago when the pressing issues were to clarify and streamline compliance with registration exemptions, the focus today is to reform the registration process—to accommodate all of these market developments, as well as to take advantage of, and adapt the system to, the communication revolution.

A Conceptual Framework

A number of specific initiatives have been proposed—and I do not plan to discuss these individual proposals today. Instead, what I would like to do in the time that remains is suggest a conceptual framework for identifying the problems posed by the Securities Act for these market developments and for developing and evaluating reforms to be undertaken.

While Securities Act registration is viewed as a mandatory provision, there is also a voluntary aspect—issuers can choose to register offerings that would qualify for private placements and thereby provide purchasers with freely saleable securities.[20] Registration of such an offering, in essence, is there for the benefit of subsequent purchasers. Little account has been taken of this elective aspect of the Securities Act. Once an offering is registered, no distinction is made with respect to the obligations of the offeror based on the nature of the purchasers. Thus, a registered offering to 25 qualified institutional buyers (QIBs) would be subject to the same prospectus delivery, prohibition of written communications, and limitation on soliciting activity, as would an offering to 25,000 individual investors. This result would not appear to be compelled by the goals of the Securities Act, and I think it is time to include the nature of the purchasers as one of the factors considered in defining the regulation of registered offers.

To evaluate the need for change and the architecture of any reform initiative, it is key to define what effect the current law has on the process of capital formation, and whether the consequences of these effects are in the public interest.

There are six basic mandates in the Securities Act: (1) public filing of specified disclosures; (2) registration of both the offer and the sale of a security; (3) restriction on written communications outside the prospectus; (4) prospectus delivery; (5) currency of information; and (6) heightened liability for disclosures. Calls for reform derive principally from three of these mandates: the registration of offers (as distinguished from sales), the restriction on written communications and prospectus delivery.[21]

The nonregistration of offers would eliminate the 'incurability' problem of a non-registered offer that can interfere with an issuer's ability to proceed with a registered offering.

There are those who might contend that treating primary offerings differently from secondary trading transactions is a fundamental problem and that liabilities for, and currency of, information should be the same for both markets. I do not fully subscribe to this view. There are a number of distinctions between primary offerings and secondary transactions that warrant these differences. From the investors' perspective, the increased compensation to distributors and the compressed period of the selling effort, as well as the issuer's interest in obtaining funds, set up a situation in which potential conflicts of interest between investors and sellers are enhanced. On a more macroeconomic level, the efficiency of the capital allocation process may be affected more immediately by the integrity and completeness of disclosures made in capital raising transactions. And finally, as to the issuer, there is a substantial distinction. The costs of updating information and enhanced liabilities are counterbalanced by the benefit of the capital raised. It is not unreasonable to hold the issuer responsible for the accuracy of the representations and warranties (*i.e.* the disclosures) it uses to raise funds. The practicalities and cost effectiveness of requiring the same ongoing currency of information and imposing the same heightened level of liability for misleading disclosures to the trading markets are not as clear.

In determining how to best address problems presented by any of the Securities Act mandates, it is important to assess whether the problem arises because the fundamental premise underlying the mandate is no longer viable or valid, or rather, because the administration of a valid mandate has not been well adapted to market developments. I'd like to suggest that as to the first two—the need to register offers and the limitations on written communications outside the statutory prospectus—it is the mandate itself that needs to be reconsidered. As to the third— prospectus delivery—I believe, rather than the mandate, it is its administration that needs to be reformed.

Registration of Offers

Do we need to continue to register offers?

Requiring offers to be registered is, in essence, simply a prophylactic. There is nothing inherently wrong, or counter to investors' interests, in telling them about a company and asking them if they'd be interested in buying its securities. Requiring that offers be registered assures that information is publicly available with respect to the issuer at the time solicitations are made. For a reporting company, that information is already available. In an IPO—where, granted, such information may not yet be broadly disseminated—could not investors be adequately protected, if, as the Test-the-Waters Release states, registered sales are conditioned on requirements that assure that:

> investors have the full opportunity to review and consider the information mandated by the Securities Act in making their decision, and
>
> the communications are not such as to cause investors to overlook the mandated disclosures.

Not only would the nonregistration of offers introduce significantly more flexibility and efficiency into the process, it would eliminate the "incurability" problem of a non-registered offer that can interfere with an issuer's ability to proceed with a registered offering.

Conversely, under such an approach, public offers would not preclude reliance on the private placement exemption of Section 4(2) of the Securities Act. So long as the sale was to the qualified buyers, and resales to the public were restricted, general solicitation and advertising would no longer run afoul of Section 5 as unregistered offers and would not seem otherwise to warrant restrictions.

In sum, offers would not be a Section 5 event and therefore would not be a source of Section 12(1) liabilities under the Securities Act. Offering communications would, and should, still be subject to the antifraud laws and could be subjected to Section 12(2) liability in the case of public offerings.

This approach could be effected by the Commission defining these communications as outside the scope of offers for purposes of Section 5 of the Securities Act, subject to conditions deemed appropriate.[22] The test-the-waters proposal for registered IPOs makes such use of the Commission's definitional authority, an approach supported in the American Bar Association's comment letter on the initiative.

I know there are some who view the Commission's authority as more circumscribed. However, the authority to define terms under the Securities Act has been used by the Commission over the past sixty years to take communications outside the scope of Section 5 where it believed the basic purposes of the Securities Act would be served. The whole history of the process by which red herrings were developed in the 1930s and 1940s, notwithstanding the Act's prohibition of offers as well as sales prior to effectiveness of a registration statement for the securities, is an apt precedent,[23] as is the Commission's allowing securities to be offered in back-end mergers to be fully disclosed, discussed and evaluated in the tender offer context.[24] Alternatively, if the Commission is given general exemptive authority under the Securities Act, such as that proposed in the Fields Bill, the Commission could exercise such authority to exempt offers of securities from registration, while continuing to require registration of the sale of such securities.

Restriction on Written Communications

This approach to offers also leads to reconsideration of the mandate that the statutory prospectus be the only written communication during the offering period. It is no longer possible, if ever it was, to expect that information flows to investors can be limited effectively. The focus of the law should be on assuring that communications, written or oral, are not used to mislead investors, rather than to restrict the form or content of the communications. Would not investors be better served by a process that encourages increased communication? The enhanced flexibility also may lead to more effective communication. Moreover, as a result of the unrestricted ability to engage in oral selling efforts once the registration statement is filed under the current law, the statute sets up a curious incentive for distributors to rely on oral, rather than written, sales practices. Is this in the best interest of investors?

One issue under such an approach is whether to require any or all such documents to be filed and publicly accessible. The answer will depend on what purpose is to be served by the filing in a particular context. In some cases, filing may be necessary to address issues of selective disclosure, in others to assure a particular level of liability for the disclosures or to provide for Commission oversight.

In the past, where the Commission has allowed written communications outside a statutory prospectus in a registered offering, it has typically done so by defining the communication not to be a prospectus.[25] This also forecloses potential Section 12(2) liability. If the offering process were revised to allow free writing in sales documents, however, Section 12(2) liability generally would appear as appropriate for these free writing communications as for oral offering communications, which are subject to Section 12(2) liabilities.[26] To keep these selling documents within the purview of Section 12(2), the Commission could allow these written offering documents pursuant to its authority to permit the use of summary prospectuses under Section 10(b) of the Securities Act.[27] This authority could be used to allow a wide spectrum of written communications with minimal mandated content to be classified as Section 10 prospectuses, subject to Section 12(2) but not Section 11 liability.[28] Under this approach, for example, financial intermediaries could negotiate and structure products using customized written materials and issuers could respond freely to press inquiries about the company or the offering without concern about the Section 5 implications of any resulting news story.

Prospectus Delivery

With respect to the prospectus delivery mandate, I believe the problem does not arise from its fundamental premise, which continues to be valid—*i.e.* that delivery of information to the investor is in some cases necessary or beneficial to assuring that:

- information about an issuer and the offering is widely available to investors,
- investor protection problems arising out of speculative or risky offerings, complex instruments, and transactions characterized by significant conflicts of interest are addressed, and
- investors are adequately advised concerning investment decisions that can affect the value of a current investment, *e.g.*, mergers and other issuer restructurings.

Rather, the problem arises from the historic application of a one-size-fits-all approach to prospectus delivery. A prospectus has to be delivered in a Form S-3 offering just as in an offering registered on Form S-1, even though there may be little, if any, substantive information set forth in the S-3 prospectus. The Commission's recent actions with respect to electronic prospectuses[29] and new Rule 434[30] do suggest an evolution in this across-the-board approach.

The Commission has broad authority to determine the form and content of a Section 10 prospectus.[31] This authority would allow it, as has been proposed by some,[32] to permit full incorporation by reference of information on file with the Commission into the confirmation and reliance on the delivery of the confirmation to meet the prospectus delivery requirement of Section 5(b)(2) of the Securities Act. The mechanics are not difficult—the harder issue is when this should be the model.

The focus of the law should be on assuring that communications, written or oral, are not used to mislead investors, rather than to restrict the form or content of the communications.

Because of the traditional across-the-board approach to prospectus delivery, those debating the issues have tended to take an all or nothing approach. Those with concerns about speculative or risky offerings that are particularly susceptible to sales practice abuses—IPOs, complex instruments, transactions with conflicts of interest and restructurings—oppose moving to a delivery on request or access approach. In contrast, those on the other side of the debate focus on the lateness of the delivery, the perception that investors do not read the prospectus, the lack of substantive information in short-form prospectuses, and, in some cases, even the lack of substance in the delivery.[33] They contend that the benefits do not warrant either the cost of delivery or the peril of Section 12(1) liability for failure to deliver the final prospectus on a timely basis.

Rejection of an across-the-board approach should allow both perspectives to be addressed. This would then allow the discussion to focus on the central issue—in what situations is mandated delivery of disclosure warranted? In such cases, pre-confirmation delivery should be the model, as it is for IPOs today. In those cases in which pre-confirmation delivery is not found to be justified, it would appear sensible to allow a confirmation incorporating the mandated information to meet the prospectus delivery requirement of Section 5.

Conclusion

This is an exciting time—the capital markets today are dramatically different not only from those in 1933, but even from those of the early 1980's. The technological revolution, internationalization of the markets, and accelerating disintermediation of the financial markets, together with the corresponding financing and regulatory innovation, have profoundly changed the markets and the implications of the regulatory regime on those markets. These changes call for a reexamination of the principles underlying the regulation of the capital raising process, and a redefining of its conceptual framework to provide the architecture for legislative and regulatory reform.

NOTES

1. *Report of Special Study of the Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess., Pt. 1, 591-595 (1963) (Special Study).

2. Cohen, "*Truth in Securities Revisited*," 79 Harv. L. Rev. 1340 (1966).

3. *Disclosure to Investors - The Report and Recommendations to the Securities and Exchange Commission from the Disclosure Policy Study*, (Mar. 1969) (Wheat Report).

4. *Capital Markets Deregulation and Liberalization Act of 1995*, H.R. Doc. 2131, 104th Cong., 1st Sess. (1995) (Fields Bill).

5. *See* Securities Act Release No. 7135 (Feb. 13, 1995).

6. On October 25, 1995, in Vancouver, B.C., the North American Securities Administrators Association, Inc. (NASAA) announced the formation of a panel to study the structure of the capital markets.

7. *See* Securities Act Release No. 7188 (June 27, 1995) (Test-the-Waters Release).

8. *See* Securities Act Release No. 7185 (June 27, 1995).

9. Quinn, *Redefining "Public Offering or Distribution" for Today*, Address to Federal Regulation of Securities Committee, Annual Fall Meeting, November 22, 1986.

10. *See* Securities Act Releases Nos. 6806 (Nov. 1, 1988), 6839 (July 18, 1989) and 6862 (Apr. 30, 1990).

11. *See* Securities Act Release Nos. 6779 (June 17, 1988), 6838 (July 18, 1989) and 6863 (May 2, 1990).

12. Black Box Incorporated (avail. June 26, 1990).

13. *See* Securities Act Release No. 7053 (Apr. 19, 1994).

14. Preliminary Note 7 to Regulation S.

15. Deutsche Telekom AG (avail. June 13, 1995).

16. *See* Securities Act Release No. 6964 (Oct. 29, 1992).

17. *See* Investment Company Act Release No. 19105 (Nov. 19, 1992).

18. *See* Keller, *Basic Securities Act Concepts Revisited*, 9 Insights, No. 5, (May 1995).

19. *See, e.g.*, Exxon Capital Holding Corp. (avail. May 13, 1988), Morgan Stanley & Co. Incorporated (avail. June 5, 1991), Mary Kay Cosmetics, Inc. (avail. June 5, 1991), Vitro, S.A. (avail. Nov. 19, 1991), Corimon C.A.S.A.C.A. (avail. Mar. 22, 1993), Shearman & Sterling (avail. July 2, 1993), Grupo Financiero InverMexico, S.A. (avail. Apr. 4, 1995).

These exchange offers are designed to avoid the need for resale registration and the consequent obligation to maintain an "evergreen" prospectus and to deliver prospectuses upon resale.

20. This elective element of registration has assumed larger significance since the presumptive underwriter doctrine was generally abandoned in 1983 with the issuance of the American Council of Life Insurance letter (avail. May 10, 1983). The letter recognized that institutional investors buying in the ordinary course generally should not be deemed underwriters simply on the basis of the purchase of large amounts of registered securities or substantial portions of a public offering.

21. Few of those urging reform appear to take issue with the mandate to file a specified disclosure package. Some have suggested that the Commission review process is an element that necessitates reassessment of the Securities Act. What filings are subject to review is strictly a matter of

discretion with the Commission. The findings necessary to accelerate effectiveness of a registration statement under Section 8 of the Securities Act have not been an impediment to application of the selective review process to registration statements. There are those who believe the Commission should not review any registration statements other than those for initial public offerings (IPOs); they suggest that the review effort should be focused entirely on Exchange Act reporting, either to allow all financings by reporting companies to go to market on demand, or to enhance the review of Exchange Act reports. I, personally, am not in favor of this approach. There are transactional filings where review substantively enhances the quality of disclosures. These include offerings involving innovative securities or financing techniques, companies in financial trouble, transactions characterized by significant conflicts of interest, corporate restructurings and mergers, or those offerings that historically have been the source of significant disclosure issues, like direct participation investment programs. Moreover, experience with filings, where an across-the-board "no review" policy has been implemented, has shown an erosion of the quality of disclosure over time. Concerns that review of Exchange Act reports are not given high enough priority are misplaced. Last year, of the 3,900 reporting companies reviewed, two-thirds were reviewed in an Exchange Act, rather than transactional, context. Of the reporting issuer reviews in a transactional context, approximately half included a review of the registrant's Exchange Act reports.

22. *See, e.g.*, Rules 135, 135a and 135c under the Securities Act.

23. *See* Securities Act Release Nos. 70 (Nov. 6, 1933), 464 (Aug. 19, 1935); 3177 (Dec. 5, 1946); 3453 (Oct. 1, 1952).

24. *See* Securities Act Release No. 5927 (Apr. 24, 1978).

25. *See, e.g.*, Rules 134 and 254(e) under the Securities Act. *See also* proposed Rule 135d(c) in the Test-the-Waters Release.

26. In view of the particular needs of small issuers accessing the public market for the first time, the Commission did not seek to impose Section 12(2) liabilities on test-the-waters communications under Regulation A or its pending test-the-waters proposal for registered IPOs. In both instances, the process is conditioned on compliance with various requirements designed to focus the investor on the mandated disclosure document.

27. While reliance on the Section 10 prospectus status of the document to assure it is subject to Section 12(2) liability should be sufficient under *Gustafson v. Alloyd*, 115 Sup. Ct. 1061 (1995), consideration needs to be given to the implications of the language in the case suggesting that the Section 2(10) definition of prospectus refers to widely disseminated documents. *Id.* at 1064. If this is the case, filing of the document may be viewed as necessary to assure that it can be defined to be widely disseminated.

28. This is analogous to the process introduced several years ago for employee benefit plan prospectuses for securities registered on Form S-8. *See* Securities Act Release No. 6867 (1990).

29. *See* Securities Act Release No. 7233 (Oct. 6, 1995).

30. *See* Securities Act Release No. 7168 (May 11, 1995).

31. *See* Wheat Report at 69, and 1 Loss & Seligman, *Securities Regulation* at 477-473 (3rd Ed. 1989).

32. *See, e.g.*, McLaughlin, *"Ten Easy Pieces" for the SEC*, 18 Review of Securities and Commodity Regulation 200 (1985).

33. *See, e.g.*, Rule 153 under the Securities Act, as to which the Special Study observed, "[t]he end result of Rule 153 is to require substantially all of the burdens but not to accomplish the ultimate purpose of prospectus delivery." Special Study at 592.