CHAPTER 7

PUBLIC OFFERINGS

Rules and Statutes

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

—*Rules 134, 135, 137, 138, 139, 153, 163, 163A, 164, 168, 169, 172, 173, 174, 193, 405, 408(b), 409, 412, 413, 415, 421, 424, 430, 430A, 430B, 430C, 431, 433, 460, 461, 462 of the Securities Act*

—*Forms S-1, S-3*

—*Regulation S-K, Items 512(a), 1100, 1104, 1111*

—*Rule 15c2–8 of the Exchange Act*

—*Regulation M, Rules 100–105*

MOTIVATING HYPOTHETICAL

J.R. is the CEO of Ewing Oil, Inc., an oil services company that has been a pioneer in hydraulic fracturing, commonly referred to in the business as "fracking." Hydraulic fracturing is a practice used to coax oil and natural gas from hard rock formations. It involves forcing large amounts of pressurized water, sand, and chemicals down the wellbore to create tiny fissures in the rock so the oil and gas can flow through the wellbore to the surface. Ewing Oil provides its services to many of the world's largest oil producers. Ray, Ewing Oil's chief engineer, has developed a new fracking process involving much higher pressures at the wellbore. Ray believes that his "turbo-fracking" process will allow for extraction of oil and gas at unprecedented depths. Ewing Oil has been closely held by the Ewing family, but it now needs a substantial amount of capital to develop Ray's turbo-fracking technology. If the company's bet on turbo-fracking pays off, J.R. believes Ewing Oil will become the dominant player in the oil services industry. To fund the expansion, J.R. is considering various financing options, including an initial public offering (IPO) of Ewing Oil common stock.

I. ECONOMICS OF PUBLIC OFFERINGS

Businesses exist to make a profit. To generate profits, businesses sell goods and services to customers in return for money. Revenues translate into profits, however, only after businesses pay for the inputs required to produce those goods and services. Costs may include expenses for employees, electricity, supplies, leases, and so on. Certain expenses go to items that provide value in the immediate future (e.g., the wages for an employee to work for the next month). Other expenses, termed capital

expenses, reflect purchases of tangible assets that can be used for production for an extended period of time (e.g., a drilling rig).

Some businesses require relatively few capital assets. Consider a photography business run by a sole proprietor; she may purchase a camera and some lights. By far the greatest expense of the photographer is her own time and effort (commonly referred to as the photographer's "human capital," although not by accountants). At the other end of the spectrum are businesses requiring significant amounts of more traditional capital assets. General Motors makes automobiles and trucks, which requires significant assets in the form of factories. In addition, it purchases large amounts of steel and other raw materials.

Capital-intensive businesses may have a timing problem. Products will eventually generate revenue when sold, but businesses often must make expenditures well before the time of sale. Ewing Oil needs to spend considerable amounts of money up front to develop its turbo-fracking technology (say $200 million). The expenditure on research and development (a capital expense) will generate revenue when oil companies hire Ewing Oil to help them exploit their oil and gas reserves. That revenue stream will continue for many years after (say $20 million per year). Although the stream of revenues over time may eventually exceed the initial capital costs, a capital-intensive business initially spends far more cash than it receives (in the case of Ewing Oil, a $180 million deficit after one year).

Companies can cover such cash flow shortfalls in a variety of ways. Many smaller businesses find investment funds through either internally generated funds, such as the prior year's profits, or through investments by the founder-owners of the business. A photographer in a sole proprietorship will typically put her own money into buying a camera. As the business grows, the photographer may use some of the earnings to purchase additional gear.

Larger businesses often face capital expenditures that dwarf the resources of most individuals. Few individuals can finance the purchase of an entire automobile factory. Even if they could, they may not want to put such a substantial portion of their wealth into one particular investment. Some larger businesses may finance a large capital expenditure out of internally generated funds. Microsoft, for example, sits on an enormous cash hoard that it can draw upon to purchase other businesses without relying on outside financing.

Businesses lacking the tremendous cash flow of Microsoft have a range of external solutions to the timing problem. For example, banks lend considerable sums to businesses. In exchange for the loan, banks will typically demand a security interest in the assets of the debtor-business and possibly a personal guarantee from its owners. Bank debt typically comes with additional constraints. Bank loans typically require businesses to make regular interest and principal payments. For some projects, the expected stream of revenues may be uncertain and only

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

Businesses lacking access to debt may raise additional capital by selling equity. Unlike debt, equity capital affords the flexibility of not requiring fixed payments. As the saying goes, "Equity is soft; debt is hard." Companies that expect profits only in the distant future may be forced to rely on equity financing. Equity, however, has a downside for the company's pre-existing owners, as bringing in more equity owners dilutes the potential upside return. If the company sells more common stock, the pre-existing common stock holders (e.g., the founders of the company) are left with a smaller proportionate share of the profits. This effect is commonly called "dilution."

Bringing outside investors into a business also poses a credibility problem: How will the outside investors know that the business will be operated to benefit *all* the equity owners? What constrains the founders or managers from diverting the firm's profits and assets? Businesses seeking to expand their ownership base typically use one of the off-the-shelf organizational forms provided under state law (e.g., limited partnership, LLC, or corporation). Those forms carry with them restrictions on self-dealing by managers, which are intended to reassure potential investors. These restrictions—if effective—increase the amount investors are willing to pay for an ownership stake in the business.

In summary, a project requiring large initial expenditures with greater returns in the future is the classic motive for raising capital. Businesses have choices in raising capital. Companies may self-finance through retained earnings or they may turn to their existing shareholders for more capital contributions. Larger sums can come from a bank loan. Even larger sums can be financed through the broader capital markets. In this chapter we discuss the application of the federal securities laws to one avenue for raising capital—the decision on the part of companies to raise capital through a public offering of securities. In Chapter 9, we discuss a different option—the private placement of securities to sophisticated investors.

An important trend in the United States has been the decline of the public offering market. In 1999, toward the end of the 1990s internet boom, the number of initial public offerings meeting certain screening requirements, including an offer price of at least $5.00 per share, was 476. In 2008, at the height of the Financial Crisis, the number of IPOs was only 21. In 2017, the number of IPOs rebounded to 108, still well

below the height of the IPO market in the late 1990s. Jay Ritter, IPO Data, http://site.warrington.ufl.edu/ritter/ipo-data. The relative lack of IPOs in recent years compared with the late 1990s corresponds with a drop in the number of listed domestic companies in the United States. In 1999, the number of listed domestic companies was 7,229. By 2017, that number had fallen to 4,336, a drop of 40%. World Bank, http://data.worldbank.org. A related trend over the past decade has been the rise of private placements in the United States.

A. A BRIEF DESCRIPTION OF THE PUBLIC OFFERING PROCESS

Suppose J.R. and the Ewing Oil board of directors decide the time is right to pursue an initial public offering of common stock. What is the first step? J.R. would probably talk to a Wall Street investment bank.

If Ewing Oil has a visible public presence and the market for IPOs is "hot," investment bankers already may have approached J.R. about a potential public offering. Sales people are always looking for a product to sell, but the market for IPOs ebbs and flows. In a slower market, or if Ewing Oil is less prominent, J.R. may need to seek out the Wall Street investment banks herself, either directly or through an intermediary such as Ewing Oil's attorneys. The attorneys, as repeat players, may have contacts with Wall Street law firms and investment banks.

What role do investment banks play as underwriters in a public offering? Underwriters are salesmen: they market the securities to the public. As repeat players in the capital markets, investment banks bring with them a wealth of contacts with institutional investors and securities dealers, which they rely on to promote demand for the offering.

In addition to selling the offering, particularly for companies going public for the first time, underwriters provide advice on the structure of the corporation, the securities to be offered, and the offering amount and price. The goal of this process is to make the firm and the offering as attractive as possible to public investors. Many startup companies develop complex capital structures and control relationships to accommodate the interests of various early-stage investors. The public capital market, in contrast, prefers straightforward capital structures, which make it easier to value the securities being offered. Consequently, IPO companies will typically have only one class of common stock, although dual-class shares have become increasingly common as a means of ensuring founders' control. The public capital markets also favor certain corporate governance features (such as an independent board and a separate chairman and CEO), so companies going public will typically adjust their board structure to meet those expectations.

Finally, investment banks help guide companies through the SEC's registration process. As you will discover in this chapter, the securities laws require companies making a public offering to file and distribute

mandatory disclosure documents containing information on the company, its management, and financials. In addition, companies must disclose information related to the offering (e.g., the security being offered, the underwriters, the discount for the underwriters, the number of securities offered, and the offering price). The securities laws also restrict the ability of companies to discuss the offering or otherwise condition the market for the upcoming public offering. Learning these rules relating to public offerings is the principal goal of this chapter.

1. DIFFERENT TYPES OF OFFERINGS

Issuers can access the public capital markets in a number of ways. The most common type of offering is the firm commitment. Below we describe briefly the firm commitment as well as three lesser-used alternatives—best efforts, direct public offerings, and the Dutch auction.

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

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

The certainty provided by a firm commitment offering may help ensure the value of the offering to both the issuer and investors. Consider Ewing Oil, which needs to raise $200 million to develop its turbo-fracking technology. A firm commitment offering ensures all investors that the company will in fact obtain the full $200 million needed, which makes the investment more likely to succeed for the investors. The underwriters' commitment to purchase the entire offering may also signal the investment bankers' confidence in the issuer.

Best Efforts. An investment bank assisting in a best efforts offering agrees only to use its "best efforts" to sell the offering. Unlike a firm commitment, the investment bank does not purchase the securities. Instead, the investment bank acts purely as a selling agent, receiving a commission on each security sold. Compared to the firm commitment offering, the investment bank assumes less risk and the issuer retains

more risk. If the securities do not sell, the issuer will receive smaller proceeds. The underwriter will only bear the opportunity cost of commissions unearned; it will not be stuck holding unattractive securities. Typically smaller, more speculative companies that cannot attract a firm commitment underwriting from one of the name brand investment banks raise capital through best efforts public offerings.

Investors face greater risks in a best efforts offering. First, because the investment bank is not putting its own money on the line, the investors have less confidence in the securities' valuation. Investment banks in a firm commitment offering, by contrast, have a strong incentive to ensure that the offering is priced correctly, or even underpriced, lest they be left holding the securities.

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

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

Dutch Auction Offering. An innovative, but little used, alternative in public offerings is the Dutch auction. In a Dutch auction, the issuer and underwriters do not fix an offering price. Instead, investors place bids for a desired number of shares at a specified price. After all the bids are placed, the issuer then chooses the highest price that will—given the range of bids—result in the offering completely selling out. Assume that Ewing Oil wants to sell 1 million shares; investors make the following bids:

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

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

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

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

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

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

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

2. THE UNDERWRITERS

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

Deregulation has allowed many commercial banks to join the ranks of underwriters, which has reduced the cost to issuers. Competition, however, may lead individual investment bankers eager to drum up more business to sacrifice the long-term reputation of the underwriter to land the big deal at hand, even if the issuer is of questionable quality. The individual investment banker who brings in more business may get a big bonus, but the reputational hit for underwriting a weak issuer will be borne by the investment bank itself.

3. THE UNDERWRITING PROCESS

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

In the syndicate, typically one to three underwriters will take on the role of the managing underwriter. Even if an offering has more than one managing underwriter, one investment bank—often referred to as the lead or book-running manager—will take the primary role in the offering.

The managing underwriter in charge of the "book" allocates the offered shares among investors. The managing underwriter also gets the issuer ready for the public offering, ensures that the registration statement is filed and becomes effective, prices the offering, performs due diligence for the registration statement, negotiates with the issuer on behalf of the syndicate, and manages the ultimate distribution of the securities to the public. For these extra services, the lead managing underwriter will typically take 20% or so of the gross spread. So if Ewing Oil sells shares to the underwriters at $18.60 and the IPO price is $20.00, the lead managing underwriter will receive $0.28 per share (20% of the $1.40 gross spread) for all shares sold in the offering as compensation for its role as lead manager.

Initially the managing underwriter and the issuer will sign only a non-binding letter of intent to do the public offering. The letter of intent will specify the role of the managing underwriter in the registration process and the size of the underwriting discount (i.e., the gross spread). The letter of intent often will also specify an overallotment option for the underwriters, labelled the "Green Shoe option," after the first company to use the technique. The option allows the underwriters, at their discretion, to expand the number of shares in the offering up to 15%. The letter of intent will omit one critical term: the price of the offering. Pricing is left until later—just before sales commence, when the issuer and the underwriters enter into a binding underwriting agreement.

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

Members of the syndicate are compensated out of the gross spread through a "selling concession." Typically, the selling concession is about 60% of the gross spread. For the Ewing Oil gross spread of $1.40 per share, the selling concession equals $0.84 per share. Each underwriter receives a selling concession in proportion to the number of shares that the underwriter purchases from the issuer—the underwriter's "allocation." If any of the allocated shares are sold by another underwriter or a dealer, the selling concession goes to them.

The remaining 20% of the gross spread ($0.28 per share in the Ewing Oil offering) then goes to paying various expenses arising from the offering. These expenses include the fees of the counsel for the underwriters, expenses relating to the "road show," and the costs of stabilization (covered below). The road show involves representatives

from the issuer and lead underwriter traveling from city to city promoting the offering to institutional investors.

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

4. UNDERPRICING

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

Underpricing is even more puzzling given the fact that offerings that have a large first-day "pop" perform relatively poorly over the first three years of the offering. (Query: Where is theglobe.com today?) Why are investors paying steep secondary market prices to buy shares that are likely to perform poorly? Underpricing is greater during "hot" issues markets when many IPOs are brought to market. One of the central advantages claimed for the Dutch auction process, described above, is the elimination of underpricing, which means that the issuer is able to capture greater proceeds from the offering. Recall that in a Dutch

auction, the issuer obtains information on the market's willingness to pay for its securities from individual bids for specific quantities of securities, which allows the issuer to select the highest price that still allows it to sell out the offering. The Dutch auction is engineered to ensure that the issuer does not leave money on the table.

The Dutch auction process, while beneficial for the issuer, is less clearly good for investors. If underpricing results from the irrational exuberance of investors artificially driving up stock prices on the first day of trading, the Dutch auction process may simply shift the gains from that run up in prices. The irrationally exuberant will simply put in an inflated bid in the auction. The winners in a traditional offering—at the expense of the exuberant investors—are the initial IPO purchasers (often institutional investors), who purchase underpriced shares and profit by reselling these shares in the secondary market. In a Dutch auction, the issuer profits instead. Although the issuer may gain higher offering proceeds, the offering price produced by the auction may still reflect irrational frenzy, leading to an offering price exceeding the company's fundamental value. As the market cools, the secondary market price may decline just as it would under a more traditional public offering. This possibility may help explain why Dutch auctions are little used.

5. CAPITAL STRUCTURE

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

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

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

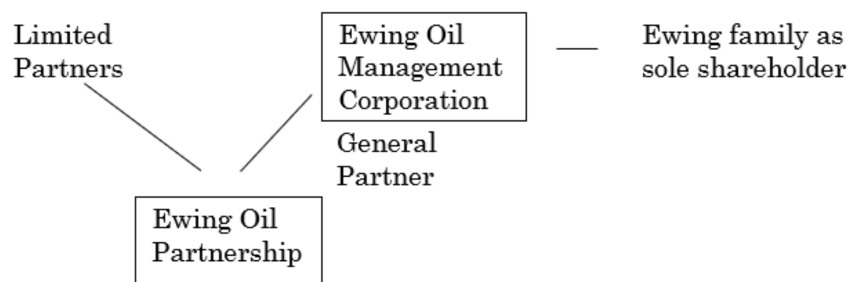
Companies typically come to an initial public offering with at least some, and often extensive, operating and financial history. With this history come assets and a pre-existing ownership base. Consider the example of Ewing Oil as depicted in the table below.

	Assets	**Liabilities (Equity)**
Pre-Offering	$25 million	$25 million (from 15 million outstanding shares of common stock primarily in the hands of the Ewing family)
Post-Offering	$225 million	$225 million (from 25 million outstanding shares of common stock after 10 million shares are sold in the public offering)

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

	Assets	**Liabilities (Equity)**
Pre-Offering	$35 million	$25 million (from 15 million outstanding shares of common stock primarily in the hands of the Ewing family) $10 million of preferred stock in the hands of Digger (convertible into 5 million shares of common stock)
Post-Offering	$235 million	$235 million (from 30 million outstanding shares of common stock after 10 million shares are sold in the public offering and Digger converts his preferred into 5 million shares of common stock)

Moreover, not all businesses are structured as corporations. Entrepreneurs can choose their organizational form under state law from among sole proprietorships, partnerships, limited liability companies and corporations. Prior to its initial public offering, for example, suppose Ewing Oil conducts its business through two separate (and interrelated) organizational forms: the limited partnership (Ewing Oil Partnership) and the corporation (Ewing Oil Management Corp.).



The limited partnership form allows outside investors (pre-public offering) to invest in Ewing Oil while enjoying limited liability and favorable tax treatment. Limited partnerships require one general partner to face unlimited liability, but that liability exposure can be avoided by having a corporation, here Ewing Oil Management Corp., serve as general partner. The Ewing family then receives their return as the shareholder of Ewing Oil Management Corp.

Although this moderately complicated structure may work for a small number of outside investors, investors in the public capital markets typically prefer a simple corporate structure—the entire business held by one formally incorporated entity—and a simple capital structure: one class of common stock. These straightforward structures make it easier for outside investors to value their potential returns. Prior to going public, the business, the lead underwriter, and attorneys will reconfigure the various ownership interests and state law entities into a single corporate form with common stock ownership.

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

B. PUBLIC OFFERING DISCLOSURE

The primary problem facing investors in a public offering is valuing the enterprise. Issuers and their insiders enjoy an informational advantage over outside investors. The risk for outside investors is that issuers may use this advantage to sell overvalued shares. More sophisticated investors compensate by demanding a lower price, which means issuers receive smaller proceeds than they would get if investors had full information. The net effect of information asymmetry is to raise the cost of capital for issuers.

The securities laws reduce informational advantages by requiring disclosure. The two primary disclosure documents are the registration statement and the statutory prospectus, which contains the disclosures found in Part I of the registration statement. The two documents give

rise to two different levels of liability exposure (a topic covered in more detail in Chapter 8):

Document	**Use**	**Special Antifraud Provision**
Registration Statement	Filed with SEC	Section 11 Liability —Due diligence defense for non-issuer participants
Statutory Prospectus	Distributed to Investors	Section 12(a)(2) Liability —Reasonable care defense for sellers

For domestic companies offering securities to the public, the two basic forms for the registration statement are Forms S-1 and S-3. The information required by these registration forms can be divided into three categories: (a) transaction-related information (e.g., the offering amount, use of proceeds, underwriters, etc.), (b) company information, and (c) exhibits and undertakings. A key concept in the application of the Forms is the "public float." The SEC defines the public float as equal to the price of a company's voting and non-voting common equity (determined, among other ways, based on the price at which the company's common equity was last sold) multiplied by the number of voting and non-voting common equity shares held by non-affiliates. Affiliates are those in a control relationship with the company. We cover affiliates in Chapter 10 in our discussion of resales of securities. The forms differ both in what they require and in their eligibility requirements as follows:

- *Form S-1* is available to all issuers. Form S-1 is the most comprehensive of the disclosure documents and contains all three categories of disclosure. The prospectus under Form S-1 contains both company information and transaction-related information. Form S-1 issuers that are Exchange Act reporting issuers and current in their filings for the past twelve months may incorporate company-related information by reference from prior SEC filings, e.g., Forms 10-K, 10-Q, and 8-K (discussed in Chapter 4).
- *Form S-3* is available to issuers that have, among other situations, been a reporting company for one year, are current in their SEC filings, and have a public float over $75 million. In addition, an issuer that has been a reporting company for at least one year and is not a shell company, may qualify for Form S-3 solely for purposes of a primary offering even if the issuer does not meet the $75 million public float requirement. Such issuers must have a class of common equity securities that is listed and registered on a

> national securities exchange. In addition, such issuers must limit their sales under Form S-3 in any 12-month period to a maximum of one-third of the issuer's public float. Form S-3 companies may incorporate by reference company-related information contained in prior SEC filings as well as information contained in Exchange Act reports that are filed after the effective date of the Form S-3 registration statement, known as "forward incorporation by reference." Forward incorporation by reference is particularly useful for shelf registration offerings, for which the registration statement may remain effective for a number of years.

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

The internet also makes it easier for investors to get information from multiple documents. Indeed, the notion of "a" document is somewhat amorphous on the internet. If a document on the internet hyperlinks to another document, should this be treated as one or two documents? Does it matter, from the perspective of an investor, if the investor has to "click" through a link to obtain more information rather than simply scrolling down within the same document?

The SEC limits Form S-3 eligibility under the one-third float method to only primary offerings. Instruction 6 to General Instruction I.B.6, Form S-3. Small issuers that qualify for Form S-3 under the alternative one-third public float test may take advantage of shelf registration under Rule 415(a)(1)(x) discussed below. Allowing these issuers to incorporate future filings by reference through Form S-3 allows for automatic updating of the shelf registration statement. Issuers eligible to use Form S-3 under the one-third public float method cannot apply this eligibility to other SEC rules and regulations. For example, Rule 139's exemption for certain research reports by brokers or dealers participating in a public offering, discussed below, requires Form S-3 eligibility. Issuers eligible for Form S-3 through the one-third public float method do not qualify as Form S-3 issuers for purposes of Rule 139.

1. PLAIN ENGLISH DISCLOSURES

In the late 1990s, the SEC reformed the statutory prospectus to make it more accessible to everyday investors. Instead of turgid prose

containing jargon and terms comprehensible only to financial professionals, the SEC mandated that the prospectus contain language drafted in a "clear, concise and understandable manner." Consider the following Securities Act rule governing how information is presented in the statutory prospectus:

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

Readable prose is an admirable goal, but were the SEC's plain English reforms worth the cost? Jargon has its benefits. Some forms of highly technical phrases provide a quick and certain form of communication among those familiar with the jargon. Consider the phrase "cash flow needs will become significant in the second quarter of the upcoming fiscal year." Is "cash flow" jargon? What if we force firms to replace this language with something more understandable, but somewhat less precise such as: "We're spending more than we're taking in." Although a larger segment of investors may understand such a phrase, more sophisticated investors may glean less information if "cash flow" has a commonly understood meaning. Does plain language disclosure sacrifice depth for breadth?

II. THE GUN-JUMPING RULES

The federal securities laws tightly regulate public offerings under a regime often referred to as the gun-jumping rules. The gun-jumping rules have three broad goals. First, the registration process focuses on two mandatory disclosure documents: a formal registration statement and a statutory prospectus. Second, the gun-jumping rules require the distribution of the statutory prospectus to both investors in the offering and other investors (for a specified period of time). Third, the gun-jumping rules restrict information about the offering if it is not part of the registration statement or prospectus.

The Securities Act divides the public offering process into three periods: the Pre-Filing Period, the Waiting Period, and the Post-Effective Period. The Pre-Filing Period ends and the Waiting Period begins when the issuer files the registration statement with the SEC. The Waiting Period gives way to the Post-Effective Period when the SEC declares the registration statement "effective."

Pre-Filing Period	Waiting Period	Post-Effective Period
	Filing of the Registration Statement	Registration Statement Effective

The three period structure of the gun-jumping rules dates back to the enactment of the Securities Act in 1933. In 2005, however, the SEC adopted a broad ranging series of reforms ("2005 Offering Reforms") to streamline offerings by large, well-followed issuers and to update disclosure requirements to reflect changing information technology. We discuss the impact of the 2005 Offering Reforms on the gun-jumping rules throughout this chapter. The SEC explained the rationale for the changes in the Promulgating Release below.

Securities Offering Reform

Securities Act Release No. 8591
Securities and Exchange Commission (July 19, 2005).

* * *

The rules we are adopting today continue the evolution of the offering process under the Securities Act that began as far back as 1966, when Milton Cohen noted the anomaly of the structure of the disclosure rules under the Securities Act and the Exchange Act and suggested the integration of the requirements under the two statutes. Mr. Cohen's article was followed by a 1969 study led by Commissioner Francis Wheat and the Commission's Advisory Committee on Corporate Disclosure in 1977. These studies eventually led to the Commission's adoption of the integrated disclosure system, short-form registration under the Securities Act, and Securities Act Rule 415 permitting shelf registration of continuous offerings and delayed offerings.

The Commission's attention to the offering and communications processes under the Securities Act continued more recently. . . . In July 1996, the Advisory Committee on the Capital Formation and Regulatory Processes delivered its report to the Commission. Its principal recommendation was that the Securities Act registration and disclosure processes be more directly tied to the philosophy and structure of the Exchange Act through the adoption of a system of "company registration." Under company registration, the focus of Securities Act and Exchange Act registration and disclosure would move from transactions to issuers, and corollary steps would be taken to provide for disclosure and registration of individual offerings within the company registration framework. . . .

The rules we are adopting today are focused primarily on constructive, incremental changes in our regulatory structure and the offering process rather than the introduction of a far-reaching new system, as we believe that we can best achieve further integration of

Securities Act and Exchange Act disclosure and processes by making adjustments in the current integrated disclosure and shelf registration systems. Further, consistent with our belief that investors and the securities markets will benefit from greater permissible communications by issuers while retaining appropriate liability for these communications, we have sought to address the need for timeliness of information for investors by building on existing statutory provisions and processes without mandating delays in the offering process that we believe would be inconsistent with the needs of issuers for timely access to the securities markets and capital.

* * *

Today's rules reflect our view that revisions to the Securities Act registration and offering procedures are appropriate in light of significant developments in the offering and capital formation procedures and can provide enhanced protection of investors under the statute. We believe that the rule changes we adopt today will:

- Facilitate greater availability of information to investors and the market with regard to all issuers;
- Eliminate barriers to open communications that have been made increasingly outmoded by technological advances;
- Reflect the increased importance of electronic dissemination of information, including the use of the Internet;
- Make the capital formation process more efficient; and
- Define more clearly both the information and the timeliness of the availability of information against which a seller's statements are evaluated for liability purposes.

* * *

1. Advances in Technology

As we noted in the Proposing Release, significant technological advances over the last three decades have increased both the market's demand for more timely corporate disclosure and the ability of issuers to capture, process, and disseminate this information. Computers, sophisticated financial software, electronic mail, teleconferencing, videoconferencing, webcasting, and other technologies available today have replaced, to a large extent, paper, pencils, typewriters, adding machines, carbon paper, paper mail, travel, and face-to-face meetings relied on previously. The rules we are adopting today seek to recognize the integral role that technology plays in timely informing the markets and investors about important corporate information and developments.

2. Exchange Act Reporting Standards

The role that a public issuer's Exchange Act reports play in investment decision making is a key component of the rules we are adopting today. Congress recognized that the ongoing dissemination of accurate information by issuers about themselves and their securities is essential to the effective operation of the trading markets. The Exchange Act and underlying rules have established a system of continuing disclosure about issuers that have offered securities to the public, or that have securities that are listed on a national securities exchange or are broadly held by the public. The Exchange Act rules require public issuers to make periodic disclosures at annual and quarterly intervals, with other important information reported on a more current basis. The Exchange Act specifically provides for current disclosure to maintain the timeliness and adequacy of information disclosed by issuers, and we have significantly expanded our current disclosure requirements . . .

A public issuer's Exchange Act record provides the basic source of information to the market and to potential purchasers regarding the issuer and its management, business, financial condition, and prospects. Because an issuer's Exchange Act reports and other publicly available information form the basis for the market's evaluation of the issuer and the pricing of its securities, investors in the secondary market use that information in making their investment decisions. Similarly, during a securities offering in which an issuer uses a short-form registration statement, an issuer's Exchange Act record is very often the most significant part of the information about the issuer in the registration statement.

* * *

Many of the recent changes to the Exchange Act reporting framework provide greater rigor to the process that issuers must follow in preparing their financial statements and Exchange Act reports. Senior management now must certify the material adequacy of the content of periodic Exchange Act reports. Moreover, issuers, with the involvement of senior management, now must implement and evaluate disclosure controls and procedures and internal controls over financial reporting. Further, we believe the heightened role of an issuer's board of directors and its audit committee provides a structure that can contribute to improved Exchange Act reports. . . .

We believe that the enhancements to Exchange Act reporting described above enable us to rely on these reports to a greater degree in adopting our rules to reform the securities offering process.

* * *

The concept of "company registration" informs the SEC's 2005 Offering Reforms. As the SEC noted in the Promulgating Release and as

we will see in this chapter, the Securities Act regulates *transactions*. Under company registration, however, companies are the regulatory focal point. Microsoft, a large publicly-traded company, has a long history of Exchange Act filings with the SEC. Many analysts follow Microsoft and there is a rich information environment for its common stock. Whether directly or through an efficient market for Microsoft's stock, investors have a solid understanding of the value of its stock. For a company such as Microsoft, proponents of company registration would argue that the public offering process provides minimal useful information to investors. What is the point of additional mandatory disclosure or prospectus delivery requirements if the market already has sufficient information to value Microsoft stock? Why use the gun-jumping rules to restrict the ability of Microsoft to communicate other information if sophisticated analysts follow the company and have the ability and resources to assess those voluntary disclosures?

The SEC did not adopt full-blown company registration, but instead incorporated the intuitions behind company registration within the existing transaction-focused regulatory framework. As we go through the gun-jumping rules, consider whether attempting to account for company-level differences while staying within a transaction-focused regime adds unnecessary complexity—at least for law students attempting to learn the rules! Should the SEC instead have moved entirely to company based registration? One could imagine registering a company and then allowing the company to offer securities freely at any time with no more than a Form 8-K filing to indicate the transaction terms and a change in its outstanding capital stock after the offering. Section 28 of the Securities Act gives the SEC sweeping authority by rule or regulation to exempt "any person, security, or transaction" from any provision of the Securities Act, including the transaction focused securities offering regime. Is there some benefit to investors or the capital markets in continuing to regulate specific offering transactions within the Securities Act framework?

In keeping with its incremental move toward company registration within the existing framework of the Securities Act, the SEC divided companies and transactions into four groups:

> *Non-Reporting Issuer*—issuer not required to file reports pursuant to § 13 or § 15(d) of the Exchange Act.
>
> *Unseasoned Issuer*—issuer required to file reports pursuant to § 13 or § 15(d) of the Exchange Act, but it does not satisfy the requirements of Form S-3 or Form F-3 for a primary offering of its securities.
>
> *Seasoned Issuer*—issuer eligible to use Form S-3 or Form F-3 to register primary offerings of securities. Primary offerings include securities to be sold by the issuer or on its behalf, on behalf of its subsidiary, or on behalf of a person of which it is the subsidiary.

Well-Known Seasoned Issuers (WKSI)—More popularly known as "wicksees," they are defined in Rule 405. The principal requirements for WKSI status are:

- the issuer is eligible to register a primary offering of its securities on Form S-3 or Form F-3; and
- the issuer, as of a date within 60 days of the determination date, has either:
  - —a minimum $700 million of common equity worldwide market value held by non-affiliates; or
  - —in the registered offering in question will register only non-convertible securities, other than common equity, or will provide full and unconditional guarantees of a subsidiary's securities *provided* that the issuer previously issued $1 billion aggregate principal amount of non-convertible securities in registered offerings during the past three years. If such an issuer is eligible to register a primary offering under Form S-3 because it has a float of at least $75 million equity in the hands of non-affiliates at the determination date, the issuer can also issue common equity as a WKSI.

WKSI status is determined on a specified "determination date." The determination date is the date the issuer's most recent shelf registration statement was filed, or its most recent § 10(a)(3) amendment to a shelf registration statement, whichever is later. If the issuer has not filed a shelf registration statement then the determination date is the date of the filing of the most recent annual report on Form 10-K.

Issuers are disqualified from WKSI status if they are:

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

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

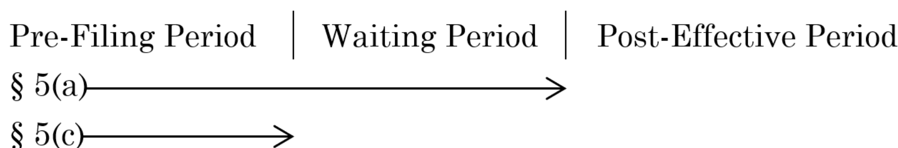
Issuers subject to a pending proceeding under § 8A in connection with an offering are also ineligible.

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

Although the SEC classifies issuers into four groups, the primary focus of regulation during a public offering remains with the offering transaction. We turn now to the regulations governing the three time periods in an offering: the Pre-Filing Period, the Waiting Period, and the Post-Effective Period. These three time periods are defined by the application of § 5 of the Securities Act, the key provision governing the public offering process. A quick word on interstate commerce. Because the Securities Act is a federal statute, § 5 conditions its application on the "use of any means or instruments of transportation or communication in interstate commerce." That said, the scope of interstate commerce is broad, including emails, texts, telephone calls, and of course, postal mail.

A. PRE-FILING PERIOD

The Pre-Filing Period runs until the registration statement is filed with the SEC. Two key provisions of § 5 of the Securities Act govern this period. Section 5(a) prohibits all sales until the registration statement becomes effective. Section 5(c) bans all offers prior to the filing of the registration statement. Once the Waiting Period commences, § 5(c) no longer applies:



1. WHAT IS AN "OFFER"?

Key to understanding the Pre-Filing Period is § 5(c). Section 5(c) prohibits "offers" prior to a registration statement being filed with the SEC. The quiet period imposed on companies stems from the SEC's broad definition of the term "offer." Section 2(a)(3) of the Securities Act defines "offer," but "offer" has been expansively interpreted by SEC administrative rulings and a series of SEC Securities Act Releases.

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

> The broad sweep of [the definition of an offer under § 2(a)(3)] is necessary to accomplish the statutory purposes in the light of the process of securities distribution as it exists in the United States. Securities are distributed in this country by a complex and sensitive machinery geared to accomplish nationwide distribution of large quantities of securities with great speed. Multi-million dollar issues are often oversubscribed on the day the securities are made available for sale. This result is accomplished by a network of prior informal indications of interest or offers to buy between underwriters and dealers and between dealers and investors based upon mutual expectations that, at the moment when sales may legally be made, many prior indications will immediately materialize as purchases. It is wholly unrealistic to assume in this context that "offers" must take any particular legal form. Legal formalities come at the end to record prior understandings, but it is the procedures by which these prior understandings, embodying investment decisions, are obtained or generated which the Securities Act was intended to reform. . . .
>
> [W]e have made clear our position that the statute prohibits issuers, underwriters and dealers from 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. . . .
>
> We accordingly conclude that publicity, prior to the filing of a registration statement by means of public media of communication, with respect to an issuer or its securities, emanating from broker dealer firms who as underwriters or prospective underwriters have negotiated or are negotiating for a public offering of the securities of such issuer, must be presumed to set in motion or to be a part of the distribution process and therefore to involve an offer to sell or a solicitation of an offer to buy such securities prohibited by Section 5(c). . . .
>
> Brokers and dealers properly and commendably provide their customers with a substantial amount of information concerning business and financial developments of interest to investors, including information with respect to particular securities and issuers. Section 5, nevertheless, prohibits selling efforts in connection with a proposed public distribution of securities prior to the filing of a registration statement and, as we have

indicated, this prohibition includes any publicity which is in fact a part of a selling effort. Indeed, the danger to investors from publicity amounting to a selling effort may be greater in cases where an issue has "news value" since it may be easier to whip up a "speculative frenzy" concerning the offering by incomplete or misleading publicity and thus facilitate the distribution of an unsound security at inflated prices. This is precisely the evil which the Securities Act seeks to prevent.

Securities Act Release No. 3844

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

* * *

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

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

This trend should be encouraged. It is necessary, however, that corporate management, counsel, underwriters, dealers and public relations firms recognize that the Securities Acts impose certain responsibilities and limitations upon persons engaged in the sale of securities and that publicity and public relations activities under certain circumstances may involve violations of the securities laws and cause serious embarrassment to issuers and underwriters in connection with the timing and marketing of an issue of securities. These violations not only pose enforcement and administrative problems for the Commission, they may also give rise to civil liabilities by the seller of securities to the purchaser. . . .

* * *

It follows from the express language and the legislative history of the Securities Act that an issuer, underwriter or dealer may not legally begin a public offering or initiate a public sales campaign prior to the filing of a registration statement. It apparently is not generally understood, however, that the publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute

to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort. . . .

Example #1

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

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

Example #2

An issuer in the promotional stage intended to offer for public sale an issue of securities the proceeds of which were to be employed to explore for and develop a mineralized area. The promoters and prospective underwriter prior to the filing of the required registration statement . . . arranged for a series of press releases describing the activities of the company, its proposed program of development of its properties, estimates of ore reserves and plans for a processing plant. This publicity campaign continued after the filing of a registration statement and during the period of the offering. The press releases, which could be easily reproduced and employed by dealers and salesmen engaged in the sales effort, contained 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.

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

* * *

Example #6

* * *

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

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

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

* * *

Securities Act Release No. 5180

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

The Commission today took note of situations when issuers whose securities are "in registration" may have [to] refuse to answer legitimate inquiries from stockholders, financial analysts, the press, or other persons concerning the company or some aspect of its business. The Commission hereby emphasizes that there is no basis in the securities acts or in any policy of the Commission which would justify the practice of non-disclosure of factual information by a publicly held company on the grounds that it has securities in registration under the Securities Act

of 1933. Neither a company in registration nor its representatives should instigate publicity for the purpose of facilitating the sale of securities in a proposed offering. Further, any publication of information by a company in registration other than by means of a statutory prospectus should be limited to factual information and should not include such things as predictions, projections, forecasts or opinions with respect to value.

* * *

GUIDELINES

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

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

1. Continue to advertise products and services.

2. Continue to send out customary quarterly, annual and other periodic reports to stockholders.

3. Continue to publish proxy statements and send out dividend notices.

4. Continue to make announcements to the press with respect to factual business and financial development; i.e., receipt of a contract, the settlement of a strike, the opening of a plant, or similar events of interest to the community in which the business operates.

5. Answer unsolicited telephone inquiries from stockholders, financial analysts, the press and others concerning factual information.

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

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

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

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

2. Publishing opinions concerning values.

* * *

NOTES

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

2. *The Pre-Filing Period.* When does the Pre-Filing Period begin? Once the Pre-Filing Period starts, a company and others associated with the offering may communicate about the offering or the company's future prospects only at their own peril. SEC Release No. 5180 notes that the Pre-Filing Period begins once the company is "in registration." But when does "registration" start? In Securities Act Release No. 5009 (Oct. 7, 1969), the SEC in footnote 4 provided the following guidance: " 'In registration' is used herein to mean 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 until the completion of the offering and the period of 40 or 90 days during which dealers must deliver a prospectus."

Rule 163A provides a safe harbor for the issuer clarifying when the Pre-Filing Period begins. Communications made by the issuer, or those working on behalf of an issuer (other than an underwriter or dealer participating in the offering), prior to 30 days before the filing of the registration statement are excluded from the definition of an "offer" for purposes of § 5(c). To be eligible for the safe harbor, the communication may not mention the offering. In addition, the issuer must "take reasonable steps within its control to prevent further distribution or publication of the information during the 30-day period immediately before the issuer files the registration statement." Regulation FD's prohibition on selective disclosures (discussed in Chapter 4) applies to communications under the safe harbor.

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

Rule 405 treats all non-real time electronic communication offering securities for sale as "graphic communications" and, thus, a written offer for purposes of the Securities Act. Thus, emails, videotapes, CD-ROMs, and recorded electronic version of roadshow presentations that offer securities are all written offers. Roadshows and other communications distributed electronically on a "real time" basis, however, are treated as oral communications.

Rule 433 specifies the treatment of hyperlinks from one web page to another. Written offers are defined to include offers of the issuer's securities that are "contained on an issuer's Web site or hyperlinked by the issuer from the issuer's Web site to a third party's Web site." Rule 433(e)(1). For example, hyperlinks included within a written communication offering the issuer's securities that connect to another web site or to other information are considered part of that written communication. Rule 433 excludes "historical issuer information" contained in a separate section on the issuer's Web site from the definition of written offers unless the information was incorporated by reference, included in a prospectus of the issuer used in the offering, or otherwise used or referred to in the offering. Rule 433(e)(2).

4. *WKSIs*. Well-known seasoned issuers are given considerable latitude to communicate in the Pre-Filing Period. Rule 163 exempts both oral and written communications, including offers, by or on behalf of WKSIs from § 5(c) during the Pre-Filing Period. Certain offerings, such as mergers and other business combinations, are excluded. In addition, underwriters and dealers participating in the offering are prohibited from using Rule 163. WKSIs using Rule 163 must treat such communications as "free writing prospectuses." The issuer must file any free writing prospectuses with the SEC promptly upon filing of the registration statement. Written communications must include a legend informing the investors about the formal statutory prospectus and how to get it. Regulation FD's prohibition on selective disclosures applies to Rule 163 communications.

The impact of Rule 163 is somewhat overshadowed by the expansion of the shelf registration process in the 2005 Offering Reforms. WKSIs may now file an automatic shelf registration statement that, as we discuss at the end of this chapter, allows the WKSI to register an unlimited amount of securities for an unlimited period. In effect, WKSIs who have filed an automatic shelf registration statement have skipped the Pre-Filing Period.

QUESTIONS

1. What counts as an offer?

2. If investors eventually will receive (or have access to) a final statutory prospectus, why does it matter that they earlier obtain information that "conditions" the market?

A common theme throughout the SEC releases is the distinction between "purely factual" disclosure and disclosures that refer to the offering directly or make forecasts, projections, or predictions (so-called "soft" information). Although avoiding disclosures that refer to the offering is easy enough, how are issuers to determine if their disclosures are purely factual? Exchange Act reporting issuers must make periodic disclosures and address a constant stream of questions from analysts and the investing public. How can the reporting company balance these demands for information with the imposition of a quiet period for disclosures that are not "purely factual"?

Two safe harbors, both introduced as part of the 2005 Offering Reforms, provide some comfort for non-WKSI issuers. These safe harbors, described below, afford protection for regularly released business and forward-looking information.

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

Factual business information includes, among other things, factual information about the issuer and its business, advertisements of the issuer's products or services, and factual information contained in the issuer's periodic Exchange Act reports. Forward-looking information that is permitted includes financial projections, statements about the issuer management's plans and the issuer's future economic performance, and any underlying assumptions. Allowing reporting issuers the ability to disseminate certain forward-looking information during a public offering is a dramatic change from the SEC's hostile attitude toward forward-looking information set forth in the Releases above. In order to use Rule 168, the issuer must have "previously released or disseminated" the same type of information in the "ordinary course of its business" and the information must be "materially consistent in timing, manner and form" with the issuer's similar past releases or disseminations of such

information. Rule 168(d). The safe harbor does not cover information relating to the offering itself.

Non-Reporting Issuer Safe Harbor—Narrower than Rule 168, Rule 169 of the Securities Act allows non-reporting issuers (i.e., most IPO issuers) to continue to disclose "factual business information." Unlike Rule 168, however, Rule 169 does not exempt forward-looking information. Underwriters and dealers participating in the offering cannot rely on Rule 169. As with Rule 168, Rule 169 provides an exemption from § 5(c)'s prohibition on offers in the Pre-Filing Period and an exclusion from § 2(a)(10)'s definition of "prospectus" for purposes of § 5(b)(1) in the Waiting and Post-Effective periods.

Rule 169 tracks Rule 168's requirements that the issuer have previously released or disseminated information of the same type in the ordinary course of business and in the same "timing, manner, and form." Rule 169 also requires that the information must have been disseminated previously to "customers and suppliers, other than in their capacities as investors or potential investors in the issuer's securities." Rule 169(d)(3). Finally, information relating to the offering is also ineligible.

HYPOTHETICAL ONE

Suppose that J.R. and the Ewing Oil board of directors decide to pursue an initial public offering. The company faces a number of choices, most importantly the number of shares to sell and the price. Timing is also an issue; is the market receptive to Ewing Oil shares now or should Ewing Oil wait to obtain a better price for its shares? J.R. is concerned not only with executing a successful IPO for Ewing Oil, she is worried about the Ewing family's financial well-being. As a closely held firm, Ewing Oil stock is generally difficult, if not impossible, to resell until after the IPO. J.R. and the Ewing family hope to cash out some of their shares in the IPO and substantially more in a possible follow-on equity offering next year.

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

1. *Scenario One:* Before finding an underwriter or filing a registration statement with the SEC, J.R. telephones a number of business associates from "the cartel" about investing in Ewing Oil's IPO. Among other things J.R. says, "I can get you in on the ground floor at $20 per share."

2. *Scenario Two:* Assume that Ewing Oil is "in registration." J.R. places an ad in *World Oil* magazine touting Ewing Oil's business (Ewing Oil had run a similar ad a year earlier in other oil industry periodicals). In the ad, J.R. does not specifically mention Ewing Oil's IPO plans. Instead, the ad discusses Ewing Oil's "optimistic" view of the demand for fracking technology. Moreover, the ad also mentions the turbo-fracking technology that Ewing Oil is developing will be "coming soon" and that it will "revolutionize the industry."

3. *Scenario Three:* J.R.'s *World Oil* ad also includes financial projections showing strong future growth in revenues and earnings for Ewing Oil. The

projections end with the following statement: "Ewing Oil's strong financial future ensures that we'll be around a long time to help customers like you!"

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

2. PUTTING TOGETHER THE OFFERING

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

HYPOTHETICAL TWO

1. One of J.R.'s first decisions after deciding to take Ewing Oil public is to contact her friend Cliff, an investment banker at Barnes-Wentworth Investments. J.R. asks Cliff if Barnes-Wentworth Investments will act as the managing underwriter for the offering. J.R. discusses pricing, the number of shares, and the timing of the IPO with Cliff over the telephone. After some discussions, Cliff agrees on behalf of Barnes-Wentworth Investments to take on the position of managing underwriter. J.R. and Cliff record their tentative agreement in a letter of intent. The letter of intent omits the offering price.

2. After agreeing to act as managing underwriter for the Ewing Oil offering, Barnes-Wentworth Investments starts putting together a syndicate of underwriters to handle the firm commitment offering. Through a series of texts, telephone calls and emails, Cliff negotiates with representatives from twenty different investment banks (fifteen of whom eventually agree in principle to participate in the offering).

3. The five investment banks that choose not to participate as underwriters make a counter-proposal. They ask Cliff if they can participate as dealers in the offering. As dealers, they will purchase shares from one of the underwriters participating in the offering rather than directly from the issuer. Consequently, they will handle far fewer shares than each of the individual underwriters, thereby reducing their risk. The investment banks acting as dealers will earn no more than the standard dealer's commission from their sales. Cliff, on behalf of Barnes-Wentworth Investments, readily agrees to the prospective dealers' counter-proposal.

4. Barnes-Wentworth Investments sends Pam, a recent business school graduate working for Cliff, to get Ewing Oil ready for the public offering. Pam goes over Ewing Oil's books, corporate records, board minutes and other records. She also has extensive discussions with Ewing Oil's auditors, Farlow & Culver. After some thought, Pam recommends that Ewing Oil reincorporate in Delaware, adopt anti-takeover protections (including a classified board of directors), and convert all existing preferred shares into common stock. Are Pam's discussions with Farlow & Culver okay?

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

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

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

Given the SEC's adoption of new safe harbors as part of the 2005 Offering Reforms under Rules 163 (for well-known seasoned issuers), 163A (prior to the 30 day period before filing of the registration statement), 168 (factual and forward-looking statements by a reporting issuer) and 169 (factual statements by a non-reporting issuer), what function does Rule 135 continue to play? Consider the situation of a non-WKSI issuing a factual notice related to the offering prior to the filing of the registration statement.

HYPOTHETICAL THREE

Excited by the prospect of Ewing Oil's upcoming public offering, J.R. puts out a press release on Ewing Oil's plans for the IPO. The press release mentions that Ewing Oil expects to raise $200 million for the offering and that the proceeds will be used to fund research and development of turbo-fracking. The press release does not mention Barnes-Wentworth Investments by name, instead only stating "a well-known, national investment bank has agreed in principle to act as our managing underwriter." Any problems?

3. EMERGING GROWTH COMPANIES

The JOBS Act of 2012 created a new category of issuers called "emerging growth companies." An emerging growth company is an issuer with total annual gross revenues of less than $1 billion (indexed for inflation) during its most recent fiscal year. Securities Act § 2(a)(19). In Chapter 4 we examined the how the JOBS Act reduces the ongoing obligations imposed on emerging growth companies after they become public. The JOBS Act also bestows significant advantages on emerging growth companies during the public offering process.

First, emerging growth companies only need to report two years of audited financial statements in the registration statement, Securities Act § 7(a)(2), rather than Form S-1's standard three years. The JOBS Act also reduces disclosure obligations under Items 301 (Selected Financial Data) and Item 303 (Management Discussion & Analysis).

Second, the JOBS Act provides that emerging growth companies may submit registration statements to the SEC staff on a confidential basis. The SEC has established a secure e-mail system for issuers to use in submitting draft registration statements. Normally, at least for U.S. domestic issuers, the SEC makes all versions of filed registration statements available to the public. Keeping an initial registration statement filed with the SEC confidential gives the issuer the ability to hide information contained in the registration statement from competitors. This ability to keep proprietary information confidential—at least temporarily—is particularly important for new IPO issuers with little public information otherwise available. Confidentiality also allows issuers to withdraw from the public offering process without sending a signal of failure to the marketplace. Issuers can maintain the confidentiality of their draft registration statements until twenty-one days prior to the date on which the issuer conducts a road show at which time the issuers must file "the initial confidential submission and all amendments thereto" with the SEC. Securities Act § 6(e).

Third, the JOBS Act establishes a new "test the waters" regime for emerging growth companies. Under § 5(d) of the Securities Act, an emerging growth company and those acting on its behalf can communicate with either Qualified Institutional Buyers or institutions that are accredited investors at any time during the public offering

process. Qualified Institutional Buyers include institutions that own and invest on a discretionary basis at least $100 million of securities. Institutional accredited investors include institutions with a minimum of $5 million of total assets. We discuss accredited investors in Chapter 9 and Qualified Institutional Buyers in Chapter 10.

One wrinkle for the test the waters provision is the prohibition on selective disclosures under Regulation FD that applies for Exchange Act reporting issuers. Although Regulation FD exempts certain communications that occur as part of a public offering, Regulation FD does apply to oral communications in the Pre-Filing Period. Because test the waters communications must occur selectively—only to QIBs or accredited investors—testing the waters would technically run afoul of Regulation FD. It is unclear whether the SEC will adjust Regulation FD to accommodate the new test the waters communications. In any case, Regulation FD does not apply to private companies, which are the companies most likely to avail themselves of testing the waters during an initial public offering.

Finally, the JOBS Act provides that an emerging growth company may choose to comply with any provision for which the JOBS Act would otherwise provide an exemption. JOBS Act § 107(a). Some issuers voluntarily provide three years of audited financial statements to bolster their credibility with investors.

HYPOTHETICAL FOUR

Ewing Oil had total revenues of $900 million for the prior fiscal year. Prior to filing its registration statement with the SEC, Ewing Oil proposes to make contact with a number of individuals, each with a net worth of over $10 million—sufficient wealth to be considered "accredited investors." Ewing Oil plans to discuss its upcoming offering with the accredited investors to get their opinion about possible pricing for the offering. Will the communications with the accredited investors violate § 5(c)?

B. WAITING PERIOD

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

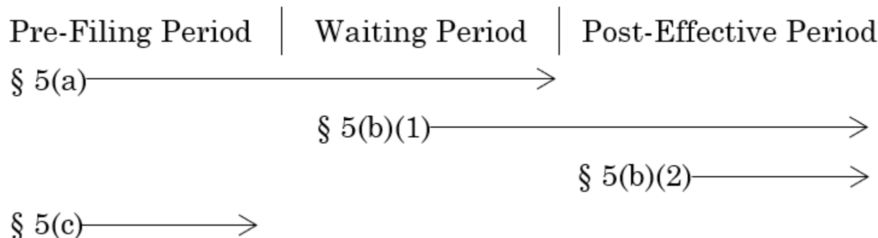
In this section, we consider (1) the process of gauging market sentiment, and (2) the process of becoming effective and the SEC enforcement powers relating to registration. During the Waiting Period, the gun-jumping rules continue to limit issuers and their affiliates in their efforts to sell the offering, albeit in a less intrusive fashion. For

companies with an active secondary trading market prior to the offering, however, it is nonetheless important to allow information to flow out to investors. We also consider here safe harbors for analyst reports, which apply throughout the public offering process.

1. GAUGING MARKET SENTIMENT

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

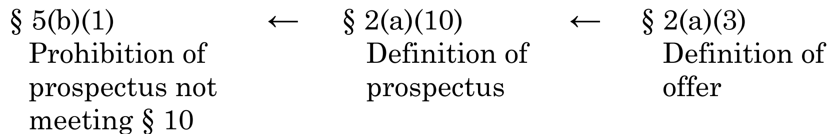
During the Pre-Filing Period, § 5(c) leaves little room to gauge market sentiment. Section 5(c) restricts all offers prior to the filing of the registration statement. As we saw above, this restriction on offers, combined with the broad definition of offers under § 2(a)(3), leads to an almost complete prohibition on communications relating to the offering in the Pre-Filing Period for non-well known seasoned issuers. (Recall though, that Rule 163 allows well-known seasoned issuers to discuss the offering in the Pre-Filing Period and § 5(d) allows emerging growth companies to test the waters with institutional investors.) With the filing of the registration statement, however, § 5(c) no longer applies. Instead, § 5(b)(1) steps in during the Waiting Period to prohibit the transmission, through interstate commerce, of any "prospectus" not meeting the requirements of the statutory prospectus as set forth in § 10 of the Securities Act. Keep in mind that § 5(a) still prohibits sales during the Waiting Period.



Section 5(b)(1) prohibits the transmission of prospectuses not meeting the requirements of § 10, but permits both preliminary and final prospectuses. The definition of a prospectus under § 2(a)(10) of the Securities Act is key to understanding the extent of § 5(b)(1)'s prohibition. Although generally defining a prospectus to include all "prospectuses," § 2(a)(10) also ropes in any "notice, circular,

advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." Note two things about this definition: (a) the breadth of the types of communication included and (b) the requirement that communication must either offer the security or confirm the sale of the security to qualify as a "prospectus." What types of communications "offer" the security for sale? Section 2(a)(3)'s definition of an offer continues to provide the answer.

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



In practice, § 5(b)(1) reintroduces the general prohibition on offers placed on all communications in the Pre-Filing Period, but because the prohibition now covers only offers by means of a prospectus not complying with § 10, the restriction is narrower than § 5(c)'s across-the-board prohibition on offers during the Pre-Filing Period. Written offers in the form of a preliminary prospectus under § 10(b) are explicitly permitted. In addition, only written and broadcast communications are restricted in the Waiting Period. By negative implication, oral communications not involving a broadcast medium are permitted. Talk all you want. In addition to offers, the SEC provides issuers with more latitude to gauge market sentiment through a number of safe harbors. These safe harbors work either to (a) include the communication as a § 10 prospectus or (b) exclude communication from the definition of a prospectus under § 2(a)(10). Which avenue the safe harbor takes is important. As we discuss in Chapter 8, communications that are deemed a § 10 prospectus face heightened liability under § 12(a)(2) for material misstatements and omissions. The following forms of communication are permitted in the Waiting Period.

a. The Preliminary Prospectus

Under Securities Act Rule 430, the preliminary prospectus must contain essentially the same information as the final statutory prospectus, except for price-related information. Typically, the issuer and the managing underwriter will set the price just before the registration statement is declared effective. (Setting the price earlier imposes large

risks on the underwriters in a firm commitment offering—what happens if the stock market declines after the price is set?) A preliminary prospectus under Rule 430 meets the requirements of § 10 only prior to the effective date and therefore may not be used in the Post-Effective Period. Exchange Act reporting issuers may also use a Rule 431 summary prospectus during the Waiting Period, but few do.

b. *The Free Writing Prospectus*

Free writing prospectuses (discussed in greater detail below) complying with the requirements of Rule 433 used after the filing of the registration statement by an issuer and other offering participants, including underwriters and dealers, are treated as a § 10(b) prospectus. As a § 10(b) prospectus, a free writing prospectus satisfies § 5(b)(1)'s requirement that all prospectuses meet the requirements of § 10.

c. *The Roadshow and Other Oral Offers*

Underwriters and issuers rely on oral offers to conduct "roadshows" to pitch the offering to potential investors. Such offers are not considered prospectuses under § 2(a)(10) and thus are not prohibited by § 5(b)(1). Typically conducted over a two-week period, the roadshow gives the issuer's top management and the managing underwriter the chance to sell the offering in face-to-face discussions with institutional investors nationwide. Underwriters may also make use of other oral communications. Brokers associated with the underwriters may make telephone calls to potential investors about the offering. Telephone calls are oral and therefore not prohibited by § 5(b)(1).

d. *Regularly Released Information in the Ordinary Course of Business*

The ordinary course of business safe harbors under Rules 168 and 169 continue to apply in the Waiting Period. Both rules exempt communications from the scope of both § 5(c) (applicable only in the Pre-Filing Period) as well as § 2(a)(10). Once exempted from § 2(a)(10), the ordinary course of business communications are not prohibited by § 5(b)(1).

e. *"Tombstone" Advertisements*

Although the Rule 135 tombstone safe harbor continues to be available in the Waiting Period, the SEC provides broader safe harbors for communications after the registration statement has been filed. Securities Act Rule 134 provides far more leeway for issuers seeking to disclose information on the offering and on their own business to the investing public. Moreover, not only the issuer, but also the underwriters, can use Rule 134.

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

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

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

Reliance on Rule 134 is conditioned on disclosing certain information, including a boilerplate legend indicating that securities may not be sold prior to the registration statement becoming effective. Rule 134(b). The name and address of a person from whom an investor may obtain a § 10 statutory prospectus must also be disclosed. These mandatory disclosures are not required if the communication is accompanied (or preceded) by a preliminary prospectus or if the Rule 134 notice "does no more than state from whom a written prospectus meeting the requirements of § 10 of the Act may be obtained, identify the security, state the price thereof and state by whom orders will be executed." Rule 134(c).

Rule 134 does not allow the disclosure of a detailed description of the offered securities, such as a term sheet. Issuers may, however, transmit

written details about the terms of the offering in a free writing prospectus during the Waiting Period.

f. Solicitations of Interest

Rule 134 also enables issuers to obtain indications of interest from investors. Under Rule 134(d), if a preliminary prospectus accompanies or precedes a Rule 134 communication, the communication may solicit an offer to buy or a less formal indication of interest. Rule 134(d) provides for a mandatory boilerplate legend advising the investor of his or her right to revoke the offer to buy prior to acceptance by the underwriter and that indications of interest involve no legal obligation. (Expressions of interest that are not followed by actual orders, however, may lead the underwriters to exclude the investor from subsequent offerings.)

The requirement that a preliminary prospectus accompany a communication under Rules 134(c) and 134(d) is satisfied by electronic communication that contains an active hyperlink to that prospectus.

HYPOTHETICAL FIVE

J.R., working closely with Cliff and Barnes-Wentworth Investments, the managing underwriter for Ewing Oil's offering, filed a registration statement for Ewing Oil's offering with the SEC. J.R. is eager to take Ewing Oil's story to investors and persuade them to purchase stock in the upcoming IPO. Do any of the following scenarios (all during the Waiting Period) violate the gun-jumping rules?

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

2. *Scenario Two:* Sue Ellen, a broker working for Barnes-Wentworth Investments, learns of the upcoming Ewing Oil offering through internal communications within Barnes-Wentworth. She immediately calls her list of "favored" investors consisting of all recent college graduates from her alma mater. (She obtains this list from her school's alumni web site.) For each potential investor who takes her call (a distressingly low percentage!), she spends about five minutes touting Ewing Oil's great growth prospects, the strength of the management team, and the tendency of IPO stocks to rise quickly in price after the offering.

3. *Scenario Three:* J.R. has Ewing Oil's newly-appointed investor relations director, Holly, put together an advertisement touting the upcoming offering for placement in the *Wall Street Journal*. Among other things, the advertisement is directed at "investors who want in on the new energy economy" and states Ewing Oil's intent to sell $200 million in common stock within the next year. The ad also includes a detailed five-year projection of future profits. The advertisement does not, however, mention Barnes-Wentworth Investments.

4. *Scenario Four:* J.R. has Holly put together a "tombstone" announcement of the offering that is carried in the *Wall Street Journal*. The tombstone mentions Barnes-Wentworth Investments and Ewing Oil and has a brief description of Ewing Oil's business. In addition, the tombstone provides a summary table of the past three years audited income statements of Ewing Oil (including revenues, costs, and earnings). Finally, the advertisement includes the standard legend indicating that no sales can be made before the effective date.

5. *Scenario Five:* Sue Ellen mails out a copy of the preliminary prospectus (omitting, among other things, pricing information) to all the members of her college graduating class. She includes with the preliminary prospectus a letter stating, "I think this is a good investment that might interest you. Please call me if you want to talk further about Ewing Oil's upcoming public offering. Hook 'em Horns!"

6. *Scenario Six:* Kristin, one of the clients solicited by Sue Ellen, sends a check in the amount of $20,000 to Barnes-Wentworth Investments. With her check, Kristin sends a note indicating that she is making a "down payment" on Ewing Oil shares from the upcoming public offering.

2. FREE WRITING PROSPECTUSES

Written and broadcast communications that offer or solicit an offer to buy securities are traditionally strictly limited in the Waiting Period through the interaction of § 2(a)(10) (defining "prospectus" broadly) and § 5(b)(1) (§ 10 prospectus delivery requirement). One consequence of the limit on prospectuses in the Waiting Period is that issuers and underwriters looking to sell an offering will tend to focus on the larger, institutional investors. Typically only the institutional investors will be invited to face-to-face meetings with the officers of the issuer and representatives from the lead underwriter at roadshow meetings. Retail investors will typically only receive communications in the form of telephone calls, if at all, from brokers associated with underwriters. Those brokers lack the full information on the offering that the corporate officers have and often are compensated on a commission basis. In sum, the institutional investors get the good stuff while retail investors end up with hard-selling brokers.

The time and expense of oral communication may limit the ability and incentive of an issuer to communicate with more than a select group of institutional investors. It is not worth the CEO's time to telephone each potential retail investor interested in investing only a few thousand dollars. One response to this problem is to allow more cost effective methods of communications such as written communications and video recordings of roadshows available for mass distribution over the internet.

In the 2005 Offering Reforms, the SEC opened up mass communication with the potential of reaching more retail investors through the use of "free writing prospectuses" prior to the effective date of the registration statement. The free writing prospectus gives issuers

more freedom to distribute prospectuses not meeting the requirements of a formal § 10 prospectus. Under Rule 164, a free writing prospectus that satisfies Rule 433 is treated as a § 10(b) prospectus, which means that a free writing prospectus satisfies § 5(b)(1)'s requirement that prospectuses meet the requirements of § 10. As a consequence, issuers and other offering participants, including underwriters and dealers, may send out a wide range of written (including broadcast and electronic) communications in the Waiting Period.

a. *Definition of a Free Writing Prospectus*

A free writing prospectus includes any written communication that offers to sell or solicits an offer to buy a security that is or will be subject to a registration statement and that does not meet the requirements of a § 10 statutory final or preliminary prospectus or a § 2(a)(10)(a) form of traditional free writing. Rule 405. Rule 405 goes on to define written communication to include written, printed, broadcast and graphic communications. Graphic communications, in turn, are defined to include "all forms of electronic media," such as e-mails, Web sites, CD-ROMS, videotapes, and "substantially similar messages widely distributed" over a variety of electronic communication networks. Significantly, the SEC excluded real-time electronic communication from the definition of graphic communication, which means that real-time electronic transmissions are "oral" communications. Included in the definition of a free writing prospectus, however, are indirect communications from the issuer to the marketplace through media sources, including interviews given by corporate officers that could be construed as offering a security.

b. *Issuer Requirements*

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

Non-Reporting and Unseasoned Issuers—Use of free writing prospectuses is permitted only after the filing of the registration statement, so non-reporting and unseasoned issuers cannot use Rule 433 in the Pre-Filing Period. For free writing prospectuses made by the issuer or on behalf of the issuer, including any paid advertisement or publication, the free writing prospectus must be accompanied or preceded by the most recent statutory prospectus that satisfies the requirements of § 10, other than a Rule 431 summary prospectus or another free writing prospectus that is deemed a § 10(b) prospectus pursuant to Rule 433. The prospectus must include a price range if required. For example, in Facebook's preliminary prospectus for its initial public offering, the company stated: "We anticipate that the initial public offering price will

be between $28.00 and $35.00 per share." In fact, Facebook's IPO was priced at $38.00 per share at the effective date of the offering.

If an electronic free writing prospectus is used, issuers can deliver the statutory prospectus by including a hyperlink to the most recent preliminary prospectus (during the Waiting Period) or final prospectus (during the Post-Effective Period). For a free writing prospectus from a media source not affiliated with nor paid by the issuer or other offering participant, the statutory prospectus does not need to precede or accompany the media free writing prospectus. Rule 433(b)(2)(i).

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

Seasoned Issuers and Well-Known Seasoned Issuers—Seasoned and well-known seasoned issuers, as well as other offering participants, may use a free writing prospectus any time after the filing of the registration statement. The filed registration statement must contain a statutory prospectus that satisfies § 10 (including a "base prospectus" under Rule 430B for shelf registrations as discussed at the end of the chapter). Unlike non-reporting and unseasoned issuers, seasoned issuers and WKSIs do not have to deliver the statutory prospectus to recipients of a free writing prospectus.

Recall that under Rule 163, a well-known seasoned issuer may also use a free writing prospectus or make oral offers prior to the filing of the registration statement. A WKSI and related offering participants do not have to deliver a statutory prospectus with the free writing prospectus. Instead, a WKSI need only provide a legend indicating where to access, or hyperlink to, the preliminary or base prospectus. The bottom line is that WKSI may therefore distribute free writing prospectuses freely throughout the public offering process, using Rule 163 in the Pre-Filing Period and Rules 164 and 433 thereafter.

c. *Disclosure, Filing and Retention Requirements*

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

Rule 433 requires that certain free writing prospectuses be filed with the SEC, which means the public can access them through the SEC's EDGAR system. The issuer must file a free writing prospectus on or before the date of first use in two situations:

- Whenever any person uses an "issuer free writing prospectus";
- Whenever any "issuer information" is contained in a free writing prospectus prepared by any other person (but not information prepared by a person other than the issuer on the basis of issuer information).

Rule 433(d)(1). The issuer must also file "a description of the final terms of the issuer's securities . . . after such terms have been established." Rule 433(d)(1)(i)(C). The issuer has until two days of the "later of the date such final terms have been established for all classes of the offering and the date of first use" to file the final terms. Rule 433(d)(5).

The application of the Rule 433 filing requirement is straightforward for "issuer free writing prospectuses," defined to include all information distributed by the issuer, on behalf of the issuer, or used or referred to by the issuer. Rule 433(h)(1). Such issuer free writing prospectuses must be filed with the SEC without exception. More complicated are the filing obligations resulting from free writing prospectuses of other persons, i.e., the underwriters. Rule 433(d)(1)(i)(B) requires the issuer to file free writing prospectuses prepared by other persons that contain "issuer information." Rule 433(h)(2) defines "issuer information" as "material information about the issuer or its securities that has been provided by or on behalf of the issuer." Issuers do not need to file the free writing prospectus of other persons if the prospectus is based on, but does not directly include, issuer information. According to the SEC, "[e]xamples of this information would include information prepared by underwriters that could be, but would not be limited to, information that is proprietary to an underwriter." Securities Act Release No. 8591.

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

There are exceptions to the filing requirement. Issuers and other participants can skip filing if the free writing prospectus does not contain "substantive changes from or additions to" a previously filed free writing prospectus. Rule 433(d)(3). Issuers do not need to file the free writing prospectus of other persons if the issuer information was already

included in a previously filed prospectus or free writing prospectus. Rule 433(d)(4). Issuers transmitting pre-recorded versions of an electronic roadshow (considered a graphic communication) may qualify for free writing prospectus treatment under Rule 433 even if they do not file the roadshow with the SEC. Non-reporting issuers registering common equity or convertible equity securities, however, must file roadshows that qualify as written communications with the SEC unless the issuer makes a "bona fide" version of the roadshow available without restriction to any person. Rule 433(d)(8). To be "bona fide," one or more of an issuer's officers or other management personnel must make a presentation in the roadshow, among other requirements. Rule 433(h)(5).

Media sources that publish or distribute a free writing prospectus with offering information provided by the issuer or any person participating in the offering (e.g., an interview of the CEO of Ewing Oil about the upcoming IPO) are potentially exempt through the operation of Rule 433(f) from the prospectus delivery requirement for unseasoned and non-reporting issuers. Rule 433(b)(2)(i). In addition, if Rule 433(f) is complied with, the issuer or offering participant is deemed to satisfy the filing and legend requirements. Rule 433(f) requires the issuer or offering participant to meet two conditions. First, Rule 433(f)(1)(i) requires that the media source not be compensated by the issuer or other participants in the offering for the written communication or its dissemination. Second, Rule 433(f)(1)(ii) requires that the issuer or other offering participant must file with the SEC the media communication with the Rule 433(c)(2) legend within four business days of becoming aware of its publication. Alternatively, the issuer or offering participant may file a copy of all the materials provided to the media including "transcripts of interviews or similar materials." Rule 433(f)(2)(iii). The media communication does not need to be filed if the substance of the communication was already filed with the SEC. Rule 433(f)(2)(i). The issuer or other offering participant may include additional information if they believe it is needed to correct information included in the communication. Rule 433(f)(2)(ii). A legend must be included on the copy that the issuer or offering participant files with the SEC but not on the copy distributed by the media source.

One concern raised by these filing requirements is the possibility that an issuer may inadvertently fail to file by the deadline (on or before the date of first use in the case of an issuer free writing prospectus). If that happens, the issuer risks a § 5 violation, exposing the issuer to potentially ruinous § 12(a)(1) liability (discussed in Chapter 8) if the issuer goes forward with the offering. To address this concern, the SEC allows issuers and other participants to cure the violation if they unintentionally or immaterially miss the filing deadline. Rule 164(b). The cure provision is only available if the issuer has acted in good faith and with reasonable care and issuer must cure the mistake by filing the free writing prospectus as soon as practicable after discovering the

failure to file. Rule 164(c) also allows the issuer to cure an omission of the required legend in the free writing prospectus.

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

d. Antifraud Liability and Regulation FD Implications

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

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

HYPOTHETICAL SIX

J.R., the CEO of Ewing Oil, working closely with Cliff and Barnes-Wentworth Investments, has filed a registration statement for Ewing Oil's offering with the SEC. Do any of the following scenarios (all during the Waiting Period) violate § 5?

1. *Scenario One:* Ewing Oil mails out a glossy pamphlet containing a photograph of J.R. and detailed information on the offering and how the offering will be "rocket fuel" propelling Ewing Oil's growth. The pamphlets are mailed to, among others, all the doctors and lawyers in Texas.

2. *Scenario Two:* J.R. gives an interview to *Business 2.0* magazine. In the interview, J.R. discusses the offering and her hope that Ewing Oil's business will rapidly expand due to the capital provided by the offering. The Business 2.0 article quotes the entire interview.

3. *Scenario Three:* Cliff of Barnes-Wentworth Investments sends out an information packet on the Ewing Oil offering, including the basic terms and its own analysis of the valuation of the company, together with the preliminary prospectus to potential dealers in the offering and a select group of institutional investors that have participated in prior IPOs with Barnes-Wentworth Investments. In constructing its valuation analysis, Barnes-Wentworth relied on detailed financial information obtained from Ewing Oil as well as discussions with Ewing Oil's chief financial officer, Bobby. Barnes-Wentworth Investments does not file the information packet with the SEC.

4. *Scenario Four:* To help drum up more interest in Ewing Oil's upcoming IPO, Cliff has Barnes-Wentworth's brokerage department mail out the same information packet from Scenario Three to all the individual investor-clients with accounts at Barnes-Wentworth.

5. *Scenario Five:* Recall that J.R. and Cliff embarked on a "road show" across the country to pitch the offering to institutional investors. J.R. has one of the road show presentations recorded and posted as a media file on the investor relations section of Ewing Oil's website.

6. *Scenario Six:* Barnes-Wentworth Investments sends an email to its investor clients containing a hyperlink to a PDF version of Ewing Oil's preliminary prospectus. The email also contains hyperlinks to various press stories (in the *Wall Street Journal*, *Fortune*, etc.) discussing Ewing Oil's upcoming offering.

NOTES

1. *Term sheets.* Issuers and offering participants have not made extensive use of the freedom to communicate through written and broadcast communications provided under Rules 164 and 433. The most common Form FWP filings are term sheets, providing factual descriptions of the terms and conditions of publicly offered securities. Transmeta Corporation, for example, filed a term sheet on September 21, 2007 where it, among other things, provided that:

> Transmeta Corporation, a Delaware corporation (the "Company"). Securities Offered: Up to an aggregate of 2,000,000 shares (the "Shares") of the Company's common stock, par value $0.0001 per share (the "Common Stock") and warrants to purchase 1,000,000 shares of Common Stock (the "Warrants" and, together with the Shares, the "Securities"), to be sold in units consisting of one Share and one Warrant to purchase 0.5 shares of Common Stock for a purchase price of $6.40 per unit (the "Offering"). The Shares and Warrants will be immediately separable and will be issued separately. There will be no minimum offering amount.

Largely absent from the Form FWP filings are selling documents that expand beyond short factual description of the offering. Why have issuers and offering participants not taken greater advantage of the free writing prospectus? One explanation is the fear of antifraud liability. The exemption from § 5(b)(1) for free writing prospectuses shields the issuer and offering participants from potential § 12(a)(1) liability for a violation of § 5 (as we

discuss in Chapter 8). Rule 433, however, does not protect issuers and offering participants making use of a free writing prospectus from reach of antifraud liability, which includes both Rule 10b–5 and—more worryingly—§ 12(a)(2). The SEC's explicit designation of free writing prospectuses under Rule 433 as public communications brings the free writing prospectus within the scope of § 12(a)(2).

The fear of § 12(a)(2) liability is compounded by Rule 159A which allows purchasers who buy securities in the "initial distribution," even if directly from an underwriter, to sue issuers under § 12(a)(2). Issuers, as a result, have an incentive to control the public disclosures of all participants in an offering, including underwriters.

To summarize, issuers can make "offers" during the Waiting Period through four broad avenues not generally available during the Pre-Filing Period:

(1) oral communications;

(2) statutory prospectuses under § 10(b) (Rules 430, 431);

(3) tombstone and safe harbor statements (Rule 134, § 2(a)(10)(b)); and

(4) free writing prospectuses (Rules 164 and 433).

3. THE PROCESS OF GOING EFFECTIVE

While the issuer and managing underwriter reach out to investors during the Waiting Period, the registration statement sits with the SEC. The issuer must wait for the registration statement to become "effective" before selling any securities to the public. Under § 8(a), a registration statement is supposed to become effective twenty days after filing. In practice, no issuer allows its registration statement to become effective automatically (other than shelf issuers, discussed below). Instead, issuers commonly file a registration statement with a Rule 473 notation, which automatically amends the registration statement until the SEC declares it effective.

The SEC has the power under § 8(a) to accelerate the effective date of a registration statement. Typically, the issuer and the underwriters will file an acceleration request with the SEC at least two days prior to the offering's desired effective date. Rule 461 outlines the factors the SEC weighs in deciding whether to grant a request for acceleration of the effective date. Among the factors that may result in a denial of acceleration include inaccurate or inadequate information in a preliminary prospectus, failure to make a bona fide effort to conform the prospectus to the plain English requirements of Rule 421(d), a current SEC investigation of the issuer, a controlling person of the issuer, or one of the underwriters, and an objection by FINRA to the compensation to be paid to the underwriters and other broker-dealers participating in the

offering. Rule 461 also stresses the importance of the "adequacy of information respecting the registrant . . . available to the public." Rule 460, in turn, states that one of the considerations in determining the adequacy of information is the distribution of the preliminary prospectus a reasonable time in advance of the anticipated effective date to each underwriter and dealer "reasonably anticipated" to be invited to participate in the offering.

Why include a delaying amendment in the registration statement pursuant to Rule 473 and wait for the SEC's approval? Why not just start selling twenty days after filing? First, under § 8(a), *any* amendment to the registration statement resets the filing date for purposes of determining when the registration statement becomes effective. Thus, issuers who intend to rely on the twenty-day effective period instead of waiting for the SEC's approval must file a complete and final registration statement twenty days prior to making their first sale. The price, of course, is one of the items that must be disclosed in the registration statement. Filing a complete registration statement would therefore require fixing the price twenty days before sale. Consider the risks of fixing the price of the offering twenty days before commencing any sales. If the price is fixed at $20, what if the price the market is willing to pay goes up to $25? What if the price the market is willing to pay goes down to $15? Recall that the underwriter is using the Waiting Period to assess investor sentiment through the roadshow. Note, however, that under Rule 430A, the issuer may, in a cash offering, file a form of the prospectus that omits price-related information as part of the registration statement. This means that the registration statement can be declared effective even before the final pricing negotiations between the issuers and the underwriters.

Second, stringent antifraud provisions apply to misstatements and omissions in the registration statement (discussed in Chapter 8). Rather than face potentially crippling antifraud lawsuits, the issuer can obtain comments from the SEC identifying deficiencies and correct them before selling to the public.

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

A more potent threat is found in § 8(d), which authorizes the SEC to issue a stop order suspending a registration statement's effectiveness.

Under § 8(d), the SEC may issue a stop order if the registration statement contains "any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading." As with the refusal order under § 8(b), the § 8(d) stop order requires both notice and a hearing within fifteen days of the giving of notice. To assist the SEC in determining whether to issue a stop order, § 8(e) authorizes the SEC to investigate the issuer and underwriters. If an issuer refuses to cooperate with the SEC's investigation, that refusal can be a basis for issuing a stop order.

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

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

4. ANALYSTS

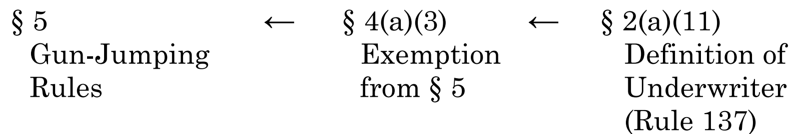
The gun-jumping rules restrict "offers" of securities. For non-public companies doing an IPO, the gun-jumping rules are only an inconvenience. Such companies typically have no audience of public investors prior to the offering. For companies with shares trading in the secondary market, however, the gun-jumping rules may chill the flow of information to investors. Although investors cannot buy the registered securities until the effective date, investors can purchase shares on the secondary market, which may be identical to the registered securities.

The issuer is not the only source of information relating to companies traded in the market. Securities analysts—typically associated with a brokerage firm—provide a constant stream of information on many publicly-traded companies. When a public company with an active secondary market and many analysts covering the company's stock does a seasoned offering, should the securities laws restrict the disclosure of these analysts' recommendations to the secondary market? The SEC's definition of an "offer" is surely broad enough to capture such

recommendations, which would put analysts and their employers at risk of violating § 5.

To avoid that conclusion, the SEC provides safe harbors for the publication or distribution of "research reports" under Rules 137, 138, and 139. Research reports are defined as a written communication that "includes information, opinions, or recommendations with respect to securities of an issuer or an analysis of a security of an issuer." Rules 137(e), 138(d), 139(d). Rule 405 defines written communication to include broadcast and graphic communications (including e-mails and websites, among other forms of communication).

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



The availability of a § 4(a)(3) exemption from § 5 does not flow automatically from the application of Rule 137. Dealers can rely on § 4(a)(3) if two conditions apply: (a) the dealer is not an underwriter and (b) the publication or distribution of research does not take place during the prospectus delivery requirement period, which is defined in § 4(a)(3) in conjunction with Rule 174. Rule 137 only removes the dealer from the definition of an underwriter. Even with Rule 137, a non-participating broker-dealer must take care not to publish or distribute research that may condition the market during the prospectus delivery period. Fortunately, this is not a great constraint for non-participating broker-dealers providing research for Exchange Act reporting companies. Rule 174(b) reduces the prospectus delivery period for a company that is an Exchange Act reporting company immediately prior to the filing of the registration statement to zero days. The SEC apparently ignores non-participating broker-dealers publishing research on non-reporting companies during the prospectus delivery period.

How does a non-participating broker-dealer qualify for the protections of Rule 137? Rule 137 applies only to research reports that a

broker-dealer publishes or distributes "in the regular course of its business." Rule 137 explicitly excludes from its coverage all broker-dealers who receive compensation from the issuer, selling security holder, or other participants in the offering. (Regular subscription fees for research are allowed under Rule 137.) Rule 137 also does not apply for securities of issuers who were a blank check company, shell company, or issuer in a penny stock offering during the past three years.

For broker-dealers participating in the distribution, the SEC provides safe harbors in Rules 138 and 139 to exempt opinions on companies in registration. (As with Rule 137, some companies are excluded: blank checks, shells, and penny stock issuers.) First, Rule 138 provides a limited safe harbor, exempting research reports of participating broker-dealers from the definition of an "offer" for purposes of § 2(a)(10) (definition of prospectus) and § 5(c) (prohibition on offers in the Pre-Filing Period). Unlike Rule 137, which is available for all issuers, Rule 138 is limited to Exchange Act reporting issuers. Rule 138 divides securities into two groups: (a) common stock and debt and preferred securities convertible into common stock; and (b) debt and preferred securities not convertible into common stock. Rule 138 gives broker-dealers a safe harbor to provide opinions on one group of securities even though the issuer is offering securities belonging to the *other* group. In order to police attempted circumventions of § 5, any broker or dealer using Rule 138 to publish research reports on a specific type of securities must have previously published or distributed research on the same types of securities in the "regular course of business." Rule 138(a)(3).

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

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

For "industry reports," the SEC allows a broker-dealer to publish or disseminate research on a broader range of issuers. Eligible issuers include all reporting issuers. Rule 139(a)(2)(i). However, greater limits

are placed on the research itself. An industry report must include "similar information with respect to a substantial number of issuers in the issuer's industry or sub-industry, or . . . a comprehensive list of securities currently recommended by the broker or dealer." Rule 139(a)(2)(iii). The broker-dealer may not devote any "materially greater space or prominence" to the issuer compared with any other securities or companies. Rule 139(a)(2)(iv). Finally, the broker or dealer must publish or distribute research reports in "the regular course of its business" and "at the time of the publication or distribution of the research report, . . . include[e] similar information about the issuer or its securities in similar reports." Rule 139(a)(2)(v).

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

Another limitation on analysts' report is the "quiet period" imposed by FINRA. FINRA Rule 2241 prohibits underwriters and participating dealers from issuing research reports until 10 days after an initial public offering. For secondary offerings, the period is reduced to three days after the completion of the offering, and only applies to the managing underwriter. This secondary offering provision has an exception for research reports complying with Rule 139 on securities that are "actively traded" as defined by Regulation M (discussed below).

The JOBS Act of 2012 expanded protections for analyst research reports. The JOBS Act of 2012 excludes analyst research reports by a broker or dealer about an emerging growth company from the definition of an offer under § 5(c) and a prospectus under § 2(a)(10) during a public offering. The exclusion covers reports even by broker-dealers participating in a public offering. Securities Act § 2(a)(3).

HYPOTHETICAL SEVEN

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

1. *Scenario One:* Donna is a reporter for the *Dallas Morning News*. She heard of Ewing Oil's public offering from a friend who saw Ewing Oil's Rule 135 notice. After researching Ewing Oil's business, Donna writes a story on the offering as part of a general report on the high-flying IPO market. The

story is published on page C1 of the *Morning News* (the market page) and includes projections on Ewing Oil's future profitability.

2. *Scenario Two:* Marilee is an analyst at Stonehurst Securities. Stonehurst regularly publishes analyst opinions on companies in various sectors. Stonehurst is not participating in the offering. Nonetheless, Marilee writes an analyst report on Ewing Oil, giving the company a "neutral" recommendation for the IPO. Stonehurst publishes the analyst report, distributing it to brokers within the company as well as to its many retail and institutional investor clients. This is, however, Stonehurst's first analyst report on Ewing Oil.

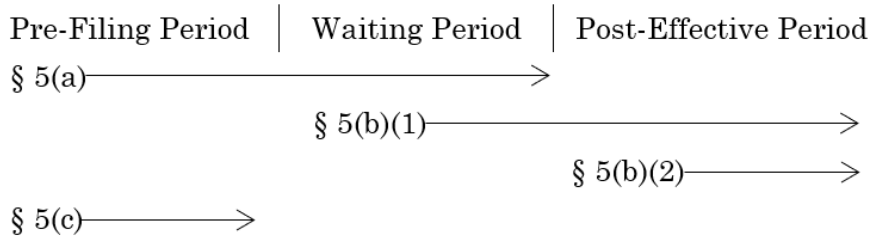
3. *Scenario Three:* Lucy is an analyst at Barnes-Wentworth Investments, the managing underwriter for Ewing Oil's offering. In preparation for the IPO, Lucy writes a research report for Ewing Oil, giving the company a "buy" recommendation for the IPO. Barnes-Wentworth publishes a summary of the report (with the buy recommendation) in its monthly newsletter sent out prior to the effective date of the offering. Ewing Oil has previously not been covered in the regular newsletter.

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

C. POST-EFFECTIVE PERIOD

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

Despite the freedom to make sales in the Post-Effective Period, the issuer and others continue to face restrictions, most critically under §§ 5(b)(1) and (2).



In this section we discuss: (1) forms of the statutory prospectus, (2) traditional free writing under § 2(a)(10)(a) and its relationship to § 5(b)(1), (3) the prospectus delivery requirement pursuant to §§ 5(b)(1) and (2), and (4) the updating of information contained in the statutory prospectus and registration statement.

1. FORMS OF THE FINAL PROSPECTUS

In the Post-Effective Period, issuers can no longer use Rule 430 preliminary prospectuses. Instead, the § 10(a) final prospectus is the primary focus in the Post-Effective Period. The final statutory prospectus adds price-related information (e.g., the offering price, the underwriters' discount, etc.) to the information contained in the preliminary prospectus. Part I of the relevant registration statement form (e.g., Form S-1 or S-3 for most domestic issuers) details the required information for the final prospectus, including information on the business, properties, management, capital stock, and audited financial statements. The final prospectus may also reflect changes in the offering or revisions based on the SEC's comments on the preliminary prospectus.

Despite the focus on the § 10(a) final prospectus, there are other variants available in the Post-Effective Period. Rule 430A allows issuers to go effective with a registration statement that contains a form of the statutory prospectus that omits certain information. The 430A prospectus addresses a timing concern. As originally conceived, the final prospectus contained all the required information in one physical document. Investors would receive the entire document through the mail or directly from their broker or a dealer. Over time, the definition of a final prospectus was relaxed. Printing a physical document takes time, but issuers and underwriters typically want to set the price immediately before selling securities to the public. If the issuers and underwriters set the offering price too high, few investors will buy. If the offering price is set too low, the issuer (and to a lesser extent the underwriters) leave money on the table, foregoing possibly higher proceeds.

Rule 430A of the Securities Act alleviates these timing concerns. Under Rule 430A, the final prospectus filed as part of the registration statement may omit price-related information. Rule 430A is available only for all-cash offerings, so offerings for non-cash consideration (e.g., an exchange offer for stock) cannot use Rule 430A. Rule 430A also applies to registration statements that are immediately effective upon filing with the SEC pursuant to Rule 462(e) and (f). Rule 462(e) deals with automatic shelf registration statements filed by a well-known seasoned issuer (we cover shelf registration below).

Issuers using Rule 430A must eventually file price-related information with the SEC. If the filing occurs within fifteen business days after the effective date of the registration statement, then no post-effective amendment is necessary. Instead, issuers must file a prospectus containing the pricing information under Rule 424(b)(1). After fifteen business days, if the required price-related information is not provided pursuant to Rule 424(b)(1), the information must be filed as a post-effective amendment to the registration statement.

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

Although the 430A prospectus allows the issuer to go effective and itself meets the requirements of § 10 for purposes of § 5(b)(1), the issuer (and others) may not use the 430A prospectus as a § 10(a) final prospectus for other purposes. For example, in the Post-Effective Period, the free writing prospectus provision under Rule 433 requires the delivery of a § 10(a) prospectus either with or preceding the free writing prospectus for non-reporting and unseasoned issuers. Rule 433(b)(2). A 430A prospectus does not qualify for this prospectus delivery provision. As we will see below, the access-equals-delivery prospectus delivery provision under Rule 172 requires (for non-dealers) that the issuer makes a good faith and reasonable effort to file a complete § 10(a) prospectus (and not merely a 430A prospectus) with the SEC in the time specified under Rule 424. Rule 172(c)(3). Rule 424(b)(1), in turn, gives the issuer two business days after "the earlier of the date of determination of the offering price or the date it is first used after effectiveness in connection with a public offering or sales" to file the § 10(a) containing the information previously omitted pursuant to Rule 430A. As we will also discuss below, traditional free writing under § 2(a)(10)(a) requires the

transmission of a § 10(a) final prospectus. Section 5(b)(2)'s provision for the delivery of securities for sale also requires a final prospectus.

There are other § 10 statutory prospectuses in the Post-Effective Period. Although § 10(b) preliminary prospectuses are not valid in the Post-Effective Period, free writing prospectuses that comply with Rule 433 continue as valid § 10(b) prospectuses in the Post-Effective Period. Summary prospectuses (although little used) are also valid under Rule 431. Consequently, issuers and offering participants may freely disseminate free writing and summary prospectuses in the Post-Effective Period without violating § 5(b)(1). As with Rule 430A, a § 10(b) free writing or summary prospectus may not be used to satisfy provisions in the Post-Effective Period that require the use of a § 10(a) prospectus (including traditional free writing under § 2(a)(10)(a) and access-equals-delivery under Rule 172). The following table details the various forms of the prospectus in non-shelf offerings and their applicability to various Securities Act Post-Effective Period prospectus requirements:

Statutory Prospectus Requirement	**Forms of the Prospectus (Non-Shelf)**
§ 5(b)(1)	Rule 430A Prospectus Rule 431 Summary Prospectus Rule 433 Free Writing Prospectus § 10(a) Final Prospectus
§ 5(b)(2) Prospectus Delivery	§ 10(a) Final Prospectus
§ 2(a)(10)(a) Traditional Free Writing	§ 10(a) Final Prospectus
Rule 433(b)(2) Prospectus Delivery	§ 10(a) Final Prospectus
Rule 172 Access-Equals-Delivery	§ 10(a) Final Prospectus

2. TRADITIONAL FREE WRITING

In the Post-Effective Period, § 5(b)(1) prohibits written materials and broadcasts offering a security for sale—that is, a prospectus under § 2(a)(10)—unless such materials qualify as a § 10 prospectus. Both §§ 10(a) and 10(b) statutory prospectuses meet the requirements of § 5(b)(1). Section 5(b)(1) therefore allows the transmission of not only § 10(a) final statutory prospectuses but also Rule 430A prospectuses, Rule 431 summary prospectuses, and Rule 433 free writing prospectuses.

But what about other written or broadcast offers? The definition of a prospectus under § 2(a)(10) incorporates the broad notion of offer under § 2(a)(3). Suppose an issuer or underwriter mails out materials touting the issuer's prospects as part of selling efforts after the start of the

offering. Section 5(b)(1) appears to block the mailing of such materials in the Post-Effective Period, just as it did in the Waiting Period.

Issuers and offering participants may attempt to fit their written and broadcast offers as free writing prospectuses under Rule 433. Section 2(a)(10)(a) provides another exemption from the application of § 5(b)(1) to allow "traditional free writing." (Free writing under § 2(a)(10)(a) pre-dates and is distinct from the exemption for "free writing prospectuses" under Rules 164 and 433; we use the term "traditional free writing" to distinguish this exemption from free writing prospectuses). Section 2(a)(10)(a) removes traditional free writing from the definition of a prospectus in the Post-Effective Period if the traditional free writing is preceded or accompanied by a § 10(a) final statutory prospectus.

Traditional free writing potentially includes all written or broadcast offering materials which would otherwise be a prospectus not complying with § 10(a). Issuers and broker-dealers can therefore send selling documents to potential investors after the effective date as long as they also include the final statutory prospectus. Post-effective communications that fit under the traditional free writing exception contained in § 2(a)(10)(a) are not treated as free writing prospectuses. Unlike free writing prospectuses, there are no legend, filing, or record retention requirements for traditional free writing. (Recall that seasoned issuers and WKSIs do not have a prospectus delivery requirement for free writing prospectuses. Rule 433(b)(1).)

3. PROSPECTUS DELIVERY REQUIREMENT

One of the primary goals of the public offering process is the creation of the mandatory disclosure documents: the registration statement and the statutory prospectus. Creation of these documents, however, can only mitigate issuers' underlying informational advantage over investors if investors receive—directly or indirectly—the information in the document. To whom, and more critically, for how long after the offering begins, must the statutory prospectus be sent?

a. The Traditional Delivery Requirement

Section 5(b) provides the cornerstone of the prospectus delivery requirement. Section 5(b)(2) requires that a § 10(a) final prospectus precede or accompany the transmission of securities for sale through an instrumentality of interstate commerce. Note that a § 10(b) statutory prospectus (such as a preliminary prospectus under Rule 430) will not meet the requirements of § 5(b)(2). Despite the straightforward prospectus delivery requirement in § 5(b)(2), the provision is of little consequence because most investors do not take physical possession of the actual security certificates (particularly for equity securities). Instead, investors often allow their brokerage firm to hold the securities in "street name" and receive only a written confirmation of sales when purchasing securities. (Written confirmations are required by Rule 10b–

10 of the Exchange Act.) Purchasing securities in street name allows investors to resell the securities quickly, with the transaction being effected by a notation in their broker's records.

The more important prospectus delivery requirement for sales of securities in public offerings is provided indirectly in the Securities Act. How? Consider the following. Section 2(a)(10) defines a written confirmation of sales as a prospectus. Because the confirmation is not itself a §§ 10(a) or (b) prospectus, the transmission of the confirmation using an instrumentality of interstate commerce would violate § 5(b)(1). The prospectus delivery requirement flows from the issuer's efforts to avoid this violation of § 5(b)(1). Issuers and offering participants can avoid § 5(b)(1) by using the traditional free writing exemption from prospectus status under § 2(a)(10)(a). To satisfy the traditional free writing exemption, issuers and offering participants must precede or accompany the written confirmation of sales with a § 10(a) final statutory prospectus—resulting in prospectus delivery.

The prospectus delivery requirement under § 5(b)(1), step-by-step:

(1) Written confirmation of sales are, without more, prospectuses under § 2(a)(10) (and must be sent under Exchange Act Rule 10b–10).

(2) Section 5(b)(1) prohibits the transmission of the written confirmation of sales since the confirmation itself is not a § 10 prospectus.

(3) Section 2(a)(10)(a) removes written confirmation of sales (and indeed other written or broadcast offers) from the definition of a prospectus if accompanied or preceded by a § 10(a) final statutory prospectus.

(4) Once § 2(a)(10)(a) removes the written confirmation of sales from the definition of a prospectus, the transmission of the confirmation no longer violates § 5(b)(1).

It is somewhat odd that investors receive the prospectus only when they receive the written confirmation of sale. Wouldn't you want to receive the prospectus *prior* to making your purchase decision? Perhaps realizing that the final prospectus does little good to an investor with the confirmation of sale, for non-reporting companies, Rule 15c2–8(b) requires that participating brokers send a copy of the preliminary prospectus at least 48 hours prior to the sending of the confirmation. Participating brokers comply with Rule 15c2–8(b) by sending the preliminary prospectus to all purchasers allotted shares in the public offering.

b. *Prospectus Delivery Period*

How long does the prospectus delivery requirement last? Section 5(b) provides no limit. Consider the cost an indefinite delivery requirement would place on secondary market transactions. Because § 5 applies to

"any person," even individual investors selling securities in the secondary market (and their brokers) would have an obligation to send a statutory prospectus to purchasing investors. How would an individual investor obtain the statutory prospectus to send with the confirmation? What if the sale takes place many years after the original public offering?

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

Note that § 4(a)(1) does not exempt transactions for securities dealers; they have to find their own exemption. Section 5(b) applies broadly to all persons, so even securities dealers who did not participate in the public offering must deliver a statutory prospectus with the confirmation during the prospectus delivery period. Section 4(a)(3) provides an exemption specifically for dealers, but its availability is limited. Dealers still acting as underwriters for the offered security are not allowed to use the § 4(a)(3) exemption, so they must comply with § 5(b)'s prospectus delivery requirements. Dealers who are not underwriters but are participants in the distribution still selling an allotment from the offering may not rely on § 4(a)(3) for securities that are part of the unsold allotment. For other dealers, § 4(a)(3)—in conjunction with Rule 174—establishes time periods when § 4(a)(3) is not available. The time periods are as follows:

- 0 days—Issuer that is an Exchange Act reporting issuer immediately prior to the filing of the registration statement (i.e., an issuer subject to the reporting requirements of § 13 or § 15(d) of the Exchange Act)
- 25 days—Issuer whose securities will be listed on a national securities exchange as of the offering date
- 40 days—Issuer that does not fit any of the above categories *not* doing an initial public offering
- 90 days—Issuer that does not fit any of the above categories doing an initial public offering

Beyond these time periods, § 4(a)(3) exempts dealers (as long as they are not acting as underwriters selling out of an unsold allotment from the public offering) from the application of § 5(b)(1). Without § 5(b)(1) there is no longer a prospectus delivery requirement. Conversely, within the time periods when § 4(a)(3) does not apply, all dealers—whether or not participating in the offering—face a prospectus delivery requirement.

c. *Access Equals Delivery*

When the Securities Act was enacted in 1933, paper documents were the primary means of communication. Although the telegraph and telephone were common by then, neither instrument provided a convenient medium to transmit a large amount of information. Investors interested in learning the details about a particular public offering had to read the paper version of the statutory prospectus.

Even in the 1930s, however, the benefit to the investors from the prospectus delivery requirement was less than clear. The SEC can mandate that the prospectus be delivered to the door of individual investors, but it cannot make them read it. (And nobody recycled in the 1930s.) Why would an investor ignore the prospectus? For individual investors making only a small investment, the cost of reading and deciphering the prospectus—shrouded in legalese and dense with accounting figures—outweighs the potential benefit of doing so.

Even if retail investors don't read the statutory prospectus, mandatory disclosure nonetheless may protect them in one of three ways. First, the mere drafting of a disclosure document that the SEC may review encourages issuers to be truthful in their disclosures. That incentive is bolstered by the possibility of an antifraud suit under the investor-friendly standards of §§ 11 and 12(a)(2).

Second, retail investors may obtain information indirectly. Retail investors may not read the prospectus, but they may read analyst reports on the company and/or obtain advice from their brokers before investing. Both of these sources may be enlightened by the disclosures in the prospectus.

Finally, even if retail investors make no effort to digest the information, disclosure may influence the market for the offering. Most public offerings are purchased primarily by institutional investors. If institutions are not willing to purchase the securities (at least at the price range initially contemplated), the issuer and underwriters may need to reduce the price to sell out the entire offering.

How to best distribute the mandatory disclosure? Rule 172, one of the 2005 Offering Reforms, streamlines the prospectus delivery requirement through "access equals delivery" for most issuers and transactions. Rule 172(c) imposes several conditions to qualify for an exemption. Most importantly, the issuer must file a final § 10(a) statutory prospectus with the SEC (with the possible omission of certain information as provided by Rule 430A) or "make a good faith and reasonable effort to file such prospectus within the time required under Rule 424 and in the event that the issuer fails to file timely such a prospectus, the issuer files the prospectus as soon as practicable thereafter." Rule 172(c)(3). (Even if this filing condition is not satisfied, dealers can nonetheless take advantage of Rule 172. Rule 172(c)(4).)

If Rule 172(c) is satisfied, Rule 172(a) exempts written confirmations of sales from the reach of § 5(b)(1), obviating the need for broker-dealers to mail out a final prospectus with the confirmation of sales. Similarly, Rule 172(b) deems the requirement that a prospectus precede or accompany a security transmitted for sale as met for purposes of § 5(b)(2). General free writing other than the written confirmation of sales is not covered under Rule 172 and therefore falls under the traditional prospectus delivery requirement discussed above. A seasoned issuer or WKSI may avoid prospectus delivery if they instead comply with the free writing prospectus requirements under Rule 164 and 433, but the free writing prospectus is still subject to § 12(a)(2) liability.

Underwriters, brokers and dealers must send some minimal additional information along with the sales confirmation. Rule 173 requires that for transactions in which the final prospectus delivery requirement applies under Rule 174 and § 4(a)(3), participating underwriters, brokers, and dealers (or issuer if sold directly by the issuer) must either notify purchasing investors that the sale took place under an effective registration statement or provide a final prospectus. This notice informs the purchaser that they may have rights under §§ 11 and 12(a)(2). The notice must be provided not later than two business days following the completion of the sale. After the effective date of the registration statement, notices mailed under Rule 173 are exempt from § 5(b)(1) (and thus avoid the prospectus delivery requirement). Importantly, Rule 173's obligation does not flow from § 5; non-compliance with Rule 173 may lead to possible SEC enforcement, but it does not violate § 5. In addition, compliance with Rule 173's notice requirement is not a prerequisite for Rule 172's access-equals-delivery. Rule 173(c).

HYPOTHETICAL EIGHT

Suppose Ewing Oil and Barnes-Wentworth Investments commence sales of the initial public offering on June 1st. Among the underwriters in the offering is Southfork Securities, a large investment bank based in Dallas. Southfork was allocated 400,000 Ewing Oil shares for sale. Assume that by June 3rd, Southfork has sold 300,000 shares from its allotment leaving 100,000 more shares to sell. Do any of the following run afoul of § 5?

1. *Scenario One:* Southfork summarizes the information in the Ewing Oil prospectus in a short memo with bullet points for its brokers to use in discussing the offering with their clients. Jock, one of those brokers, passes the memo along to one of his clients, Christopher.

2. *Scenario Two:* Southfork sells shares out of its remaining allotment to Christopher, an investor based in New York City. Together with the confirmation of sales, Southfork mails out a copy of the final prospectus.

3. *Scenario Three:* Simultaneously with the commencement of the offering, Ewing Oil's shares are listed on Nasdaq. Secondary market trading quickly follows. Westar Securities, a securities dealer not participating in Ewing Oil's offering, decides to sell some of its Ewing Oil common stock inventory

into the market one week after the start of Ewing Oil's IPO. Westar Securities mails the stock certificates for the shares it sells to purchasing investors but does not send a statutory prospectus.

4. *Scenario Four:* Westar Securities pitches Ewing Oil common stock through cold calls to retail investors who then purchase the shares. Westar Securities acts as their broker in placing the investors' orders with a market maker in Ewing Oil stock. Westar Securities sends each purchasing investor a written confirmation, but not the statutory prospectus.

5. *Scenario Five:* Southfork issues an analyst report on Ewing Oil on June 12. At that time, Southfork still holds 50,000 shares from its allotment. The report covers a number of high-growth companies, including Ewing Oil. The report recommends Ewing Oil as a "buy" and talks glowingly about Ewing Oil's future growth prospects. The analyst report is sent to all of Southfork's customers.

6. *Scenario Six:* Suppose that Jason decides to purchase some Ewing Oil stock on the secondary market. He contacts his broker, Jock, at Southfork and instructs him to purchase 1,000 shares at the prevailing market price. Jock executes the order for Jason on June 10, sending him a written confirmation two days later, but does not include the statutory prospectus.

4. UPDATING THE PROSPECTUS AND REGISTRATION STATEMENT

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

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

The concept of materiality helps answer this question. Recall from Chapter 2 that materiality is defined by reference to the "total mix of information." Information that in isolation may seem important to reasonable investors loses its materiality if the market already has the information. For companies whose securities trade in an informationally efficient capital market, "new" information on the company may already be incorporated in the stock market price, making it unnecessary to update the prospectus and registration statement. Indeed, most

investors would never read an updated prospectus. As a practical matter, the market price is the *only* way such new information will (indirectly) reach the investors. Consider the extent to which the efficient capital market hypothesis informs the requirements for updating the prospectus and registration statement.

a. Updating the Prospectus

Depending on the type of issuer, the prospectus delivery requirement may extend up to 90 days after the start of the public offering for securities dealers who are not part of the underwriting syndicate. Regardless of the prospectus delivery time period, underwriters selling their allotment are required to deliver a final prospectus until their allotment is entirely sold.

Although underwriters and dealers must deliver the final prospectus, three basic duties require updating of the prospectus:

> *Section 10(a)(3) of the Securities Act.* Under § 10(a)(3), if a prospectus is used more than nine months after the effective date, the information used in the prospectus may not be more than sixteen months old to the extent that the information is known or can be provided without unreasonable effort or expense.
>
> *Antifraud Liability.* No explicit updating duty is specified in § 12(a)(2) or Rule 10b–5. Instead, the prospect of antifraud liability indirectly imposes an incentive for issuers to update the prospectus. If the information in a prospectus is no longer accurate, the issuer and others involved with the prospectus are potentially liable for both § 12(a)(2) and Rule 10b–5 liability.
>
> *Shelf Registration.* Issuers doing a Rule 415 shelf registration must update the prospectus to reflect any "fundamental" change to the information set forth in the registration statement. Item 512(a) of Regulation S-K. As we discuss below, Item 512(a) also requires the filing of a post-effective amendment to the registration statement.

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

Instead, antifraud liability provides the major incentive for updating the prospectus, principally § 12(a)(2). Section 12(a)(2) has no scienter

requirement, but defendants can avoid antifraud liability if they can show that they did not know (nor could have known with "reasonable care") about the materially misleading misstatement or omission.

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

The Second Circuit's opinion in *Manor Nursing* has been criticized. The Fifth Circuit in *SEC v. Southwest Coal & Energy Co.*, 624 F.2d 1312, 1318–19 (1980), wrote:

> The *Manor Nursing* thesis of fraud as a basis for § 5 violations has been roundly criticized . . . § 12[a](1) provides strict liability for one who offers or sells a security in violation of § 5. Sections 11 and 12[a](2) similarly provide liability for offers or sales of securities upon misrepresentation or misleading nondisclosure of material facts, but only if the offeror cannot demonstrate that he did not know, and could not reasonably have been expected to know, of the untruth or omission. Under the *Manor Nursing* construct, however, one who proves a misrepresentation actionable under § 11 or § 12[a](2) has also proved a violation of § 5, thus automatically establishing liability per se under § 12[a](1). Not only does this interpretation render § 11 and 12[a](2) essentially superfluous as remedial mechanisms, but it also obliterates the due diligence defense contained in these sections, plainly intended to be available to defendants in actions under the 1933 Act based on such misrepresentations or nondisclosures. Such a result could not possibly have been intended by the drafters of these provisions.

When required to update the prospectus, issuers generally prefer (if possible) to employ a process known as "stickering" under which new information is directly added (or substituted) onto the relevant page of the prospectus. Stickering has the advantage of updating only the prospectus and not the registration statement, thereby exposing the issuer only to the possibility of § 12(a)(2) and not § 11 liability for material misstatements (or omissions where there is a duty to disclose) in the updated information.

b. Updating the Registration Statement

The registration statement must be accurate as of its effective date because antifraud liability under § 11 and Rule 10b–5 is measured as of that time. In addition, the SEC may issue a stop order pursuant to § 8(d), as discussed above, if the registration statement contains misrepresentations. The SEC's authority under § 8(d), however, only reaches registration statements that contain a material misstatement at the time of the effective date. *See Charles A. Howard*, 1 S.E.C. 6 (1933).

Although issuers (and other associated parties) may have a duty to correct materially false or misleading information in the registration statement at the time of the effective date, no duty exists to update previously accurate information. That is, there is no general duty to update the registration statement.

There are two major exceptions to that general rule. First, issuers using a Rule 415 shelf registration, as we will see below, must include an Item 512(a) undertaking pursuant to Regulation S-K. The Item 512(a) undertaking requires the issuer to make a post-effective amendment to the registration statement for certain events, including any § 10(a)(3) change to the prospectus, any "fundamental" change to the information set forth in the registration statement, or any material change to the plan of distribution. Rule 412 allows issuers to incorporate Exchange Act filings by reference instead of making a post-effective amendment to meet the updating requirement of Item 512(a).

Second, in certain circumstances, if the issuer updates the prospectus, the issuer also must file that updated prospectus with the SEC. Rule 424(b)(3) requires that issuers must file an updated prospectus that represents a "substantive change from or addition to" a previously filed prospectus. Once filed, the SEC will deem the prospectus to be part of the registration statement. In contrast, issuers may make non-substantive changes or additions to the prospectus through "stickering" without a new filing with the SEC.

Updating the registration statement is far more significant than stickering the prospectus. Information contained in a sticker is not considered part of the registration statement. In contrast, information filed with the SEC pursuant to Rule 424(b) is deemed part of the registration statement for purposes of § 11 antifraud liability (discussed in Chapter 8). Issuers that make a substantive change or addition to the prospectus therefore open themselves up to additional antifraud liability.

HYPOTHETICAL NINE

Ewing Oil's IPO registration statement has been declared effective by the SEC. In the registration statement and final prospectus, Ewing Oil disclosed that it is in the midst of negotiating a contract with a government in Asia to use Ewing Oil's turbo-fracking technology to exploit potential gas reserves. The registration statement did not include a risk factor mentioning that the government of the Asian country was unstable. Two weeks after the effective date of the registration statement, the Asian government is overthrown in a coup and, consequently, all of the contract talks have fallen through. The new regime is now in negotiations with one of Ewing Oil's major competitors. Is there any duty to update either the final prospectus or the registration statement and why?

III. PUBLIC OFFERING TRADING PRACTICES

During and immediately after a public offering, underwriters have a lot at stake in maintaining the market price of the offered securities. If the securities price drops precipitously during an offering, the underwriter may have trouble selling an unsold allotment. In a firm commitment offering, the underwriter bears the risk of selling the securities and thus is stuck with any unsold allotment. Downward pressure on the secondary market price can result from "flippers"—investors who purchased in the offering (at a price lower than the current secondary market price) who are looking to make a quick profit through resales—and short sellers, who are betting on a stock price decline.

Another motivation for maintaining the secondary market price is that most public offerings include an overallotment option for underwriters to expand the size of the offering. This "Green Shoe" option allows the underwriters to purchase up to an additional 15% of the offered securities at the discounted price for resale to investors at the offering price. If the price holds up, the overallotment option can mean additional profits for the underwriters. (FINRA rules prohibit the underwriter from siphoning off any of the shares from the offering for itself for subsequent resale at a higher price in the secondary market; all the offered shares must be sold at the offering price.)

A price drop after an offering commences may harm underwriters indirectly as well. Among the services underwriters provide to issuers is access to investors willing to buy the IPO stock. Large institutional investors depend on the underwriters to bring them fairly priced—or better still, underpriced—securities. If the price drops, the institutional investors that purchased in the offering will lose money and the underwriters will lose face (and, potentially, customers for future offerings). Conversely, a price rise in the aftermarket allows the underwriters' customers—the institutional IPO investors—to sell their stock to retail investors at a profit. Thus, underwriters are happy to see the secondary market price rise after an offering because it enhances their reputation with institutional investors.

These incentives give underwriters an interest in inflating the secondary market price by purchasing shares. How do purchases influence the market price? First, increased demand could exhaust the supply of securities that investors are willing to sell at a particular price. Different investors may have disparate beliefs about the value of the security or, alternatively, face different tax consequences from selling the securities. To induce more investors to sell, the market price must increase. Second, the presence of a large volume of purchase orders may signal to the market that informed investors have non-public information that the company is undervalued and are acting on this information by purchasing securities. This signal will also cause the market price to rise.

Regulation M limits the ability of underwriters and issuers to influence the secondary market price of a security during an offering. The SEC explains that Regulation M "prohibit[s] activities that could artificially influence the market for the offered security, including, for example, supporting the offering price by creating the exaggerated perception of scarcity of the offered security or creating the misleading appearance of active trading in the market for the security." Securities Act Release No. 8511 (Dec. 9, 2004). Regulation M does not afford a private right of action; only the SEC can enforce it. (Section 9(e) of the Exchange Act provides a private cause of action for manipulation, but it is little used.)

A. IPO ALLOCATIONS

On December 6, 2000 the *Wall Street Journal* ran a front-page story exposing abuses in the market for initial public offerings. *See* Susan Pulliam & Randall Smith, *Seeking IPO Shares, Investors Offer to Buy More in After-Market*, Wall St. J. A1 (Dec. 6, 2000). The story revealed "tie-in" agreements between investment banks and initial investors seeking to participate in "hot" offerings. Under those agreements, initial investors would commit to buy additional shares of the offering company's stock in secondary market trading in return for allocations of shares in the IPO. As the *Wall Street Journal* related, those "[c]ommitments to buy in the after-market lock in demand for additional stock at levels above the IPO price. As such, they provide the rocket fuel that sometimes boosts IPO prices into orbit on the first trading day." This process of encouraging purchases in the aftermarket at ever-higher prices is called "laddering." The *Journal's* account of the practice essentially lays out a conspiracy between underwriters and their favored investor-customers to engage in a scheme of market manipulation. Retail investors—who end up purchasing the stock after the IPO at inflated prices—systematically lose from the manipulation.

Why would underwriters want to boost the aftermarket price? At first glance, the clear winners from a hot IPO are those initial investors who purchase at the IPO offering price, typically large institutional investors. As noted above, however, underwriters may benefit indirectly, by reducing their risk in a firm commitment offering and by enhancing their reputation among institutional investors. An alternative—and less benign from the issuer's perspective—explanation emerged from the laddering scandal. In a follow-up story on the laddering scheme, the *Journal* reported that underwriters were demanding commissions from investors favored with hot IPO allocations: "Wall Street dealers may have sought and obtained larger-than-typical trading commissions in return for giving coveted allocations of IPOs to certain investors." *See* Randall Smith & Susan Pulliam, *U.S. Probes Inflated Commissions for Hot IPO*s, Wall St. J. C1 (Dec. 7, 2000). Not surprisingly, the fallout from these revelations was severe for the investment banking industry. The SEC's

investigation into the practice led to substantial settlements with many of the best-known investment banks.

If market purchases on behalf of underwriters artificially raise the price of securities, these purchases distort the true value of the securities, causing investors to pay too much. One possible regulatory response to the problem of underwriter trading practices designed to maintain or increase the secondary market price of an offered security would be a flat ban. The SEC, however, instead, adopted a more nuanced approach in Regulation M under the Exchange Act to regulate trading practices surrounding a distribution of securities.

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

Second, attempts to artificially influence the market price through purchases are much less likely to work for companies with a "deep" secondary market with large volumes of unrelated, independent trades. An underwriter purchasing 100,000 shares is much more likely to affect the market price for a company with an average daily trading volume of 200,000 shares than a company that trades 10 million shares daily.

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

B. MARKET MANIPULATION

Regulation M regulates efforts to manipulate the market price of "covered" securities. Covered securities include "any security that is the subject of a distribution, or any reference security." Regulation M defines a reference security as "a security into which a security that is the subject of a distribution . . . may be converted, exchanged, or exercised or which, under the terms of the subject security, may in whole or in significant

part determine the value of the subject security." Rule 100. Thus, if a company is issuing convertible bonds then the reference security is the class of common shares into which the bonds could be converted. The common shares, as reference securities, would also come under the restrictions of Regulation M as covered securities.

In order to curb market manipulation, Rules 101, 102, and 105 limit certain types of trading during the "restricted period." The restricted period is defined under Rule 100 and depends in part on the worldwide average daily trading volume (the "ADTV") for the two months, among other possible time periods, preceding the filing of the registration statement. The different possible restricted periods are as follows:

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

"Distribution participant" is defined to include an "underwriter, prospective underwriter, broker, dealer, or other person who has agreed to participate or is participating in a distribution." Rule 100.

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

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

- Bids and purchases relating to transactions in connection with the distribution (i.e., when the underwriters purchase directly from the issuer in a firm commitment offering). Rule 101(b)(8).
- De minimis transactions, defined as purchases "during the restricted period, other than by a passive market maker, that total less than 2% of the ADTV of the security being purchased." Rule 101(b)(7).

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

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

Finally, Rule 105 prohibits, with certain exceptions, short selling during equity offerings by persons purchasing in the offering. The prohibition is intended to discourage purchasers in the offering from manipulating the offering price down by selling the securities short prior to the pricing of the offering.

HYPOTHETICAL TEN

Ewing Oil and its managing underwriter Barnes-Wentworth Investments have commenced the initial public offering of 10 million shares at $20 per share. The IPO is a firm commitment underwriting with Barnes-Wentworth Investments and the other underwriters purchasing the securities from Ewing Oil at a 7% underwriters' discount. In addition, the underwriters enjoy an overallotment option of 1 million shares. The underwriters agree to purchase the firm commitment shares from Ewing Oil on the day the registration statement becomes effective. The price of the offering initially jumps up to $30 per share but then starts falling down to $25 per share on the first day of trading. Consider whether the following market activities run afoul of Regulation M.

1. *Scenario One:* During the course of the public offering, Barnes-Wentworth Investments initiates market research for Ewing Oil, issuing a "buy" recommendation for Ewing Oil securities.

2. *Scenario Two:* Suppose that Barnes-Wentworth Investments promises to allocate 100,000 additional shares of Ewing Oil's IPO to the Southern Cross Hedge Fund. Southern Cross, in turn, promises to purchase 10,000 shares of Ewing Oil in the secondary market at prices above the offering price in the first day of trading.

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

C. STABILIZATION

Rule 104 of Regulation M regulates efforts on the part of any person (including underwriters and purchasers affiliated with the underwriters) to stabilize the market price. Stabilization includes bids and purchases made with the "purpose of pegging, fixing, or maintaining the price of a security" (Rule 100). Rule 104 stabilization is the principal exception to the prohibition of Rule 101.

What types of stabilization in connection with a public offering of a security are permitted under Rule 104? First, stabilization is only permitted to prevent or retard a drop in the secondary market price of a security. Purchases intended to increase the market price are not permitted. Rule 104(b). Second, Rule 104 requires that stabilization bids must give way to "any independent bid" at the same price regardless of the size of the independent bid at the time it is entered. Rule 104(c). Third, Rule 104 requires prior notice to the market of stabilization and disclosure of the purpose of the bid to the person with whom the bid is entered. In addition, the prospectus must contain a statement notifying investors of the stabilization. To facilitate monitoring of stabilization, a group attempting stabilization may only have one stabilizing bid in a market at any one time. Rule 104(d). Finally, the stabilization price cannot be greater than the offering price. Rule 104(f). In addition, stabilization is not allowed for "at-the-market" offerings for which the price is not fixed.

Rule 104 then distinguishes between initiating and maintaining stabilization. Initiation of stabilization that occurs when the principal market for the securities is open must take place at a price no higher than the last independent transaction price if the security has traded in the principal market on that day. Similar formulations apply if the security has not traded on that day; the rule looks instead at the previous day's transaction price and the last current asking price for the stock. Persons seeking to continue with stabilization after initiation may maintain the initial stabilization price in the principal and other markets. Persons may also reduce the stabilizing price at any time.

Persons may increase the stabilization price—while staying below the offering price—no higher than the highest current independent bid for the security in the principal market (if the market is open).

HYPOTHETICAL ELEVEN

Barnes-Wentworth Investments, Ewing Oil's managing underwriter, decides that maintaining the market price for Ewing Oil's common stock at near the offering price ($20 per share) after the start of the public offering would assist the efforts of the underwriters to sell out the entire offering and provide an orderly secondary market for investors. Assume that Ewing Oil common stock is listed for trading on the Nasdaq after the offering (making Nasdaq the "principal" market for Ewing Oil shares). Are the following permitted under the federal securities laws?

1. *Scenario One:* After the Ewing Oil IPO commences, the market price sinks immediately to $15 per share (the last transaction price on Nasdaq). Barnes-Wentworth Investments commences stabilization, putting in a bid to purchase 1,000 shares of Ewing Oil at $20 per share, the IPO offering price.

2. *Scenario Two:* After the Ewing Oil IPO commences, the market price increases dramatically to $50 per share (the last transaction price on Nasdaq). Happy, but worried that this price will not last, Barnes-Wentworth Investments puts in a stabilization bid for 1,000 shares at $50 per share.

IV. SHELF REGISTRATION

The public offering process is expensive and time consuming. Issuers must not only draft the registration statement and wait for SEC review, but they also need to take care that their communications do not run afoul of restrictions imposed during the quiet period.

How can issuers reduce the cost of the registration process? Suppose Ewing Oil registers an enormous number of shares at the time of its IPO. Can Ewing Oil then draw from this reserve of registered shares indefinitely into the future to sell additional securities without a new registration? If the registration statement and prospectus are kept current, investors may already have adequate information to assess any newly-offered securities.

There are legal barriers, however, standing in the way of continuous registration for Ewing Oil. Section 6(a) of the Securities Act states that a "registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." The SEC in *Shawnee Chiles Syndicate*, 10 S.E.C. 109, 113 (1941), interpreted § 6(a) as prohibiting issuers from registering securities not intended to be offered immediately or in the near future. Although the precise time limit on sale is not clear, sales continuing for over a month after the effective date pose a problem.

For little-known issuers seeking to sell stock indefinitely into the future, the SEC's prohibition of indefinite registration of securities protects investors from unwise purchases of securities. Investors also

enjoy other legal protections. If an issuer sells securities using an out-of-date or otherwise misleading prospectus, the issuer and those soliciting purchases on its behalf potentially face § 12(a)(2) antifraud liability.

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

Situation 1

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

The offering of convertible bonds involves two securities: (1) the bond and (2) the security into which the bonds may be converted (common stock here). Section 2(a)(3) of the Securities Act states (emphasis supplied):

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

Ewing Oil's sale of convertible bonds implicates the offer and sale of the bonds as well as the common stock into which they can be converted. Because a holder of the convertible bonds controls the timing for when to convert the bonds into common stock, the issuer cannot be sure when a "sale" of the common stock will be deemed to occur under § 2(a)(3). A holder of the convertible bond could convert immediately, leading to the need for the issuer to register the "sale" of the common stock. But because the conversion is likely to occur on a delayed basis (if at all), the issuer must also be ready to register the "sale" of the common stock into the (possibly distant) future.

Situation 2

Consider seasoned and well-known seasoned issuers. For many Form S-3 issuers, large numbers of analysts and investors follow the

stock of the company. By definition, seasoned issuers and WKSIs also must comply with the Exchange Act reporting requirements (and remain current in their filings), assuring that investors and analysts receive a periodic flow of company-specific information. This means that the registration process is unlikely to provide much additional new information. Indeed, under the integrated disclosure system, much of the information contained in the registration statement will simply be incorporated by reference from the existing periodic disclosure filings (i.e., Forms 10-K, 10-Q and 8-K filings). Why force WKSI issuers to go through the entire public offering process if the market already has the WKSI's periodic disclosures?

To address these situations, among others, the SEC promulgated Rule 415 of the Securities Act to allow for shelf registration. Under shelf registration, issuers (and others) can sell registered securities for an extended period after the initial effective date without running afoul of § 6(a).Rule 415 provides that offerings meeting its requirements may be offered on a "continuous or delayed basis in the future." Rule 415 imposes five basic requirements. First, only certain types of offerings may qualify. These include:

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

Second, for non-S-3 issuers, Rule 415(a)(2) imposes a two-year time limit for shelf registration offerings falling under Rules 415(a)(1)(viii) (business combinations) and (ix) (continuous offerings to be commenced promptly). The rule leaves some wiggle room; securities for such offerings must be "reasonably expected to be offered and sold" within two years from the effective date of the registration statement. Securities sold by Form S-3 issuers under Rule 415(a)(1)(ix) or (x) are not subject to the two-year limitation. Also excluded are offerings on behalf of persons other than the registrant (e.g., a large pre-existing shareholder of the registrant) or issued upon conversion.

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

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

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

Can the issuer avoid additional § 11 liability from an amendment by opting instead for a prospectus supplement or incorporation-by-reference of the required Item 512(a) information? No—regardless of the method the issuer uses to satisfy the Item 512(a) updating requirements, the issuer will still face potential § 11 liability. "Information included in a base prospectus or in an Exchange Act periodic report incorporated into a prospectus is included in the registration statement." Securities Act Release No. 8591 (July 19, 2005). Item 512(a)(5) stipulates that the prospectus supplements authorized by Rule 430B and 430C (discussed below) are also deemed to be part of the registration statement and therefore subject to § 11 liability. Only the Rule 430B prospectus supplement (for shelf registration), however, resets the registration date for the entire registration statement, and even then, only for the issuer and underwriters (thus excluding the officers, directors and experts from new liability exposure). Rule 430B(f)(2).

Fourth, Rule 415(a)(4) provides that an "at the market" equity offering (an offering into an existing market at the prevailing market price) by or on behalf of the issuer may only use Rule 415(a)(1)(x) to qualify for a shelf registration.

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

In addition to the basic requirements for a Rule 415 shelf registration, the SEC provides special rules for: (a) automatic shelf registrations, and (b) the use of a minimal "base" prospectus.

A. AUTOMATIC SHELF REGISTRATION

The SEC eases the restrictions on shelf offerings for well-known seasoned issuers. Well-known seasoned issuers can file an automatic shelf registration for most types of offerings filed on Form S-3 (sometimes referred to as a "universal shelf registration statement"). *See* Rule 405 (definition of "Automatic shelf registration statement"); Form S-3, General Instructions I.D. Under Rule 462, an automatic shelf registration statement, and any post-effective amendment, becomes effective upon filing. The issuer need not wait for SEC review.

The automatic shelf registration statement gives well-known seasoned issuers considerable flexibility. They can register an unspecified amount of securities, only indicating the name or class of the securities. Rule 430B(a). Well-known seasoned issuers using an automatic shelf registration statement can also add additional classes of securities to the offering without filing a new registration statement. (Rule 413 requires the filing of a new registration statement to cover additional securities for most other types of offerings.) Under Rule 413(b), additional classes of securities may be added to an automatic shelf registration statement through a post-effective amendment. Drafting a post-effective amendment is a much simpler task than drafting an entire new registration statement. The ability to add an additional class of securities at a later time gives WKSIs latitude to determine the types and amount of securities to register, including securities of their eligible subsidiaries and secondary offerings of their securities (in the hands of insiders, for example).

Rule 415(a)(5) imposes a time limit of three years from the initial effective date for automatic shelf registration statements. The three-year re-registration requirement serves primarily a house-keeping purpose for WKSIs, aggregating all updates into one document. A WKSI using an automatic shelf registration statement may simply file a new registration statement that becomes effective immediately upon filing under Rule 462(e). Under Rule 415(a)(6), any unsold securities and filing fees paid in connection with the unsold securities are transferred to the new automatic shelf registration. Thus, a WKSI can register an unspecified amount of a class of securities for, essentially, an unlimited time, with the ability to add on new classes of securities under Rule 413(b). WKSIs can therefore seamlessly sell any amount of securities off the shelf without delay after the filing the initial shelf registration statement. Finally, rather than pay filing fees based on the amount of securities registered up front, a WKSI can "pay-as-you-go," paying filing fees only when securities are actually sold. Rule 456(b).

In many ways, the automatic shelf registration statement for WKSIs provides the equivalent of company registration. WKSIs effectively need to only register once (with periodic house-keeping re-registrations). Although offering securities for sale will trigger various transaction-specific disclosure requirements (such as amount offered and price and price-related information), the securities regime no longer puts automatic shelf registration WKSIs through the time consuming and expensive gun-jumping rules.

B. THE BASE PROSPECTUS

A shelf registration issuer could simply file a complete prospectus, including price-related information, with the initial registration statement. The issuer's only obligation would then be to update the registration statement pursuant to Item 512(a) as well as to file any required prospectus supplements, such as under § 10(a)(3) of the Securities Act. In practice, issuers will often file only a minimal "base" prospectus with the initial registration statement in a shelf offering. The base prospectus omits information related to the public offering price and the underwriters, among other information. The issuer will include any omitted information from the base prospectus as part of a prospectus supplement. Rule 424(b)(2) requires that the issuer file such a prospectus supplement with the SEC "no later than the second business day following the earlier of the date of the determination of the offering price or the date it is first used after effectiveness in connection with a public offering or sales." The prospectus supplement that is filed under Rule 424(b)(2) may disclose "public offering price, description of securities, specific method of distribution or similar matters."

Rule 430B, the shelf registration corollary to Rule 430A, gives issuers considerable latitude to omit information from the base prospectus. (Rule 430C provides a "catch all" prospectus supplement

provision for offerings not covered by Rules 430A and B). The following information may be omitted from the base prospectus for a shelf registration statement.

- Shelf offerings pursuant to Rule 415(a)(1)(vii) (mortgage-related securities) or (x) may omit "information that is unknown or not reasonably available to the issuer pursuant to Rule 409." Rule 430B(a). What constitutes information that is "unknown" or "not reasonably available"? Information omitted generally includes the public offering price and other price-related information, such as the underwriting discount. In addition, to the extent the issuer does not know the specific characteristics of securities to be offered on the shelf at the time of the initial filing of the registration statement, the issuer may omit such information, providing only general terms. The issuer may then include more specific details for offered securities later as part of a prospectus supplement. Other information may also qualify for omission, such as the identities of the underwriters for future takedowns off the shelf, if unknown at the time of filing of the initial registration statement.
- Shelf offerings under an automatic shelf registration statement and pursuant to Rule 415(a)(1), other than Rule 415(a)(1)(vii) or (viii), can omit information on the plan of distribution and on whether the shelf is a primary or secondary offering even if the issuer knows the information or the information is otherwise reasonably available. Rule 430B(a). The issuer may not know in advance which of its investors in a private placement, for example, will want to take advantage of a registered offering to resell.
- Shelf offerings under Rule 415(a)(1)(i) conducted by an issuer eligible for Form S-3 or F-3 may omit the information specified in Rule 430B(a) as well as "the identities of selling security holders and amounts of securities to be registered on their behalf." This exclusion applies only for (1) an automatic shelf registration statement or (2) situations where "(i) The initial offering transaction of the securities . . . the resale of which are being registered on behalf of each of the selling security holders, was completed; (ii) The securities . . . were issued and outstanding prior to the original date of filing the registration statement covering the resale of the securities; (iii) The registration statement refers to any unnamed selling security holders in a generic manner by identifying the initial offering transaction in which the securities were sold."

Under Rule 430B, a base prospectus omitting information pursuant to the Rule would meet the requirements of § 10 for purposes of § 5(b)(1)

of the Securities Act. As with Rule 430A discussed above, Rule 430B does not allow the omission of such information for a prospectus to satisfy § 10(a) for purposes of § 5(b)(2) or for the free writing exception contained in § 2(a)(10)(a). Thus, the issuer must eventually include the omitted information to transmit securities for sale (under § 5(b)(2)) or to engage in traditional free writing under § 2(a)(10)(a).

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

NOTES

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

2. *Overhang.* When a company registers securities with a shelf registration, the stock price of the company typically drops. The price drop is known as the shelf registration overhang. One explanation for shelf overhang is that the presence of a large supply hanging over the market results in a fear of substantial dilution among present stockholders, depressing the stock price. The potential sale of securities in and of itself, however, will not necessarily dilute pre-existing security holders. If a company sells common stock at a premium to the market price, the sale should increase the per share value of the pre-existing common stock. (But who would buy at a premium to the market price?) Dilution will occur only where the shares are sold at a price *lower* than the market price. But why would managers (who typically own shares) ever choose to sell for less than the market price? Only a company with serious cash flow problems would dilute shareholders this way.

An alternative explanation for market overhang is that managers can time stock sales to coincide with market overvaluation of the stock. Imagine that pre-existing shareholders cannot tell whether the market under or overvalues the stock, but managers do know. First, consider when the stock is overvalued. Those who own pre-existing stock will be less likely to obtain the benefit from selling overvalued stock (as the company will flood the

market with new stock in this case). Second, consider when the stock is undervalued. The owners of pre-existing stock will then bear the entire cost of selling undervalued stock. Pre-existing shareholders, therefore, will systematically bear the cost of selling undervalued stock but miss out on selling overvalued stock—reducing their expected returns and therefore lowering the price of stock in the marketplace.

3. *Asset-backed securities.* Issuers of asset-backed securities are among the principal users of shelf registration. Indeed, mortgage backed securities warrant their own category under Rule 415(a)(vii). Asset-backed securities have also garnered their own regulatory regime. We discussed Congress's efforts to rein in asset-backed securities as part of the Dodd-Frank legislation in Chapter 3.

The SEC has also acted to provide enhanced disclosure for asset-backed securities. Regulation S-K has a separate section for disclosures by asset-backed issuers. Regulation ABS, Item 1100 et seq. of Regulation S-K, imposes detailed requirements for disclosures relating to the assets that are bundled to create these securities (Item 1111), as well as the sponsors of the securities (Item 1104). Item 1111 requires information about cash flows, such as interest rates and terms for pooled assets, but also mandates disclosure about default rates and any non-performing loans that might be included in the pool. In an effort to increase the quality of assets going into such pools, the SEC also requires a review of the assets going into the pool as provided in Rule 193. A report of that review must be included in the registration statement. Regulation S-K, Item 1111(a)(7).

HYPOTHETICAL TWELVE

Two years have passed since Ewing Oil's initial public offering (in which Ewing Oil issued eleven million shares of common at $20 per share). Ewing Oil's shares now trade on Nasdaq at around $80 per share. The Ewing family currently holds nine million Ewing Oil common shares, with eleven million in the hands of the public. Ewing Oil has been current in its Exchange Act filings over the past two years. Ewing Oil frequently has business opportunities that require it to raise capital on very short notice. Consider the following options for raising more capital.

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

2. *Scenario Two:* Suppose that six months after the initial effective date of the shelf registration described in Scenario One, J.R. is indicted for bribing foreign officials and jailed; Bobby, Ewing Oil's CFO, replaces her as CEO. If this were not a shelf registration and Ewing Oil had not yet completed its offering, what updating would Ewing Oil have to do? What about with Rule 415(a)(3)? What difference does it make?

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

4. *Scenario Four:* Ewing Oil decides to do a shelf registration offering of common stock through Nasdaq with the assistance of Barnes-Wentworth Investments. On February 1, Ewing Oil files a Form S-3 registration statement, including a "base prospectus." The base prospectus excludes information on the offering price, underwriters, underwriting discount, and on the securities offered (referring only to an "unspecified" amount of "common stock"). Later, on June 1, Ewing Oil sells $200 million of common off the shelf. The common stock is sold at the prevailing market price of $80 per share with Barnes-Wentworth Investments acting as underwriter. On June 2, Ewing Oil files a prospectus supplement containing the previously omitted information with the SEC. Has Ewing Oil complied with Rule 415?

5. *Scenario Five:* Ewing Oil will issue $250 million of convertible bonds on a delayed basis over the next two years. Each bond (principal amount of $1000) can be converted at any time into ten shares of voting common. Assume that if all the bonds were converted today they would result in $200 million of common. The bonds' term is ten years; the conversion therefore may take place up to ten years after the bonds are sold.

6. *Scenario Six:* As noted above, the Ewing family holds nine million shares of Ewing Oil common stock. These shares are "restricted" in the sense that the securities laws prohibit the family from freely reselling the shares into the public markets absent a registration statement. (We explain why in Chapter 10.) May the Ewing family use a shelf registration covering a ten-year period for these shares?