CLASS I

Corporations need a rich source of capital to obtain the money they need to grow and experiment. In the United States and, increasingly, worldwide, corporations look to raise necessary capital from the public. Typically, they sell common stock and investors place rational bets that the money they pay to buy the common stock will be put to profitable use by the company so that the value of their shares of common stock will rise. A strong capital marketplace that attracts investors is crucial to the U.S. economy. This lesson was learned the hard way back in the 1920s. Until 1933, there was virtually no regulation of the way corporations raised money from the public. Securities were sold on the basis of partial, incomplete information, and on the basis of false information. The pernicious effect of a capital marketplace that could not be trusted became dreadfully evident in 1929. In that year, the Great Depression began and it rattled the country enough to cause Congress to adopt legislation aimed at protecting the American investing public.

By March, 1933, when the Democratic Party President, Franklin Roosevelt, took office, Vincent P. Carosso, author of *Investment Banking in America,*\(^1\) reports that most of the nation’s banks were closed, the securities markets were near collapse and the Depression was at its height, adding that investors had no confidence in the securities market or in investment bankers. Roosevelt asked Congress to take action and pass legislation that would require those companies that wished to sell securities to the public and those investment bankers who took companies public to provide the public with clear, accurate and complete information about the company. The Securities Act of 1933 was drafted quickly and modeled on an English precedent.

The 1933 Act as drafted and as interpreted by the Securities and Exchange Commission until the 2005 Reform, sharply limited what information issuers “in registration”\(^2\) could convey to the public because of a fear that issuers and underwriters would attempt to manage public interest in an offering by flooding the marketplace with only favorable and, even, unreliable information in the interest of developing an appetite to buy the shares. In other words, the longtime felt concern was that securities would be peddled the way cars, cosmetics and fast food are sold.

Section 5(c) was, as a result, read to proscribe communications with the public that could “condition the market.” Section 5(b) was read to generally limit what information could be conveyed in writing to prospective investors to the long, dry and factual formal prospectus forming a part of the registration statement. Moreover, research reports published by analysts

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2. i.e., said the Securities and Exchange Commission in Securities Act Release No. 5180 (August 16, 1971) “the entire process of registration, at least from the time the issuer reaches an understanding with the broker-dealer which is to act as managing underwriter prior to the filing of a registration statement and the period during which dealers must deliver a prospectus.”
reporting on issuers “in registration” were viewed with suspicion and were subject to restrictions found in old rules 137, 138 and 139.

The 1933 Act itself, coupled with interpretations by the Securities and Exchange Commission, broadly limited selling efforts because at the time of the adoption of the 1933 Act, dealers and underwriters had effectively hustled investors into making poorly understood investments based on little or no relevant information. That perception continued to rule until recently. For example, in 1959, the Securities and Exchange Commission said in the *Carl M. Loeb, Rhoades & Co.* case we will study:

“One of the cardinal purposes of the Securities Act is to slow down this process of rapid distribution of corporate securities, at least in its earlier and crucial stages, in order that dealers and investors might have access to, and an opportunity to consider, the disclosures of the material business and financial facts of the issuer provided in registration statements and prospectuses. Under the practices existing prior to the enactment of the statute in 1933, dealers made blind commitments to purchase securities without adequate information, and in turn, resold the securities to an equally uninformed investing public. The entire distribution process was often stimulated by sales literature designed solely to arouse interest in the securities and not to disclose material facts about the issuer and its securities.”

The Securities and Exchange Commission’s suspicion that communications could be for the purpose of whetting the public appetite to buy securities created justifiable tension between issuers who, in good faith, needed to communicate with the public, but felt constrained to do so when they were preparing to engage in a public offering or were actually in the process of offering securities, having filed a registration statement. Concerns arose as to whether issuers could issue press releases announcing material news, such as the signing of a new contract, or the settlement of a strike, respond to unsolicited shareholder inquiries, etc., or whether they could make predictions as to their expected earnings or revenues, even if they routinely provided this information when not “in registration.” The Securities and Exchange Commission tried to help differentiate between legitimate publication of information of value to the public market and publication of information designed to cause investors to want to buy securities in upcoming offerings. But issuers were never entirely comfortable with what could and should be said in the interest of generally informing the marketplace versus what could not be said because it would be deemed an illegal offer to sell.
Late in 2005, the 1933 Act, after considerable formal and informal comment, was very significantly modified by the adoption of new rules. The 2005 Reform revisited communications with the public and adopted new rules that, on the one hand, permit well-known seasoned issuers, or WKSIs, who plan to make a public offering or who are actually making one, to go about their normal business of freely communicating with the public, including providing forecasts of future results, if this had been their practice without fear of violating the 1933 Act. See Rule 163. At the other end of the new 2005 Reform spectrum, issuers who are not yet public companies and do not yet make public filings, must generally limit what they convey to the public outside the confines of a formal statutory prospectus or a new "free writing prospectus," to only factual business information of the type previously released by the issuer in the ordinary course intended for use by persons such as customers or suppliers. See Rule 169.

This new approach has come about for several reasons:

- Unlike the early years after adoption of the 1933 Act when there was precious little on-going, regular information made available by issuers, a sister act, the Securities Act of 1934 has, over time, become the main and constant source of required, factual up-to-the-minute information about publicly traded companies. One of the first to recognize the utility of 1934 Act disclosure was Milton H. Cohen who wrote in *Truth in Securities Revisited*, 79 Harv. L. Rev. 1340 (1966),

> "It is my thesis that the combined disclosure requirements of these statutes would have been quite different if the 1933 and 1934 Acts...had been enacted in opposite order, or had been enacted as a single, integrated statute—that is, if the starting point had been a statutory scheme of continuous disclosures covering issuers of actively traded securities and the question of special disclosures in connection with public offerings had then been faced in this setting. Accordingly, it is my plea that there now be created a new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 Act and treating the '1933 Act' disclosure needs on this foundation."

- The information required by the 1934 Act, consisting of annual reports and audited financial statements, quarterly reports and current material event reports, can be found on the Securities and Exchange Commission's website and on company websites. The very fact that it can be so readily accessed has led to the creation of the profession of financial analysts who constantly monitor the

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3 The modifications took advantage of the broad power given to the Commission found in Section 28 of the 1933 Act to rewrite the black letter law. Section 28 was added to the statute in 1996 precisely to enable the Commission to keep the law, adopted in 1933, pertinent to an evolving capital market structure.
prospects of public companies and convey their assessment to investors. Buyers of stock in the trading markets, such as over the New York Stock Exchange, do not want to pay more than the stock is worth or sell it for less. They rely on the fact that the up-to-the-minute public disclosure now required under the 1934 Act, through the intermediation of analysts, creates what is known as an "efficient market": the stock price accurately impounds all relevant information about a publicly traded company. As a result, it is not easy or even possible in many cases, to cause the marketplace to overvalue a well-followed 1934 Act registered security through deliberate hype and distortion.

We will be focused on the process by which companies that have never sold securities to the public negotiate the 1933 Act going public process because this process remains as the bedrock of the 1933 Act. But, we will also take the time to compare and contrast the now available opportunities for WKSIs, and other already publicly traded companies to provide more information. To help you gain some idea of the way of the 2005 Reform plays out, you should, over the term, become very familiar with TAB 3 of the coursepack which sets forth the invaluable release giving notice of adoption of the 2005 Reform. It is crucially important to your understanding of the 1933 Act in 2006. As is always the case, the Securities and Exchange Commission Releases that propose and adopt new rules are invaluable reading. They spell out, together with their informational footnotes, far better than the cryptic rules and statutes themselves, what the rules and statutory language mean. See, during this course, new Rules 163, 163A, 164, 168, 169, 172, 173 and 433 which relate to what can be disclosed without violating Section 5 of the 1933 Act and new Rules 159 and 159A, which put new emphasis on what information investors have at the time of sale. Also, see additions to Rule 405 necessary to making the new rules work.

As you will very quickly see, while the 2005 Reform makes straightforward practical sense, the manner of its technical formulation, that is through dense rules that contain many cross references to other dense rules, makes the 2005 Reform difficult to absorb. The Adopting Release reads very much more clearly than the Rules. Also, the new Rules are a form of "reverse English." For example, Rules like 163A simply turn the 1933 Act statutory language on its head when they state if the Rule is complied with, then the stipulated communications will not be deemed to constitute a prohibited offer within the meaning of Section 5(c) of the statute. In effect, by rulemaking the Securities and Exchange Commission has rewritten the statute. While this works legally under Section 28 of the 1933 Act, it does not work from a plain English approach. As a result, securities law expertise has become much more complicated. At the same time, the role of a good securities lawyer is to understand the dense new rules well as to be able to guide issuers and underwriters in making good, effective use of the 2005 Reform.

This course is aimed at giving you that expertise.