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OSBP MEMO NO.

MEMORANDUM

TO : Tim Lawler, Atlanta Regional Office
Susan Davis, Boston Regional Office
Nicholas Pecora, Chicago Regional Office
Martha Fulford, Denver Regional Office
Tom Baudhuin, Fort Worth Regional Office
Rosalind Tyson, Los Angeles Regional Office
Donald Rinehart, New York Regional Office
Walter Pitts, Seattle Regional Office

FROM : Karen M. O'Brien, Attorney-Advisor
Broc M. Romanek, Law Student-Intern
Office of Small Business Policy
Division of Corporation Finance

SUBJECT : Communications by issuers whose securities are "In Registration".

I. Introduction

Section 5 of the Securities Act of 1933, (the "Act") in effect divides the registration process into three distinct time periods: (1) the pre-filing period, (when registration is contemplated in the near future) (2) the pre-effective or waiting period, and (3) the post-effective period. During these three time periods an issuer's securities are considered to be "in registration". The discussion below focuses on certain specific restrictions regarding the release of information and communications by issuers whose securities are in registration. 1/

II. The Pre-Filing Period: Before the Filing of a Registration Statement

Absent an exemption, Section 5(c) of the Act makes it is unlawful "for any person... to offer to sell or offer to buy

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1/ The term "issuer" is defined in Section 2(4) of the Act. Note that this discussion is limited to issuer activities.

through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security...". 2/ The term "offer", as included in this restriction and as defined by the Act, has been liberally construed by both the Courts and the Commission. 3/ For example, in addition to the obvious prohibition against the express oral or written offer of sale by an issuer, an issuer is also restricted from contacting any prospective purchasers, using any type of prospectus to create public interest in its securities 4/ or from publicly identifying underwriters associated with the offering which is apt to prompt "offers to buy". These restrictions are required in order to avoid a "priming" of the market in the securities to be registered prior to the availability of specified disclosure by the issuer, otherwise known as "gun jumping". 5/

2/ The interstate commerce requirement must also be met for Section 5 to apply regardless of the time period. However, the Courts have consistently held an expansive interpretation of the interstate commerce requirement.

3/ See, e.g., In the Matter of Loeb, Rhoades & Co., 38 S.E.C. 843 (1959) (term "offer to sell" is defined broadly and encompasses pre-filing publicity efforts even if not couched in terms of an express offer).

4/ See SEC v. Arvida Corporation, 169 F. Supp. 211 (S.D.N.Y. 1958) (written and oral communications to the press by representatives of the underwriter and the issuer concerning a forthcoming initial public offering of the issuer's securities constitutes an "offer to sell"). But see Securities Act Release No. 5927, at 3.

5/ Securities Act Release Nos. 3844 (October 8, 1957), 4697 (May 28, 1964), 5009 (October 7, 1969), and 5180 (August 13, 1971) (providing examples of what constitutes "offers to sell" in pre-filing period in contravention of Section 5(c)).

This need for restraint, however, must also be balanced against an issuer's continuing duty to provide necessary, factual information to both shareholders and employees and its need to prepare for the registration process in general. 6/ Thus, all communications by an issuer during this time are not necessarily "offers" in contravention of Section 5(c).

The registration process begins once an issuer decides to proceed with an issuance of its securities. This decision may be in the form of an understanding with an underwriter. After this event, but prior to the filing of a registration statement, normal communications between an issuer and its stockholders or the general public are not necessarily restricted by the Act. The Commission fosters a policy of allowing factual information concerning important business and financial developments during all time periods. 7/ In some instances, certain information must be disclosed by public companies in order to comply with mandated reporting requirements, anti-fraud statutes or requirements of self-regulatory organizations.8/ For example, disclosure required by the Williams Act to be made by a bidder in a cash tender offer concerning a subsequent statutory merger is normally not deemed to constitute an "offer to sell" the bidder's securities to be exchanged in such merger but, instead, is viewed as a

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6/ Securities Act Release No. 5180.

7/ Id.

8/ See, e.g., New York Stock Exchange Listed Company Manual, Section 2 Disclosure and Reporting Material Information; American Stock Exchange Company Guide, Part 4. Disclosure Policies (Sections 401-405).

permitted written communication to existing shareholders prior to the filing of a registration statement pursuant to mandated reporting requirements. 9/ An issuer, however, must be careful not to instigate publicity for the purpose of facilitating the sale of securities prior to the post-effective period through means which are not authorized by the Act. Rather, any publication of information by the issuer during the pre-filing period should be limited to factual information as provided during the regular course of business including such periodic reports as mandated by the Securities Exchange Act of 1934 and should generally be of a factual rather than a promotional nature. 10/

In preparation for the registration process, Section 2(3) of the Act provides that the terms "offer to sell" and "offer to buy" do not include preliminary negotiations and agreements between the issuer and any underwriter or between underwriters during the pre-filing period 11/. Such communications are necessary in order for the financing to proceed. On the other hand, this section does include within the definition of "offer" negotiations with the selling group. The "offer to buy" restriction prohibits such communications with dealers during this time. 12/

9/ Securities Act Release No. 5927.

10/ Securities Act Release No. 5180.

11/ Section 2(3) of the Act provides: "the term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value".

12/ Securities Act Release No. 5180.

The only communication specifically authorized during the pre-filing period is an announcement by an issuer of certain proposed public offerings as specified by Rule 135. 13/ It is important, however, to note the limited kinds of offerings covered by the Rule. Rule 135 permits an issuer to publish a notice directed to its existing security holders or its employees containing no more than the designated, factual information specified in the Rule, pertaining only to limited types of offerings and specifying that the offering will be made only by means of a prospectus. For example, an issuer may publish a news release directed to its current security holders that it proposes to make a registered exchange offer of its common stock only by means of a prospectus. Such a notice would not be deemed to offer any securities for sale. 14/ An issuer relying upon Rule 135, however, must carefully observe the restrictions prescribed. 15/

II. The Waiting Period: After the Filing and Before the Effective Date

The waiting period, as the term suggests, is that time period from when the registration statement is filed until "the wait" is over and the registration statement is declared

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13/ Rule 135, 17 C.F.R. 230.135.

14/ Id.

15/ See Chris - Craft Industries, Inc. v. Bangor Punta Corp. 426 F.2d 569 (2d Cir. 1970) (Rule 135 provides an exclusive checklist of features to exempt certain disclosures of forthcoming issues from the definition of "offer to sell").

effective. During the waiting period, Section 5(a) of the Act continues to prohibit all sales of securities but does permit oral offers. Furthermore, Section 5(b)(1) of the Act permits written offers but only by means of a Section 10 prospectus. 16/ Specifically, a Section 10 prospectus includes both the preliminary prospectus ("red herring") as provided for in Rule 430 17/ and the preliminary summary prospectus as provided for in Rule 431 18/. More specifically, the prospectus need only meet the requirements of Section 10(b), not Section 10(a) at this time. 19/

The term "prospectus" is defined by Section 2(10) of the Act. This Section also identifies those written offers excluded from the definition of prospectus and therefore permissible during the waiting period pursuant to Section 5(b)(1). Rule 134, promulgated pursuant to Section 2(10), specifically excludes from the term

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16/ The term "prospectus" is defined in Section 2(10) of the Act. For a discussion on what constitutes an offer of a security for sale by means of a prospectus, see Diskin v. Lomasney & Co., 452 F.2d 871 (2d Cir. 1971).

17/ 17 C.F.R. 230.430.

18/ 17 C.F.R. 230.431. Although the preliminary summary prospectus is permitted during this time, it is not used much in practice due to the risks associated with providing summary material.

19/ Section 10(b) of the Act provides: "In addition to the prospectus permitted or required in subsection (a) [of Section 10], the Commission shall by rules or regulations . . . permit the use of a prospectus for purposes of Subsection (b)(1) of Section 5 which omits in part or summarizes information in the prospectus specified in Subsection (a).

"prospectus" written offers limited to designated information as set forth in the Rule, otherwise known as "Tombstone Ads". 20/ Although through these announcements an issuer is able to ascertain "indications of interest" in its securities from possible purchasers which in addition enables the issuer to "price" the issuance, most "indications of interest" are ascertained through oral solicitations by broker-dealers. Rule 135 announcements by an issuer also continue to be permissible during the waiting period.

In summary, during the waiting period oral offers and written offers made by means of a "red herring" prospectus or a preliminary summary prospectus are permitted. All other offers are prohibited. Furthermore, although these offers are permitted, Section 12(2) and Rule 10b-5 impose liability for misleading statements. Sales literature, known as "free writing", is strictly prohibited during this time.

The following examples describe particular problem areas regarding the distribution of information by an issuer which

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20/ Rule 134 provides an exclusive list of those disclosures which either are required or are permitted to be included in the notice. See In re National Association of Securities, Dealers, Inc., Robert L. Butler (No-action letter, June 23, 1984) (listing permissible and prohibited activities) and Securities Act Release No. 5180.

may constitute an "offer" by means of a nonstatutory prospectus during the waiting period.

1. An advertising campaign related to an offering is a violation. See Competitive Capital Corp., Securities Exchange Act Release No. 9184 (May 25, 1971).

2. An underwriters internal memo, if distributed, constitutes an unlawful offer to the recipient. See Diskin v. Lomasney & Co., 452 F.2d 871 (2d Cir. 1971).

3. The distribution at due diligence meetings (sometimes referred to as "road shows") of written sales material even in conjunction with a "red herring" prospectus is a violation of Section 5.

4. The distribution of prerecorded video or audio tapes (i.e., except those limited to the information in a tombstone ad) is probably a violation. See Transamerica Corp. (No-action letter, May 24, 1978) But also see Exploration Inc. (No-action letter, October 9, 1986). In Exploration Inc., the Division stated that it would not recommend enforcement action to the Commission if Exploration produced and distributed video cassette tapes describing or

The requirement that a Section 10(a) prospectus either precede or accompany any free writing and the sale of any security continues until the end of the distribution. 25/ However, the prior or concurrent availability of a Section 10(a) prospectus with all releases of information by an issuer is not possible, nor is it required. Sometimes, disclosures made in a press release, however, may present a tension between an issuer's continuing obligation to inform its investors and the restrictions placed on it by Section 5. This tension, in fact, may be more apparent than real. 26/

The Commission has stated that the "flow of normal corporate news, unrelated to a selling effort for an issue of securities is natural, desirable and entirely consistent with the objectives of disclosure to the public which underlies the Federal Securities laws". 27/ The question is what may be deemed to be related to a "selling effort"?

Disclosures made during the registration process may relate to continuous reporting obligations under the Exchange Act

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25/ The restrictions placed on the distribution of information by dealers apply at least from the time an issuer reaches an understanding with the firm that it 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, Release No. 33-5010 (October 7, 1969) at 2 [34 FR 18130].

26/ Securities Act Release No. 5009.

27/ In the Matter of Loeb, Rhoades & Co., 38 S.E.C. at 853 (emphasis added).

requirements, prompt disclosure under the anti-fraud provisions, timely disclosures pursuant to policies of self-regulatory organizations or routine announcements to the press. 28/ All such disclosures are proper. However, it is the manner in which such disclosures are made that determines whether or not an issuer is merely complying with disclosure requirements or instigating a selling effort: i.e., the so-called facts and circumstances test. Normally, all such disclosures may be effected in a manner which will not unduly influence the proposed offering.

The use of press releases by an issuer and publicity relating to an issuer whose securities are in registration are two occurrences which probably raise the "selling effort" question most frequently. As previously indicated, such press releases and publicity are permissible but an issuer must be reminded that the information that is disclosed should be factual and cannot be misleading by omitting or exaggerating material facts. An important mitigating factor of any violation which arises from these disclosures is where the final content of the

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28/ Securities Act Release No. 5009.

news item, the resulting publicity and the timing of the release is not totally within the control of the issuer.

An all inclusive list of permissible and prohibited activities by an issuer whose securities are in registration is not feasible because determinations are based upon the particular facts of each case. Issuers, however, have been encouraged by the Commission to establish internal procedures concerning the release of information to avoid unlawful communications. In summary, no practical sales effort can be made through the media by an issuer whose securities are in registration because normally the selling communications could not be preceded or accompanied by the required prospectus. However, disclosures of material, factual information which do not constitute an offer are permitted at any time during the registration process and may be required under the reporting requirements of the Exchange Act for issuers that are reporting companies.

IV. A Case Study

The discussion below provides a factual analysis of a specific case concerning the release of information by an issuer whose securities were in registration. In this particular instance, the information was released a few days after the registration statement was declared effective or during the so-called "quiet period". 29/ The facts of this

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29/ The "quiet period" ends upon the completion of the distribution. See note 25 supra.

case were brought to our attention by the Boston Regional Office.

Scientific Systems, Inc. (the "Company") is an engineering firm located in Cambridge, Massachusetts. The Company filed a registration statement with the Boston Regional Office in contemplation of an offering of its securities. On October 10, 1986, four days after the effective date of its registration statement, the Company intended to announced its offering by means of a Rule 134 announcement which it submitted to a local newspaper. A second release was also prepared and issued by the Company at that same time disclosing that it had entered into a distribution agreement with Allen-Bradley, an event considered by the Company to be a material development. The text of this second release included a statement of the Company's sales (in fact, a misstatement because actual sales were 20% lower), a brief discussion of the agreement between the two companies and a descriptive statement about the reputation of Allen-Bradley. In preparation of an article on the Company, the staff of the local newspaper combined the information contained in the Rule 134 announcement and the press release into a single news item, disclosing both the offering and the agreement between the companies. The disclosure of the information in this manner complicates the analysis as to whether or not the release was proper. First, each release will be examined separately.

A tombstone ad or a release containing only such information as permitted under Rule 134 may be made anytime after the filing of the registration statement. Here, the intended Rule 134 announcement was not employed until even later - after the registration statement had been declared effective. Therefore, if made separately, as anticipated by the Company, the tombstone disclosure would have been proper.

The publication of the intended independent press release concerning the distribution agreement, however, is subject to a more critical analysis. Specifically, the timing and content of the release are of interest. Although the press release was also made during the post-effective period, the content of the release is not specifically permitted under any rule as with Rule 135 announcements. Nor did it meet the requirements of a valid prospectus under Section 10 of the Act or qualify as a tombstone ad or release under Rule 134, both of which are permitted during this time. All written promotional or sales efforts may be made only when preceded or accompanied by a Section 10(a) prospectus. There can be no certainty that everyone reading such release was also given a Section 10(a) prospectus. Therefore, because the release was a written disclosure during the quiet period and did not meet any of the aforementioned qualifications, in order for it to have been proper, even independent of the Rule 134 announcement,

the content of the release must have been limited to factual, material information which did not constitute an offer. Such disclosures are always permissible and may be made through any medium.

In order to determine whether or not the release was such a permitted disclosure by the Company, first we must assess the specific facts to determine whether or not the information disclosed in the release was an express written offer. If so, regardless of whether or not the disclosure was also a factual statement, it would still be a violation because a written offer must be accompanied or preceded by a qualified prospectus. Even if the words "offer" or "sale" are not contained in a communication, the facts and circumstances may still establish that an offer has been made. If the release was not an express offer but, instead was strictly factual information, regardless of the manner of the disclosure (i.e., by press release or direct mailings to shareholders), the release of such information was probably (or presumptively) permissible. (The staff ordinarily should not second-guess the issuer as to the importance of the information disclosed.) On the other hand, disclosure of selective factual information may be both promotional and misleading and thus inappropriate.

The content of the second press release encompasses several items but no express written offer. The istribution agreement was stated by the Company as a material development.

Therefore, the disclosure of this event and its effects was probably a proper factual disclosure.

In its description of Allen-Bradley as "a leading manufacturer" of industrial automation control systems and equipment, the company did not necessarily go beyond the pale of permissible statements inasmuch as this company at least arguably is a major manufacturer in the industry in question. In another light, such a statement would more likely be properly characterized as "puffing". We do not totally eliminate the possibility that this kind of statement could be both false and misleading depending upon the circumstances. Here, however, it did not appear to be the case.

Of greater concern was the fact that the Company's total sales were inaccurately reported in the release. Total sales were reported as $6 million instead of $5 million, an error of 20%. Such misstatements are in direct conflict with the policies and provisions of the Act. The combination of inaccurate information with the disclosure that shares are being offered for public sale is particularly troublesome, regardless of who put the segments together.

In light of these facts, the Boston Regional Office met with Counsel for the issuer to express their concerns. Primarily because the offering was not marketed in the

area where the news item was published, no enforcement action was recommended. Whether such a referral would have been made if the issue were being sold in the Boston area is hard to say. Since a current prospectus was available, it is possible that some less drastic remedial measures could have been taken, depending upon an assessment of the damage, i.e., investor interest resulting from the misstated information.

V. Conclusion

The release of information by an issuer whose securities are "in registration" is governed by Section 5 of the Act. Prior to filing a registration statement, an issuer is prohibited from "offering" to sell its securities except by means of a Rule 135 announcement. Once the registration statement is filed but before it is declared effective, oral offers may be made but written offers must be by means of a Section 10 "prospectus". Sales of securities may only be made once the registration statement is effective. Furthermore, sales may only be made by means of a Section 10(a) prospectus and such a prospectus must accompany or precede any sales literature which is also permitted at this time.

Two general theories apply to the release of information by an issuer anytime during the registration process. First, material, factual information by an issuer who has a continuing obligation to disclose to its investors is always permissable. Secondly, all offers, whether written or oral, and regardless of the type of prospectus are covered by the general anti-fraud provisions of the Securities Act and the Exchange Act.