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Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration

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Re-Engineering Corporate Disclosure: The Coming Debate Over Company Registration

John C. Coffee, Jr.*

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I. Introduction

Statutory obsolescence is the fate of all legislation.¹ At some point in the natural "life cycle" of any statute,² courts tend to move from purposive statutory construction, focused on the actual legislative intent, to greater deference towards administrative expertise as they implicitly recognize that the original legislative intent no longer fits the contemporary institutional landscape. Given that the federal securities laws were passed during the 1930s, they have now entered the geriatric zone where their possible obsolescence must be considered. Some academics have already called for the SEC's elimination on precisely this basis.³ Practitioners complain about the "metaphysical" and "hypertechnical" distinctions that the SEC's doctrinally absorbed staff has developed, which arguably have little relationship to public policy concerns or the needs of investors.⁴ Meanwhile, the SEC, itself, appears to be administratively repealing some of the Securities Act of 1933's clearest prohibitions.⁵ Independently, Congress seems intent on "deregulating" the Securities Act of 1933, in part by making prospectus delivery optional with the investor.⁶

Although the idea that the federal securities laws need rejuvenation is timely, it is not new. A well-known and widely respected model for updating the federal securities laws has existed for the past thirty years. In

1. See generally GUIDO CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* (1982) (arguing that courts should update obsolete statutes rather than remain faithful to their out-of-date legislative intent); Donald C. Langevoort, *Statutory Obsolescence and the Judicial Process: The Revisionist Role of Courts in Federal Banking Regulation*, 85 MICH. L. REV. 672 (1987).

2. For a discussion of statutory life cycles and shifting standards of judicial interpretation, see GRANT GILMORE, *THE AGES OF AMERICAN LAW* 97 (1977).

3. See Jonathan R. Macey, *Administrative Agency Obsolescence and Interest Group Formation, A Case Study of the SEC at Sixty*, 15 CARDOZO L. REV. 909 (1994) (discussing principles for determining agency obsolescence and applying principles to SEC); Jonathan Macey, *The SEC Dinosaur Expands Its Turf*, WALL ST. J., Jan. 29, 1992, at A12 (expressing view that changes in securities markets have eliminated need for SEC).

4. For such a representative complaint, see Gerald S. Backman & Stephen E. Kim, *A Cure for Securities Act Metaphysics: Integrated Registration*, INSIGHTS, May, 1995, at 18.

5. See *infra* notes 27-34 and accompanying text.

6. See Mark Anderson, *Republicans in House Begin Push To Overhaul U.S. Securities Laws*, WALL ST. J., July 27, 1995, at A2 (noting introduction of bill by Representative Jack Fields, Chairman of House Subcommittee on Telecommunications and Finance, that would "ease rules that require investors to get a prospectus before making an investment"); Anita Raghavan et al., *GOP Securities Law Plan May Tilt Balance of Power*, WALL ST. J., July 28, 1995, at C1 (discussing Fields bill).

1966, Milton Cohen published what probably has become the most influential article ever written on the federal securities laws, *Truth in Securities Revisited*.⁷ Cohen argued that the combined disclosure requirements of the Securities Act of 1933 (the '33 Act) and the Securities Exchange Act of 1934 (the '34 Act) produced pointless duplication. Had the statutes instead been passed in the reverse order or as part of a single integrated statute, he suggested that our disclosure system would have been structured very differently. Because the '34 Act creates a system of continuous, periodic disclosure, the existence of this system profoundly reduces the need for transaction-specific disclosure at the time when an issuer later seeks to sell its securities. Logically, a corporate issuer seeking to sell securities under a continuous disclosure system would only be required to disclose any additional material information that it had not previously disclosed pursuant to the continuous disclosure system.

In modern terms, Milton Cohen's point was that the development of securities regulation in the United States was "path dependent." Because the '33 Act came first, it understandably keyed the timing of disclosure to the issuer's sale of its securities. Later, the '34 Act overlaid a system of company-specific disclosure on top of the '33 Act's system of transaction-specific disclosure. Had events occurred in the reverse order, no one would have sought to overlay transaction-specific disclosure on top of company-specific disclosure.

Although Milton Cohen's fundamental point — that our two principal statutes governing securities regulation are not well integrated — has received nearly universal acceptance, progress toward implementing his vision has been slow and halting, at least until recently. Thirty years after his article, serious administrative efforts have been made to integrate the '33 and '34 Acts, but their statutory structure has not been significantly altered. Most notably, the American Law Institute (ALI) labored for over a decade on its Federal Securities Code,⁸ an ambitious attempt to recodify all six federal securities statutes into one seamless code. Almost everyone in the field applauded this effort, accomplished under the magisterial direction of Harvard Professor Louis Loss. Eventually, even the SEC endorsed this approach, but when the ALI's Federal Securities Code was presented to Congress in 1980, Congress essentially yawned and declined to act. Unfortunately, "good government" reform does not excite powerful consti-

7. Milton H. Cohen, "Truth in Securities" Revisited, 79 HARV. L. REV. 1340 (1966).

8. See AMERICAN LAW INSTITUTE, FEDERAL SECURITIES CODE (1980). For an overview of early criticisms and reform efforts, see Louis Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27 (1969).

tuencies nor generate the level of emotion necessary to stir a lethargic Congress into action.

During the 1980s, however, many of the essential ideas in Milton Cohen's vision and the ALI's Code were implemented through SEC rule-making to create an effectively integrated disclosure system.⁹ Modern concepts that today border on household words for the securities bar — such as "incorporation by reference" and "shelf registration" — are in essence means of implementing the vision of efficient statutory integration without legislation.

Full integration, however, was not achieved and, absent legislation, arguably may never be fully achievable. Under a completely integrated disclosure system, registration under the '34 Act would suspend the obligation to register issuances of securities under the '33 Act. To date, administrative integration of the two statutes has stopped well short of this point — its principal achievement being a shelf registration system under which issuers can obtain quick access to the capital markets by incorporating by reference '34 Act filings.¹⁰

These matters rested until 1995, when two things happened. First, the SEC appointed an "Advisory Committee on the Capital Formation and Regulatory Processes" (Advisory Committee),¹¹ whose assigned tasks included "evaluating the efficiency and effectiveness of the regulatory process and the disclosure requirements relating to the public offering of securities . . . [and] identifying and developing means to minimize costs imposed by current regulatory programs."¹² Second, House Republicans introduced legislation that would, among other things, substantially eliminate the prospectus delivery requirements of the '33 Act.¹³ Competitive efforts at deregulation thus

9. See Edward F. Greene, *Integration of the Securities Act and the Exchange Act: A Case Study of Regulation in the Division of Corporation Finance of the United States Securities and Exchange Commission*, 3 J. COMP. CORP. L. & SEC. REG. 75, 79-90 (1981).

10. Shelf registration is governed by Rule 415. See 17 C.F.R. § 230.415 (1995). Rule 415(a)(1)(x) allows an issuer to register securities "to be offered and sold on a continuous or delayed basis" if the issuer qualifies for Form S-3 or Form F-3. Currently, domestic issuers (which must use Form S-3) must have not less than \$75 million in aggregate market value of their common stock held by non-affiliates to qualify to use such form. See Form S-3, General Instruction I(B)(1), 17 C.F.R. § 239.13(b)(1) (1995).

11. See Advisory Committee on the Capital Formation and Regulatory Processes, Securities Act Release No. 7135, Exchange Act Release 36,368, 1995 WL 71378 (Feb. 13, 1995).

12. *Id.* at *2.

13. For a summary of the bill, introduced by Congressman Jack Fields (R. Tex.), Chairman of the House Subcommittee on Telecommunications and Finance, see Anderson,

appear to be underway. Whether they will produce a race to the top or to the bottom is debatable, but little about the process of legislative drafting suggests that legislatures can outperform a sophisticated administrative agency.

Against this backdrop, this Article will examine both how integration of the two Acts should be pursued and what its consequences likely will be. Different paths to implementation are possible and carry very different implications. In particular, the goals underlying a company registration system are multiple. For some, the aim is not simply to integrate the '33 and '34 Acts, but also to integrate public and private markets as well to end the current system of complex and uncertain exemptions from registration under the '33 Act. At this point, the trade-offs become more complicated. This Article will argue that, although the complexity surrounding affiliate resales of issuer securities can safely be reduced, the private placement exemption has continuing value. In particular, private sales to institutional investors might constitute a preferable vehicle by which securities of some issuers should reach the public market, with institutional investors undertaking some of the risk-taking and due diligence functions formerly performed by underwriters.

In overview, a mismatch has developed between the '33 Act and the system of shelf registration that corporate issuers prefer. Long-term shelf registration contemplates that securities will dribble into the market in small and discontinuous trickles. Offerings on such a reduced scale mesh poorly with the '33 Act, which presupposes large and deliberately planned issuances — in fact, they fit about as well as the proverbial round peg and square hole. Meanwhile, market developments have increased the utility of shelf registration to the issuer. First, increased volatility in the equity markets has made issuers more sensitive to short-term timing considerations and more eager to exploit short-lived market windows.¹⁴ Second, empirical research has repeatedly demonstrated that announcements of proposed stock offerings will usually elicit a negative stock price reaction.¹⁵ Dribbling securities into

supra note 6 and Raghavan, *supra* note 6. One provision in this bill would limit the current statutory obligation to deliver a prospectus (*see* 15 U.S.C. § 77(e)(b) (1994)) to persons who actually request a prospectus. *See* Anderson, *supra* note 6; Raghavan, *supra* note 6.

14. The significance of this increase in the volatility of the equity markets is hotly debated. Some believe that inefficient "noise trading" has increased because of the decline in trading transaction costs. Others see increased volatility as largely limited to the 1987 stock market crash. *See* Paul G. Mahoney, *Is There A Cure for "Excessive" Trading?*, 81 VA. L. REV. 713, 730-32 (1995).

15. *See, e.g.*, Paul Asquith & David W. Mullins, *Equity Issuers and Offerings Dilution*,

the market in smaller installments may mitigate this problem. Third, the dividing line between private and public transactions has blurred, and issuers are finding it increasingly useful to structure transactions as private placements but with an immediately available shelf registration for resale by the purchasers.¹⁶

Yet, if there are thus reasons to encourage shelf registration, there is clearly insufficient time available in a shelf registration for traditional due diligence procedures to be conducted before each individual offering. In addition, plausible public policy arguments can be made that transaction costs need to be minimized so that equity issuances are not discouraged. If so, many of the assumptions underlying the '33 Act may need to be rethought in this context if the law is to accommodate a marketplace capable of handling repetitive, small issuances. In particular, one might reasonably focus on (1) the level of responsibility, and liability, that can be realistically placed on outside directors; (2) the nature of the investigation that the underwriters can conduct under severe time constraints; (3) the degree to which enhancement of the '34 Act's continuous disclosure system can substitute for transaction-specific '33 disclosure; and (4) likely judicial reactions to administrative attempts to relax the '33 Act's requirements. Needless to add, none of these themes have escaped the attention of the powerful interest groups who will be affected by changes in our disclosure system.

Although this Article starts from the premise that the integration of the '33 and '34 Acts makes sense, it must be underscored at the outset that the context has changed dramatically since Milton Cohen wrote in 1966. In general, most major changes enhance the relevance and logic of his prescription, but they also suggest the need for modifications that reflect developments that he could not possibly have anticipated in 1966. Four such developments stand out. First and most notably, Milton Cohen could not have foreseen in 1966 the dramatic growth of institutional investors, who have more than doubled the percentage of equity that they hold so that today their holdings represent the majority of the equity in U.S. publicly-held

15 J. FIN. ECON. 61 (1986); Michael J. Barclay & Robert H. Litzenberger, *Announcement Effects of New Equity Issues and the Use of Intraday Price Data*, 21 J. FIN. ECON. 71 (1988). Most commentators attribute this phenomenon to an inference made by investors that if management wishes to sell stock then the current stock must be overpriced. A related theory is that underwriters underprice the offering as compensation for the risk of negligence-based liability that they must assume under the federal securities laws. See Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789 (1989).

16. These are called "PIPE transactions" (for "private investment, public equity"). See Stanley Keller, *Basic Securities Concepts Revisited*, INSIGHTS, May 1995, at 5, 7.

corporations.¹⁷ Some believe their rise, along with related developments, may eventually make the role of the underwriter obsolete.¹⁸

Second, the balance between the primary market and the secondary market has shifted even more dramatically in the direction of secondary trading. SEC staff estimates provided to the Advisory Committee show that secondary market trading exceeds primary market issuances by nearly a 100 to 1 margin.¹⁹ As the secondary market increasingly overshadows the primary market, the '33 Act's preoccupation with the primary market and the unique protections it gives the relatively few investors who buy in primary markets seems anomalous. Increasingly, the '33 Act is becoming peripheral, not central, to modern securities regulation.

Third, the development and acceptance of modern finance theory — in particular the Efficient Capital Market Hypothesis (ECMH) — has shifted the focus of disclosure from the individual to the market.²⁰ With the Supreme Court's acceptance of the "fraud on the market" doctrine in *Basic, Inc. v. Levinson*,²¹ regulators and practitioners now tend in common to assume, perhaps prematurely, that disclosure to the market should satisfy all disclosure obligations.

A final factor suggesting the statutory obsolescence of the '33 Act involves the behavior of the SEC staff who interpret and enforce it. Increasingly, they appear to be treating several of the fundamental pillars of the '33 Act as outmoded and have proposed rules or interpretations that effectively downsize them. Statutory norms that only a decade ago were treated as

17. For a summary of the equity holdings of institutional investors, see John C. Coffee, *The SEC and the Institutional Investor: A Half-Time Report*, 15 CARDOZO L. REV. 837, 848 (1994) (noting that institutional investors held 23% of equity in 1955, 38% in 1981, and now hold over 50%).

18. See Donald C. Langevoort, *Information Technology and the Structure of Securities Regulation*, 98 HARV. L. REV. 747, 750-63 (1985).

19. An SEC staff estimate provided to the Advisory Committee placed the volume of annual secondary trading of equity common stock at \$4 trillion and primary issuances at \$50 to 100 billion — nearly a 100 to 1 ratio.

20. Shelf registration was indeed a legitimate child of this intellectual paradigm shift. See Shelf Registration, Securities Act Release No. 6499 and Exchange Act Release No. 20,384, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,449, at 86,335, 86,339 (Nov. 17, 1983) (noting that integrated disclosure "recognize[s] the applicability of the efficient market theory to those companies which provide a steady stream of high quality corporate information to the marketplace and whose corporate information is widely disseminated"). For an overview of finance theory's effect on securities regulation, see Lawrence A. Cunningham, *From Random Walks to Chaotic Crashes: The Linear Genealogy of the Efficient Capital Market Hypothesis*, 62 GEO. WASH. L. REV. 546 (1994).

21. 485 U.S. 224, 241-47 (1988).

inviolable are now being distinguished away when policy reasons suggest that compliance with them would be costly. If the high priests of securities law — the staff of the SEC — have lost faith in the old dogma, the question naturally arises whether others should still adhere to the old dogma's premises. Thus, as a prelude to a discussion of the appropriate scope of the '33 Act, Part I of this Article will survey the degree to which the old order of securities regulation is rapidly changing.

Part II will then proceed to examine how a "company registration" model might operate. Here, important differences result depending upon whether such an approach is sought to be implemented by legislation or by administrative rulemaking. If the latter approach is pursued, there may be less danger of a "runaway" Congress overreacting and effectively nullifying the federal securities laws, but the level of liability that results from administrative integration may be undesirable. The trade-offs are problematic. As a result, proceeding by means of administrative rule-making may also require supplemental and alternative forms of deregulation.

Part III turns to the issue of liability. However well designed a company registration system may be, few companies may voluntarily convert to it if its adoption implies increased exposure to liabilities under the federal securities laws. To what extent can liability be appropriately reduced or refocused? To the extent that it cannot be administratively relaxed, other approaches may also be necessary as at least a supplement to company registration.

In that light, Part IV explores the special, and possibly twilight, status of private markets and the private placement exemption under such an integrated "company" registration system. Here, the claim will be examined that institutional investors may be able to perform much of the gatekeeper function formerly performed by underwriters in traditional fixed-price underwritings. Phrased in Milton Cohen's terms, had institutional investors existed or been contemplated in 1933 and 1934, the structure of the federal securities laws might also have looked very different.

II. Obsolescence and the '33 Act: The Old Order Slowly Changeth

Stripped to its essentials, the '33 Act pivots around Section 5, which contains three critical statutory injunctions. First, prior to the filing of its registration statement, the issuer may not solicit buyers, either orally or in writing, or otherwise seek to condition the market (the "gun jumping prohibition").²² Second, after the filing of its registration statement, the issuer may

22. See 15 U.S.C. § 77e(c) (1994).

use only the preliminary prospectus contained in its registration statement and no other form of written communication to solicit investors, at least until its registration statement is declared effective by the SEC (the "free writing prohibition").²³ Third, after the registration statement is declared effective, underwriters and dealers are required to deliver a copy of the final prospectus to the buyer at or before the time that the buyer receives either a confirmation of sale or the share certificates (the "prospectus delivery requirement").²⁴ Collectively, these three constraints effectively create a period of enforced silence before the offering begins and then give an informational monopoly to the SEC-approved prospectus. Their common purpose is to force the company to market its securities principally by means of the disclosure document prepared in accordance with the SEC's rules and subjected to prior review by the SEC's staff. The obvious premise to Section 5 was that if investors could receive glossy, promotional literature from the issuer, they might pay little attention to the dull, formalistic prospectus prepared in accordance with the rules of a government agency. Understandably, the government is not as slick, persuasive, or enticing as Madison Avenue, and thus, if its mandated disclosure document is to receive investor attention, the state needs a monopoly for at least a limited period on access to the investor. Section 5 essentially provides that monopoly, both by prohibiting "gun-jumping" (i.e., solicitations prior to the filing of the registration statement) and by barring any written communications during the waiting period that could compete with the SEC-filed preliminary prospectus for the investor's attention (i.e., "free writing").

Yet, within the last two years, the long-established equilibrium created by these provisions has been disrupted by major SEC staff initiatives that seem in the aggregate to be undercutting the doctrinal foundations on which the '33 Act rests. The clearest example has been the SEC's reversal this year of its traditional position on "gun jumping." In the past, not only has the Commission precluded any attempt to solicit or condition the market prior to the filing of a registration statement, but it has deemed attempts to ascribe value to the issuer's securities or to estimate the worth of its assets as such a solicitation in violation of Section 5(c).²⁵ In a series of releases,

23. See *id.* § 77e(b)(1).

24. See *id.* §§ 77d(3), 77e(b)(2).

25. See *In re Carl Loeb, Rhoades & Co.*, 38 S.E.C. 843, 848-51 (1959). See also *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 574-76 (2d Cir. 1970); *SEC v. Arvida Corp.*, 169 F. Supp. 211, 215 (S.D.N.Y. 1958). For a general discussion, see Eric A. Chiappinelli, *Gun Jumping: The Problem of Extraneous Offers of Securities*, 50 U. PITT. L. REV. 457 (1989) (proposing that pre-filing offers of securities should be permitted in light

the Commission previously drew a not-always-clear line between those forms of preregistration publicity that were permitted and those that were not.²⁶ Still, no doubt existed that direct attempts to solicit the investor would not be tolerated.

Then, this year in Securities Act Release No. 7188,²⁷ the Commission reversed itself by proposing a new rule — proposed Rule 135(d) — that would allow issuers contemplating initial public offerings to solicit indications of interest from potential investors *prior* to the filing of a registration statement. This proposed rule goes well beyond tolerating some market conditioning through public disclosures and expressly permits direct solicitations, both through oral solicitations and through written communications. Its rationale is that the issuer may need to "test the waters" and evaluate the feasibility of a public offering before committing itself to the possibly substantial costs of registration.

Surprisingly, proposed Rule 135(d) is not limited to the solicitation of institutional investors or other sophisticated purchasers, but would broadly authorize the marketing of the issuer's stock to small and unsophisticated purchasers as well. Indeed, even use of a public media, including radio and television, is permitted. This extraordinary tolerance seems unnecessary if the alleged need is just to evaluate the feasibility of an offering. Presumably, an issuer needing a market reaction to its proposed offering could get such a sense from a relatively quick canvass of underwriters and/or institutional investors, who as sophisticated, repeat players could compare the proposed offering with other comparable deals or with their own standard investment criteria. This could be done without authorizing a broad public solicitation of more susceptible individual investors, who in truth have

of modern finance theory).

26. See *Publication of Information and Delivery of Prospectus by Broker-Dealer Prior to or After Filing of a Registration Statement*, Securities Act Release No. 5010 and Exchange Act Release No. 8710, [1969-1970 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,743, at 83,702 (Oct. 7, 1969); *Publication of Information Prior to or After the Filing and Effective Date of a Registration Statement*, Securities Act Release No. 5009, [1969 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,744, at 83,705 (Oct. 7, 1969); *Guidelines for the Release of Information by Issuers Whose Securities Are in Registration*, Securities Act Release No. 5180, [1970-1971 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78,192, at 80,578 (Aug. 16, 1971). In addition, SEC Rules 135 through 139 permit the issuer to publish certain notices and allow broker-dealers to circulate certain research reports and analyses without being deemed to have made an offer in violation of § 5(c). 17 C.F.R. §§ 230.135 to 230.139 (1995).

27. See *Solicitations of Interest Prior to an Initial Public Offering*, Securities Act Release No. 7188, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,639, at 86,885 (June 27, 1995) (proposing new Rule 135(d)).

little advice or expertise to offer the issuer. Moreover, once unsophisticated investors are approached and decide they are interested in the offering, they may have little reason thereafter to read the formal prospectus once the registration statement is filed. After all, this was precisely the logic that led the draftsmen of the '33 Act to write Section 5(c) so as to forbid pre-filing solicitations of any kind (oral or written). Yet, the proposed rule would permit a general solicitation of all investors, even by such public means as the press, media, television, and the Internet.

In short, although limited to the initial public offering context, the proposal represents a major retreat from the old orthodoxy, which insisted that the prospectus be the only selling document that the investor saw prior to the effectiveness of the registration statement. At bottom, this reversal suggests that the staff may agree with those critics who believe that Section 5(c) is an anachronism in light of modern finance theory.²⁸

Nor does this example stand alone. Section 5(b) of the '33 Act also prohibits the use of any written offering materials prior to the sending of the final prospectus. Again, the purpose is to ensure that investors read the prospectus, instead of other promotional materials. However, in several recent no-action letters, the SEC's staff has permitted the use of certain written materials prior to the sending of the final prospectus.²⁹ Admittedly, this new tolerance of "free writing" is limited to the context of specialized asset-backed deals and authorizes only the use of "term sheets" and "computational materials." In all likelihood, the potential for harm is small, but in doctrinal terms the loophole thus administratively opened could over time be enlarged to become a triumphal arch for issuers who wish to use offering materials other than the statutory prospectus. The relevant point for present purposes is that the SEC staff again has shown itself willing to grant exemptions on policy grounds, where in the past it almost certainly would have said that it lacked discretion because its hands were tied by the statutory language.

Another example is the Commission's recent expansion of Rule 430A and its adoption of new Rule 434, which collectively seem to abandon the

28. See Chiappinelli, *supra* note 25, at 497-501 (arguing that modern financial theories support proposal to allow extraneous offers). However, it should be noted that the proposed rule applies only to the initial public offering context, which by definition is not an efficient market, but rather one in which offering prices are determined by negotiation between the issuer and its underwriters without a prior trading history.

29. See Distribution of Certain Written Materials Relating to Asset-Backed Securities, SEC No-Action Letter, 1995 WL 96251, at *6 (Mar. 7, 1995); Kidder Peabody Acceptance Corp. I, SEC No-Action Letter, 1994 WL 200784, at *5 (May 17, 1994).

traditional idea of a single integrated prospectus in favor of a stream of documents from the issuer. Adopted in 1992, Rule 430A³⁰ permits the issuer to omit the public offering price and underwriting discounts, as well as information about the underwriting syndicate, from the final prospectus, provided that this information is later filed with the Commission within five business days.³¹ In 1995, the Commission expanded this approach significantly by extending the post-effectiveness period during which a prospectus supplement containing pricing and other related information can be later filed from five to fifteen business days.³² More importantly, the Commission also adopted Rule 434 in 1995, permitting issuers to convey the required prospectus information in multiple documents delivered to investors at different times, rather than in a traditional, integrated final prospectus.³³ This abandonment of the traditional integrated prospectus may well be justified by new cost considerations,³⁴ but it shows an agency largely indifferent to the traditional '33 Act concept of a single disclosure document and willing to accept information being provided to it after the time of sale to the investor.

The aggregate significance of these changes is debatable, but they leave the SEC at an unstable transitional point. Once cost considerations to issuers

30. See Rule 430A, 17 C.F.R. § 230.430A (1995); Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964, [1992 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,653 (Oct. 26, 1992).

31. See Rule 430A(a)(3), 17 C.F.R. § 230.430A(a)(3) (1995). Unfortunately, this relaxation may permit "coercive" rights offerings in which shareholders face dilution if they fail to subscribe. In 1991, Time Warner attempted a sliding-scale subscription offering in which the price investors would pay rose as a higher percentage of shareholders subscribed. As originally proposed, the offering price could range from the low \$60s to over \$100 per share, with the lower price applying if few shareholders subscribed. Thus, if most shareholders refused to purchase, those few who did subscribe would receive a very attractive price that diluted existing shareholders. The SEC objected to the transaction because it failed to disclose in the prospectus the exact price at which investors would purchase. See Anne Schwimmer, *Rights Deal Had Funds Up in Arms*, PENSIONS & INVESTMENTS, Jan. 6, 1992, at 27. Yet, under the latest SEC rules, an issuer can delay disclosure of the offering price until after the offering; hence, coercion may now work.

32. See Prospectus Delivery; Securities Transactions Settlement, Securities Act Release No. 7168, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,620, at 86,563 (May 11, 1995).

33. See *id.* at 86,570.

34. The principal justification cited by the SEC in Securities Act Release No. 7168 was the time constraint imposed by the shift to T+3 settlement date, which made it more difficult for underwriters to print and mail out final prospectuses. *Id.* at 86,563-64. Understandable as this concern is, it does balance the investor's need for disclosure against the costs to the issuer and underwriters. Such balancing inevitably places the SEC on the proverbial slippery slope.

and underwriters justify material administrative modifications of the statutory framework, most anything becomes possible, and predictably, the issuer and underwriter community will lobby for whatever relief they think is politically possible.

III. Toward Company Registration

A. An Overview of Company Registration

The core idea in company registration is that eligible companies should be able to make offers and sales of securities without submitting to a costly transaction registration process. Prospectus content — and, indeed, the use of any recognizable "prospectus" — would be determined by marketing needs and the general antifraud obligation to make full and fair disclosure of material information, instead of by a predetermined formula prescribed in the instructions to an SEC-mandated form of prospectus. Once a company became eligible for company registration, it would register under the '34 Act and thereafter file periodic reports under it. Routine financings would be consummated without any further '33 Act registration, and any prospectus that was in fact prepared for marketing purposes would be shaped by marketing needs, plus, of course, the antifraud rules of the '34 Act.

For issuers, the advantages to such a system are obvious. First, it eliminates the delay inherent both in preparing and in filing a registration statement, as well as in waiting for SEC approval and "effectiveness." This delay may cause the issuer to miss what it perceives as market "windows" of opportunity. Second, the various prophylactic rules surrounding the '33 Act drop out of the picture. Gone are both the period of enforced silence mandated by the "gun jumping" prohibition of Section 5(c) and the prohibition on "free writing" in Section 5(b). Third, although some form of a prospectus might well continue to be used as a marketing necessity, the absolute right of rescission that the '33 Act gives an investor who does not receive a prospectus prior to the mailing of a confirmation of sale or share delivery would also cease to apply.³⁵ Fourth, communications between the issuer and the investor would no longer be filtered through the SEC, with arguably some information loss in terms of the issuer's ability to explain itself in the manner that it considers most effective.

35. This rescission right is conferred by § 12(1) for any violation of § 5. *See* Securities Act of 1933 § 12(1), 15 U.S.C. § 771(1) (1994). In addition, an informal prospectus that was not filed as part of the registration statement would seemingly not come within the scope of § 12(2). *See* *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061 (1995).

Finally, because of significant differences in the liability provisions of the '33 and '34 Acts, the issuer would enjoy a substantial reduction in both its exposure and that of its officers and directors under a company registration system. Under the '33 Act, the issuer is subject to strict liability for material misstatements or omissions in its registration statement,³⁶ and its directors and principal senior executives are subject to a negligence-based form of liability under which they carry the burden of proving that they conducted a reasonable investigation of, and had a reasonable belief in, the accuracy of most statements made in the registration statement.³⁷ In contrast, under the '34 Act, the only relevant express provision is Section 18, which applies only to reports filed with the SEC and requires that the investor actually rely on the alleged misstatement; for these reasons, it has long been regarded as an ineffective weapon for plaintiffs.³⁸ Injured investors can, of course, sue under Rule 10b-5 for misleading statements made to the market, but here proof of scienter is required and persons who aid or abet the violation have no civil liability after a recent Supreme Court decision.³⁹ As a practical matter, secondary participants, such as officers and directors, face only a remote risk of personal liability under the '34 Act for materially misleading statements or omissions made by the issuer.

These benefits to the issuer from a company registration system may be counterbalanced, however, by corresponding costs to investors. Chief among these costs is the danger that there may be an erosion in the quality of disclosure, at least to the degree that disclosure is driven by the fear of liability. Here, the perspectives of lawyers and economists tend to deviate. Economists, focusing more on the issuer's need to attract capital at the lowest possible cost, argue that market forces will be sufficient to maintain disclosure quality. Practicing lawyers, on the other hand, almost uniformly

36. See Securities Act of 1933 § 11, 15 U.S.C. § 77k(a) (1994). Section 11(b) gives an elaborate due diligence defense, but only to defendants "other than the issuer." *Id.* § 77k(b).

37. For the fullest description of this defense in the context of an actual case, see *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 682-703 (S.D.N.Y. 1968). The defense varies significantly depending upon whether the alleged misstatement or omission relates to a section of the registration statement prepared by an expert. *Id.* at 683-84.

38. See Securities Exchange Act of 1934 § 18, 15 U.S.C. § 78r(a) (1994). To state a claim under § 18, a plaintiff must plead that it purchased or sold a security in actual reliance on a specifically identified document filed with the SEC. See *Ross v. A.H. Robbins Co.*, 607 F.2d 545, 552-53 (2d Cir. 1979); *Heit v. Weitzen*, 402 F.2d 909, 916 (2d Cir. 1968). Thus, the "fraud on the market" doctrine, which has simplified plaintiffs' burdens under Rule 10b-5, does not apply to § 18.

39. See *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439 (1994).

believe this analysis oversimplifies. The issuer's incentive to raise capital, they argue, is not constant, but episodic. Liability drives disclosure, they recognize, because managers often have interests that conflict with those of the corporation that cause them to suppress the disclosure of some negative information. Probably every experienced securities attorney has experienced this reluctance first hand.

From their more institutionally sensitive perspective, securities attorneys also raise a second common theme: '34 Act filings receive relatively low-level attention within the corporation, and interim filings, such as the Form 10-Q and the Form 8-K, tend not to be reviewed by the corporation's outside professionals. Even the corporation's outside independent accountant tends to focus on the annual audited financial statements and to overlook the interim quarterly reports. In contrast, '33 Act filings receive closer attention and more outside review. Traditionally, '33 Act due diligence was vastly superior to the limited due diligence performed on '34 Act filings by corporate insiders. However, with the partial integration of the federal securities laws effected by shelf registration, there has been increasing convergence between the '33 and '34 Acts' requirements and decreasing due diligence in connection with '33 Act filings.

Moving to a company registration system does not, however, inevitably entail acceptance of lower quality disclosure. Two basic approaches seem possible to enhance the quality of the existing periodic disclosure system. A substantive approach could require enhancements in the nature of the disclosures that must be made under the '34 Act. Alternatively, a procedural approach could impose additional requirements on the corporation's gatekeepers — its accountants, directors, attorneys, and other outside professionals — to upgrade the character of the due diligence review they give to the corporation's periodic filings. Both approaches have been discussed in detail at Advisory Committee meetings. Neither approach, however, is cost-free, and any significant new requirement is likely to elicit some controversy.

Two other sets of issues that will necessarily arise in the course of formulating any concrete proposal are also likely to generate controversy. The first involves eligibility for inclusion within the system: Should any company which registers under the '34 Act be eligible, or should eligibility be restricted to some narrower class of companies whose boundaries are more or less co-extensive with the contours of market efficiency? The second issue involves the best means of implementation: Should (or can) company registration be implemented through administrative rule-making, or is legislation necessary? As will be seen, the issue is not simply whether

Congress can be convinced to act, but whether an administrative system carries with it hidden costs in the form of increased liabilities.

It is easiest to approach these issues by first reviewing what the SEC has already done to move towards administrative implementation and then assessing what it could do further.

B. SEC Integration of the '33 and '34 Acts

For decades, the '33 and '34 Acts were administered independently and seemingly almost in oblivion of each other. Not only was duplicative information required under each, but the manner of its required presentation was different and terms used in common by both Acts were defined differently by each. Contemporaneously with the progress of the ALI Federal Securities Code during the late 1970s, the Commission began to pursue equivalency between transactional reporting under the '33 Act and periodic reporting under the '34 Act.⁴⁰ The Commission's basic strategy was to make the periodic reports filed under the '34 Act contain disclosure equivalent to that which would be in a '33 Act prospectus, and then to allow certain widely followed companies to incorporate by reference the information from their periodic reports into their prospectuses at the time they made a subsequent public offering.

The last step in this process was shelf registration. For decades, the SEC had resisted shelf registration of securities in excess of the amount that the issuer then intended to offer, for fear that advance registration would mean stale prospectuses.⁴¹ Integration of the '33 and '34 Acts solved this problem, at least in theory, because by incorporating subsequently filed '34 Act reports the prospectus would remain current. In 1983, the Commission accepted the arguments for shelf registration and broadened Rule 415 to permit an issuer to register up to approximately ten percent of its voting

40. The course of the transition is recounted in Proposed Comprehensive Revision to System for Registration of Securities Offerings, Securities Act Release No. 6235, [1980 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,649, at 83,484-90 (Sept. 2, 1980). See also Greene, *supra* note 9, at 76-94 (describing program designed to integrate information furnished by company under Exchange Act into registration statements required by Securities Act).

41. There was also a doctrinal obstacle. Section 6(a) of the '33 Act states: "A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." Securities Act of 1933 § 6(a), 15 U.S.C. § 77f(a) (1994). Early on, the SEC took the view that registration of more securities than were presently intended to be offered would be misleading. See *In re Shawnee Chiles Syndicate*, 10 S.E.C. 109, 113 (1941) (noting significance of assuring investors that registration statement and prospectus provide current information).

stock for sale in delayed "at the market" offerings.⁴² However, the issuer was required to certify that it "reasonably expected to . . . [offer and sell the amount so registered] within two years from the initial effective date of the registration."⁴³

Operationally, shelf registration meant that stock could be registered for up to two years in advance of its sale, with the incorporation of subsequently filed '34 Act reports being relied upon to keep the document current. Thus, in theory, issuers and underwriters did not need to worry about the delay, cost, and uncertainty incident to registration and SEC review because the stock could be pre-registered and sold on literally a moment's notice when market windows later appeared. Of course, the prospectus largely deteriorated into a legal fiction as a result of this transition. Only the one or two page summary table at the front of the typical Form S-3 registration statement is today coherent to the average investor. Shelf registration and incorporation by reference really implied that disclosure to the market through '34 filings replaced disclosure to individual investors through prospectuses.

In reality, shelf registration signaled the future supremacy of the '34 Act over the '33 Act. Thereafter, the Form 10-K became the principal disclosure filing and the prospectus became an appendage to it.

C. Limitations on Administrative Integration

Reports of the death of the '33 Act can be exaggerated. In truth, important and often cumbersome vestigial remnants of the '33 Act survive to complicate and possibly confound efforts at administrative integration. Three obstacles stand out: the prospectus delivery obligations of Section 5, the strict and vicarious liability provisions of Section 11, and the uncertain limitations of Section 6 on shelf registration. Collectively, they may preclude full integration of the two statutes through administrative rule-making.

First, Section 5(b) of the '33 Act requires the sending of a final prospectus to at least the initial purchasers of shares under a registration statement. Effectively, this delivery obligation has already been relaxed by Rule 174, which, in the case of reporting companies, suspends the obligation for

42. See Registration of Securities — Self Registration — Rule Adoption, Securities Act Release No. 6499, [1983-1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,499, at 86,335 (Nov. 17, 1983). For the 10% limitation, see Rule 415(a)(4)(ii), 17 C.F.R. § 230.415(a)(4)(ii) (1995).

43. Rule 415(a)(2), 17 C.F.R. § 230.415(a)(2) (1995).

dealers who are not members of the selling group to deliver prospectuses.⁴⁴ Yet, prospectus delivery remains an obligation for underwriters with unsold allotments. From a policy perspective, the prospectus delivery requirement seems an anachronism because the modern Form S-3 prospectus used in shelf registrations provides little intelligible information to the investors.

If the prospectus delivery requirement seems outdated, the liability provisions of the '33 Act are far more significant. Section 11 of the '33 Act imposes strict liability on the issuer and a form of vicarious liability for negligence on officers, directors, experts, underwriters and others. In addition, Section 12(2) creates negligence-based liability for those persons in privity with the purchaser, typically the underwriters. Thus, although '34 Act filings are the primary disclosure documents today, the incorporation by reference of '34 Act filings into the prospectus seemingly means that these documents now carry strict liability for the issuer.⁴⁵ To some probably minor extent, exemptive rules have softened this liability in the case of directors,⁴⁶ but no rule softens the risk of strict liability for the company whose '34 Act filings, prior or subsequent to the registration statement's filing, will be incorporated by reference.

Third, Section 6 of the '33 Act places uncertain limits on shelf registration. Shelf registration was long disfavored by the Commission, in part because of the statutory obstacle posed by the last sentence of Section 6(a), which states that: "A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered."⁴⁷ Early on, the SEC took the view that registration of more securities than were presently intended to be offered would be misleading.⁴⁸ When modern shelf registration was introduced in 1983, the SEC rationalized an end run around this doctrinal obstacle. Rule 415 today permits the issuer to register for "at

44. Rule 174 suspends the delivery obligation in the case of reporting companies for dealers, who are required to make delivery for specified periods by § 4(3) of the '33 Act, but does not apply to the unsold allotments of underwriters and selling group members. See Rule 174(f), 17 C.F.R. § 230.174(f) (1995).

45. There is some debate among practitioners as to whether § 11 liability actually applies to interim '34 Act filings, but all agree that it applies to the annual report on Form 10-K. See *infra* notes 61-66 and accompanying text.

46. See Rule 176, 17 C.F.R. § 230.176 (1995). Rule 176 says only that some specified factors are "relevant circumstances" for purposes of determining if a person has satisfied his or her due diligence defense under § 11(c) of the '33 Act. The rule appears not to have been interpreted by any case and is largely considered ineffective by the bar. See *infra* note 90 and accompanying text.

47. Securities Act of 1933 § 6(a), 15 U.S.C. § 77f(a) (1994).

48. See *In re Shawnee Chiles Syndicate*, 10 S.E.C. 109, 113 (1941).

the market" offerings only that amount that "is reasonably expected to be offered and sold within two years from the initial effective date of the registration,"⁴⁹ and in no event more than ten percent of its voting stock.⁵⁰ A full-scale company registration would eliminate both the two year and ten percent limitations, allowing the registration statement to be permanently "evergreen" and to register all the securities authorized to be issued under one or more classes. However, it remains uncertain whether the Commission has authority to dispense with Section 6(a) in this cursory fashion.

A related and even more technical problem surrounds Section 6(b) of the '33 Act, which mandates a filing fee "at the time of filing" of the registration statement equal to "one twenty-ninth of 1 per centum of the maximum aggregate price at which such securities are proposed to be offered."⁵¹ If an "evergreen" registration statement were to cover all authorized but unissued shares, the filing fee would be prohibitively inflated if the current market value of the stock were used; even then, it would be impossible to specify the actual offering price in the future. This language again suggests that the '33 Act as originally drafted never contemplated long-term shelf registration. Of course, legal fictions might be used: The fee might be based, for example, on the par value of the stock at the time of the filing, at least when no immediate offering was intended. This initial nominal fee could later be supplemented based on the actual offering price as individual offerings occurred. Does such a solution comply with the statute? Much depends on the degree of discretion the courts will give the SEC to relax the statute's commands and who they will recognize as having standing to object.

Of these problems, the prospectus delivery requirement is probably the easiest to address and solve. The term "prospectus" is broadly defined by Section 2(10) of the '33 Act to include, among other things, the confirmation of sale.⁵² Dealers will always mail a confirmation of sale even if SEC rules did not require them to do so, because under state law the receipt of the confirmation of sale by the customer solves the dealer's statute of frauds problem (unless the purchaser objects within a specified number of days after its receipt).⁵³ Thus, because the confirmation of sale both cannot be elimi-

49. Rule 415(a)(2), 17 C.F.R. § 230.415(a)(2) (1995).

50. See Rule 415(a)(4)(ii), 17 C.F.R. § 230.415(a)(4)(ii) (1995).

51. Securities Act of 1933 § 6(b), 15 U.S.C. § 77f(b) (1994) (as amended by Pub. L. No. 103-121, 107 Stat. 1153, 1168-69 (1993) and Pub. L. No. 103-352, 108 Stat. 3148 (1994)).

52. See Securities Act of 1933 § 2(10), 15 U.S.C. § 77b(10) (1994).

53. The statute of frauds makes an oral transaction for the purchase of securities above

nated and is already defined to be a prospectus, it could serve as the actual statutory prospectus. SEC rules could provide that a legend set forth on the back of the confirmation of sale, incorporating by reference the issuer's recent '34 Act filings, would qualify the confirmation of sale as a Section 10(a) prospectus.

One qualification to this analysis must be noted. Section 7(a) of the '33 Act requires that a registration contain the information specified on Schedule A to the '33 Act.⁵⁴ Much of this information is transaction-specific to the particular offering and is not contained in '34 Act filings (for example, underwriting discounts). If this information must be set forth in the registration statement, then the confirmation of sale would have to do more than simply incorporate '34 Act filings — it would have to include those items on Schedule A that had not previously been disclosed. In fact, however, there are several routes around this problem. Transaction-specific information about the offering could be set forth in a voluntary Form 8-K offering, which would be incorporated by reference. Or, the Commission could act pursuant to Sections 7(a) and 10(a)(4) of the '33 Act to "provide that . . . such information . . . need not be included in respect of" a defined class of eligible issuers.⁵⁵ Still another possibility is electronic disclosure through entry on a computer system to which the investor has access.⁵⁶ In any event, to the extent that the confirmation of sale will reach the typical investor after the investment decision, it is not clear that any information at this stage has much value. Put more simply, the anachronistic reality of the '33 Act is that it permits after-the-fact disclosure at a time when few will pay attention.

Although the prospectus delivery obligation can probably be abolished administratively by any of several routes, the cost to the issuer in these techniques is that they all seemingly extend Section 11 liability to all '34 Act

a defined dollar level unenforceable in most U.S. jurisdictions. Usually, the writing must be signed by the party to be charged (i.e., the buyer), but the U.C.C. treats a writing signed by the dealer as sufficient to make an oral agreement to purchase securities enforceable if the buyer does not object within a specified number of days after its receipt. See, e.g., N.Y. U.C.C. LAW § 8-319 (McKinney 1990). As a result, sellers have a strong incentive to mail a confirmation of sale.

54. See 15 U.S.C. § 77g(a) (1994).

55. *Id.* See also *id.* § 77j(a)(4) (1994) (authorizing Commission to omit information from prospectus that it determines "as not being necessary or appropriate in the public interest or for the protection of investors").

56. The SEC has already begun to accept this technique. See Joseph McLaughlin, *SEC Approves Use of Electronic Prospectuses and Proposes T+3 Relief*, INSIGHTS, Apr. 1995, at 3.

filings so incorporated by reference.⁵⁷ The result is an uncertain tradeoff: Although the issuer obtains instant access to the capital markets, any issuance of securities under a shelf registration statement creates Section 11 strict liability for the issuer and negligence liability for its directors and senior executives. Given such liability, issuers might prefer either to issue debt securities, which carry little practical risk of liability, rather than equity securities, for which the litigation risk is substantial, or to issue equity securities only under some statutory or jurisdictional exemption from registration. As a matter of social policy, however, such an incentive initially seems perverse, because it leads to debt-laden, riskier capital structures or to less disclosure to the market.

Can this problem be solved administratively? To a limited degree, the SEC might be able to reduce the scope of the registration statement and thereby minimize Section 11 liability. Section 7(a) of the '33 Act permits the Commission to exempt some categories of information from the registration statement "if it finds that the requirement of such information . . . is inapplicable to such class and that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement."⁵⁸ This exemptive authority might permit the Commission to exclude some categories of information from the registration statements, but the language of Section 7(a) does not give the Commission unlimited flexibility. For example, any attempt to reduce the registration statements based on the above quoted language from Section 7(a) must meet Section 7(a)'s express condition that the Commission, in waiving any item on Schedule A, find "that disclosure fully adequate for the protection of investors is otherwise required to be included within the registration statement."⁵⁹ In addition, Section 12(2) of the '33 Act also clouds the picture, because it focuses on the disclosure actually given to the investor, instead of simply the contents of the registration statement.

To sum up, the Commission could deem a confirmation of sale that incorporates all '34 Act filings to constitute a prospectus, thereby eliminating any meaningful prospectus delivery requirement; could specify that shelf registration statements would become effective upon filing without staff review; and could exclude some limited kinds of information from the

57. *But see infra* text accompanying notes 60-67.

58. 15 U.S.C. § 77g(a) (1994). Also, both § 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(4) (1994), and Regulation S, 17 C.F.R. §§ 230.901-230.904 (1995) provide obvious means by which to outflank § 11 liability.

59. *See* 15 U.S.C. § 77g(a) (1994). Thus, the Commission cannot simply define the registration statement to be co-extensive with the Form 10-K and include nothing else.

registration statement. However, it cannot shrink the registration statement so that it need not include clearly material information. These changes would give issuers instantaneous access to the capital markets, but liability concerns would remain. Section 11 is not easily outflanked, and Section 12(2) liability might also dissuade underwriters from relying on a scaled-back, minimalist registration statement.

D. Ambiguities in Shelf Registration

Although shelf registration of equity in "at the market" offerings has now been permissible for over a decade, some important ambiguities about its operation still remain. In particular, there is uncertainty about the meaning of "incorporation by reference." Item 12 to Form S-3 states that the prospectus incorporates all reports filed by the issuer pursuant to the '34 Act and "all documents subsequently filed by the registrant pursuant to Sections 13(a), 13(c), 14 or 15(d) of the Exchange Act prior to the termination of the offering."⁶⁰ But what does this mean? Some practitioners argue that "incorporation by reference" of '34 Act filings means only that such documents are incorporated into the prospectus and so carry Section 12(2) liability, but, with the exception of the Form 10-K, are not incorporated into the registration statement, in which event they would also carry Section 11 liability.⁶¹ Their position rests on the fact that, after the effectiveness of the registration statement, only the subsequent filing of a Form 10-K is deemed an actual amendment to the registration statement, which changes the effective date of the registration statement.⁶² Section 11(a) of the '33 Act indicates that Section 11 liability arises with respect to "any part of the registration statement" only as of the time "when such part became effective."⁶³ This language therefore makes it necessary to find that the registration statement somehow "became effective" as to the subsequent '34 Act filing as of the date of its filing before Section 11 liability can logically attach to this filing. Historically, only a post-effective amendment to the registration statement was deemed to change the time of its effectiveness.

60. See Item 12 to Form S-3, 17 C.F.R. § 239.13 (1995).

61. For this suggestion, see William J. Williams, Jr., *Problems in the Application of the Securities Act of 1933 and Rules Thereunder to Shelf Offerings*, in 14TH ANNUAL INSTITUTE ON SECURITIES REGULATION 293, 297 (1982).

62. See Item 512(b) to Regulation S-K, 17 C.F.R. § 229.512(b) (1995). The point of Item 512(b) is to restart the statute of limitations under § 13 of the '33 Act so that it cannot run before the actual offering is accomplished, which in its absence would be a possibility.

63. See 15 U.S.C. § 77k(a) (1995). In short, the argument runs that for a post-effective statement or filing to carry § 11 liability, there must be a new effective date.

In truth, however, incorporation by reference is neither fish nor fowl. The traditional practice with respect to most post-effective date developments has been to insert a "sticker" or prospectus supplement into the prospectus, instead of filing a post-effective amendment to the registration statement, unless the change was truly fundamental in character.⁶⁴ Clearly, such stickers do not carry Section 11 liability. By analogy, proponents of this view argue that documents incorporated by reference also should not trigger Section 11 unless the registration statement is amended at the time they are filed, which would give rise to a new effective date.⁶⁵

This position oversimplifies, however, particularly in view of Rule 439, which refers to all subsequently filed documents as incorporated into the registration statement, not the prospectus.⁶⁶ In addition, Regulation S-K clearly expresses the view that periodic reports filed under the '34 Act are a substitute for the post-effective amendments that would otherwise be necessary to reflect "a fundamental change in the information set forth in the registration."⁶⁷ This equivalence between periodic reports and post-effective amendments suggests that both were intended to carry Section 11 liability.

Nonetheless, the SEC's rules are imprecise. Prior to the advent of shelf registration, incorporation by reference inherently referred to previously filed documents, which were deemed to be part of the registration statement as of the time of its effectiveness and so carried Section 11 liability. With the advent of shelf registration for "at the market" offerings, the staff failed to clarify that documents incorporated by reference into the registration statement, not simply the prospectus, would carry Section 11 liability. As Rule 439 implies, each subsequently filed '34 Act filing should be viewed

64. See Item 512(a)(1)(ii) to Regulation S-K, 17 C.F.R. § 229.512(a)(1)(ii) (1995).

65. Under Rule 424, prospectus supplements and stickers must be filed with the SEC within a specified number of days following their first use after effectiveness. See Rule 424(b)(4), (c), 17 C.F.R. § 230.424(b)(4), (c) (1995). Rule 424 does not deem the sticker or supplement to be part of the registration statement.

66. See 17 C.F.R. § 230.439 (1995). Rule 439 states in part that where material is to be incorporated by reference into the registration statement, such as subsequent '34 Act filings, and filed written consent is required, such consent shall be filed as an amendment to the registration statement. *Id.* Because Rule 439 speaks of documents being incorporated into the registration statement, instead of simply into the prospectus, it implies that such documents are to carry § 11 liability. Note also that the instruction to Item 12 to Form S-3 specifically states: "Attention is directed to Rule 439 regarding consent to use of material incorporated by reference." Item 12 to Form S-3, 17 C.F.R. § 239.13 (1995). The SEC normally uses consents to document that the consenting person has accepted § 11 liability.

67. Item 512(a)(1)(ii) to Regulation S-K, 17 C.F.R. § 229.512(a)(1)(ii) (1995).

as the equivalent of an amendment, although not one that starts the statute of limitations over, except in the case of the Form 10-K.

Still, there is a potential gap here and a need to clarify the nature of liability for documents incorporated by reference. If a '34 Act filing were incorporated only into the prospectus and not into the registration statement, the consequence would be Section 12(2) liability, but not Section 11 liability, with regard to the incorporated document. Because Section 12(2) applies only to persons in privity with the issuer and those who solicit the sale,⁶⁸ a consequence could be that the issuer might escape liability under the '33 Act.

E. A Public Policy Perspective: How Far Should Integration Go?

The case for company registration is not unanswerable. Potentially countervailing concerns suggest that pursuit of integration between the '33 and '34 Acts will be costly to some investors. At least three such concerns need to be answered before the '33 Act can be safely dismantled for seasoned issuers. First, a plausible case can be made for transaction-specific disclosure aimed at the individual investor, at least with respect to major securities issuances. Second, dismantling '33 Act disclosure may also undercut and eliminate the underwriter's role as a "gatekeeper" (or third party enforcer) by eliminating any realistic opportunity for the underwriter to engage in due diligence. Third, facilitating direct issuer access to the market may produce changes in market structure, including direct issuer penetration of the secondary market. Whether these changes would be desirable requires some analysis.

1. The Limited Case for '33 Act Disclosure

Even once a company has become subject to the '34 Act, two distinct arguments can be made for the continued relevance of the '33 Act's disclosure system. First, "transaction specific" disclosures may sometimes be necessary because they represent material information that has not been previously released pursuant to the '34 Act's continuous disclosure system. Second, disclosure to the individual investor is desirable to the extent that the individual investor needs unique information for his own subjective evaluation, which he cannot gain from even an efficient market's reaction to the issuer's disclosures. However, these concerns justify at most only modest inroads upon the concept of company registration.

68. See *Pinter v. Dahl*, 486 U.S. 622 (1988) (holding that only persons who solicit sales in order to serve financial interests of seller or personal financial interests are liable under § 12).

"Transaction-specific" disclosure is desirable when the issuance of securities fundamentally changes the capital structure of the corporation and thereby renders existing '34 Act filings out of date. For example, a corporation could have filed its most recent Form 10-Q several months ago. Informed only to this extent, investors would have no ability to understand or appraise the significance of the facts that the current transaction would fundamentally alter the corporation's debt-equity ratio, that the proceeds would be used to enter an entirely new line of business, or that most of the shares being sold belonged to insiders who seemed to be bailing out of the corporation. In short, past '34 Act filings alone do not describe a changing corporation, and a corporation issuing securities is typically a changing corporation.

This argument can be addressed in a variety of ways. For example, a new '34 Act filing (perhaps a Form 8-K) could be required whenever new material developments had transpired or would be caused by the offering. This new filing could be made on the eve of the offering and would then be incorporated by reference on the one-page confirmation of sale, which would also constitute the statutory prospectus. Thus, it would still be possible to reduce the prospectus to a one-page document.

A stronger case can be made for disclosure aimed at the individual investor to the extent that investor attitudes toward risk are necessarily subjective. Disclosure to the individual investor is necessary, even in an efficient market that has absorbed and impounded all information into price, because the taste for risk is personal, whereas the market's reaction is risk neutral. A risk averse investor may wish to avoid high-risk stocks even if they are efficiently priced to reflect their value to a basically risk-neutral market. For example, both a conservative low-growth, low-risk public utility and a high-growth, high-risk "biotech" stock with only a fifty percent chance of surviving the next three years could trade at \$50 per share. In neither case does the market price fully impound the significance of the security's risk to investors who have either a taste for risk or, more likely, an aversion to it. To be sure, bond rating agencies concisely provide such risk information in the case of debt securities in an easily digestible form (i.e., a bond rating between "AAA" to "BB") that could be set forth even on a single-page prospectus. However, in the case of equity securities some substitute is necessary to provide a fuller sense of the risk-return profile of the company, even in an efficient market.

Valid as this argument may be in theory, it probably requires no more than a modest adjustment in the company registration scheme. Seasoned issuers are typically not high-risk stocks and the investor can consult the

company's publicly available annual report to gain a sense of the riskiness of most seasoned issuers. Moreover, the sale of equity tends to reduce risk, not increase it. Thus, the risk-averse investor is really exposed only if the risk level has changed significantly and recently. Relatively few offerings will change the issuer's risk level in such a manner as to necessitate individualized disclosure under the foregoing premises, but some indication of any significant deterioration in the company's risk level might be the one item of substantive information that should be contained on even a condensed one-page prospectus.

2. *The Underwriter as Gatekeeper*

Reducing the '33 Act also inevitably reduces the role of the underwriter. In a compressed time period, the underwriter cannot conduct the same "due diligence" investigation that the '33 Act intended in its provision for a "due diligence" affirmative defense to civil liability under Sections 11 and 12(a). This point was elaborately debated when the SEC adopted Rule 415 in 1983. One side argued that underwriter due diligence was not worth its cost; thus, the SEC should exempt underwriters from their due diligence obligations for "all offerings into an efficient market."⁶⁹ Taking a broader view of the market, the other side saw due diligence as producing a real societal benefit: reduced agency costs. By increasing the accuracy of individual securities prices, due diligence "influences the decisions of corporate management in ways that increase the efficiency with which scarce resources are allocated."⁷⁰

Who is right? Much depends on one's view of what the market is supposed to accomplish. From a simple portfolio perspective, investors do not necessarily benefit from due diligence because, although it may improve the accuracy of the prices of individual securities, any inaccuracies tend to cancel out at the portfolio level. Thus, skeptics of due diligence argue that investors, who typically hold diversified portfolios of securities and not just individual stocks, would not want to expend real resources just to adjust the relative values of stocks in their portfolios. Proponents of due diligence

69. See Barbara A. Banoff, *Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415*, 70 VA. L. REV. 135, 184 (1984). Professor Banoff argues that if "investors were given a choice, they would not pay underwriters a premium to insure them against company-specific risk." *Id.* at 183. This argument is, of course, based on an assumption that investors are diversified, because company-specific risk tends to cancel out at the portfolio level.

70. Merritt B. Fox, *Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis*, 70 VA. L. REV. 1005, 1010 (1984).

reply that changing the price of a stock disciplines its management and increases efficiency across the portfolio.

This latter view sees the securities market not simply as a fair game or as an attempt to achieve a portfolio rate of return, but as a lever by which to increase corporate efficiency. Due diligence then not only makes securities pricing more accurate, but over the long run disciplines management and fosters corporate accountability.⁷¹ From this perspective, an underwriter is more than a risk-bearing financial intermediary who helps effect the distribution of securities to the market. Rather, the underwriter is a disciplinary force — a "gatekeeper."⁷² Interestingly, modern scholarship on underwriters has emphasized that their real function is less risk-bearing — indeed, they take little risk because they typically have commitments for their allotments before they buy them — than certification of the integrity of the offering.⁷³ That is, by its association with a securities offering, a high prestige underwriter places its "seal of approval" on the offering. In "law and economics" shorthand, the underwriter pledges its reputational capital and thereby becomes a reputational intermediary.

Yet, it is exactly this role that is eclipsed as the '33 Act's disclosure system is dismantled in favor of the '34 Act's continuous disclosure system. If issuers are permitted to issue securities based only on a "notice" filing, there would be little justification for retaining the provision in current Rule 415 that requires the issuer in a shelf registration to use an underwriter in an "at the market offering" of equity securities.⁷⁴ If such a requirement ever made sense, it no longer does once the underwriter is not in a position to conduct due diligence.

When Rule 415 was adopted in 1983, the same arguments were made that due diligence would be eclipsed by shelf registration. The SEC responded with the claim that advance due diligence could be performed by underwriter's counsel. Although there have been no memorable scandals in the dozen years during which shelf registration has been in force, it is clear

71. See *id.* at 1018-22; see also Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. CHI. L. REV. 1047, 1105-11 (1995).

72. See Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Control*, 93 YALE L.J. 857, 890-91 (1984). As a definitional matter, the "gatekeeper" must not have a large financial stake in the success of the offering or venture, but must be subject to special, and usually statutory, liabilities that give this person a strong incentive to monitor for law violations by others and little incentive to cheat itself.

73. See Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 613-21 (1984).

74. See Rule 415(a)(4)(iii), 17 C.F.R. § 230.415(a)(4)(iii) (1995).

today that advance due diligence, at least by disinterested persons, is more the exception than the rule. Even when such investigation occurs, the reputational capital involved may be more that of the law firm, serving as agent of the underwriter, than that of the underwriter, as principal. Perhaps irretrievably, underwriters have lost their role as reputational intermediaries in shelf registrations. Indeed, shelf registration has encouraged the growth of a new distribution technique — the "bought deal," which is in reality a more or less direct sale from the issuer to a group of institutions that involves only a token role for the underwriter.⁷⁵

The actual experience with Rule 415 has, however, resulted in a puzzle. Despite the quick market access and obvious cost savings made possible by the rule, equity shelf registration remains rare.⁷⁶ Some explain this phenomenon in terms of the market's greater negative reaction to the announcement of a shelf offering, which negative reaction, they believe, exceeds the cost savings from the rule.⁷⁷ Because investors tend to perceive the announcement of an equity offering to signal that the issuer's stock is probably overpriced, the role of underwriters in such a context is to certify that the post-offering announcement corrected market price is accurate in light of management's implicit concession that the prior market price was excessive. As a repeat player who has both reputational interests and high liability, it can potentially provide a credible certification to this effect. But, it can do this less well in the shelf registration context, where it cannot perform a meaningful due diligence investigation. Hence, its lesser ability to provide a credible certification in this context arguably leads to a more negative market reaction, which chills the use of the shelf registration vehicle for equity offerings.⁷⁸ "Bought deals," however, survive because the institutional buyers in them can directly negotiate with the issuer for con-

75. See RICHARD W. JENNINGS ET AL., *SECURITIES REGULATION: CASES AND MATERIALS* 584-85 (1992) (describing "bought deal").

76. See David J. Denis, *Shelf Registration and the Market for Seasoned Equity Offerings*, 64 J. BUS. 189, 191-95 (1991). Indeed, such offerings have decreased since the initial period following Rule 415's adoption. *Id.* at 190.

77. *Id.* at 197-98.

78. See David W. Blackwell, *Shelf Registration and the Reduced Due Diligence Argument: Implications of the Underwriter Certification and the Implicit Insurance Hypothesis*, 25 J. FIN. AND QUANTITATIVE ANALYSIS 245, 250-58 (1990) (providing view that market reaction is more negative in response to equity shelf registration statement and that this causes issuer to prefer traditional distribution techniques). Others argue that this market reaction results in a premium charged by the underwriters that exceeds the protection they provide investors. See David M. Greene, Comment, *Due Diligence Under Rule 415: Is the Insurance Worth the Premium?*, 38 EMORY L.J. 793 (1989).

tractual covenants and other assurances that protect them at least as well as the underwriters' reputational pledge.

All in all, this evidence suggests that it is costly to structure the system so that no one is well positioned to perform the certification function. If underwriters cannot do it within the time constraints they are given, other reputational intermediaries need to be identified and their services induced. This is a topic to which we will return shortly.

3. Market Structure

When shelf registration was first proposed in the early 1980s, it nearly foundered on the fear of underwriters and broker-dealers that it would disrupt and revise the structure of the securities markets in a manner adverse to them. A variety of concerns were raised: Issuers might sell their equity securities directly to the specialists on the stock exchange, thereby resulting in a de facto merger of the primary and secondary markets; small, regional underwriters would be excluded from the underwriting process because there would not be time to assemble the traditional large selling group; and individual investors would be excluded from primary offerings via shelf registration for similar reasons because underwriters would find it quicker and easier to sell to institutions in "bought deals."⁷⁹ In all likelihood, shelf registration probably has encouraged greater concentration within the securities industry, but few seem alarmed about this tendency in what is clearly a very competitive marketplace.

Arguably, the fears expressed in the early 1980s now look more like self-interested rationalizations than prophetic warnings. From this perspective, the greater danger may be that company registration will provide the opportunity for rent-seeking by highly organized special interests. To a degree, this already happened when shelf registration was originally adopted. Rule 415 requires that an "at the market offering" be "sold through an underwriter," thereby precluding direct issuer sales to institutional investors.⁸⁰ With some justification, a cynic could describe this requirement as a full-employment act for underwriters, who otherwise were prepared to fight the adoption of shelf registration vehemently. Indeed, it is particularly

79. Many of these concerns were voiced by then-SEC Commissioner Barbara Thomas in her dissent to the shelf registration release. See *Delayed or Continuous Offering and Sale of Securities*, Securities Act Release No. 6423, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,250, at 85,281-84 (Sept. 2, 1982) (dissent of Commissioner Thomas). For a differing view, see Banoff, *supra* note 69, at 145-54.

80. See Rule 415(a)(4)(iii), 17 C.F.R. § 230.415(a)(4)(iii) (1995).

hard to justify the mandatory presence of an underwriter when shelf registration almost by definition eliminates any opportunity for them to play a meaningful gatekeeper role.

The counterargument to this rent-seeking hypothesis starts from the limited use still made of shelf registration for equity offerings. Arguably, the market fears something and, unless its fears are assuaged, the greater negative stock price reaction to a shelf registration will cause issuers to stick to traditional distribution techniques. From this perspective, there is a market demand for due diligence and for a gatekeeping role for underwriters that current institutional arrangements are not satisfying.

What would solve this need? Some have argued that a brief pause between the announcement of the offering and actual sales thereunder would provide time for due diligence.⁸¹ But, while such prior announcement would alert the market, it might be too little time for meaningful due diligence; indeed, the required announcement might only make certain that the market would note and respond negatively to the offering. The greater need may be for an institutional structure in which institutional purchasers can directly negotiate with the issuer for contractual protections and assurances. Possibly, the requirement in Rule 415 that the underwriter act as a principal may interfere with such direct negotiations.⁸² In any event, for whatever reason, such direct negotiations appear to occur only in transactions that are sold privately, even if, as in PIPE transactions, they are later publicly registered for resale.

IV. *The Problem of Liability*

What if the SEC gave a party and no one came? This is a critical dilemma in formulating a company registration model because, so long as it is voluntary, there is a significant risk that companies may decline to elect into it. For example, if a "universal" company registration model were but one option among several, with existing Form S-3 being another, and if the election of company registration precluded a company from relying on existing exemptions (such as the private placement and Regulation S exemptions), many companies might well decide to remain with the existing Form S-3 and not accept any "universal" registration system that chilled their ability to make exempt offerings.

81. See Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 823 (1985) (proposing one or two day "cooling off" period between announcement and sales).

82. See Rule 415(a)(4)(ii), 17 C.F.R. 230.415(a)(4)(ii) (1995).

Initially, issuers' primary concern with company registration might be the risk of '33 Act liabilities. Today, in a private placement or in a Regulation S extraterritorial offering, the issuer may face liability under Rule 10b-5, but need not fear liability under Sections 11 or 12(2) of the '33 Act.⁸³ Equally important, its officers and directors face very little prospect of liability on any basis because of the effective abolition of "aiding and abetting" liability by the Supreme Court in its 1994 *Central Bank* decision.⁸⁴ In contrast, in a registered offering, Section 11's applicability means that the issuer faces strict liability and its directors and principal officers confront vicarious liability under a statutory system that shifts the burden of proving nonnegligence to them as an affirmative defense. As a result, the unfortunate choice today may be between too much liability under Section 11 and too little liability in a private placement subject only to Rule 10b-5.⁸⁵

A plausible rebuttal can be framed to this claim that the threat of Section 11 liability will deter issuers from adopting a company registration system: Namely, the issuer fares no better in private placements. That is, in private transactions, the institutional purchasers extract elaborate covenants and detailed representations and warranties from the issuer during long and intensive negotiations; collectively, these private terms leave the issuer in about the same position as if it were strictly liable under Section 11 for any material misstatement or omission. True as this may sometimes be, this response is incomplete in two respects. First, even if the issuer, itself, faces the equivalent of strict liability in private deals because of contractual covenants, its officers and directors do not; their exposure is much greater in registered transactions. Second, issuers do escape strict liability in some unregistered deals. Both Regulation S and Rule 144A provide examples, because these transactions are typically underwritten, with the underwriter buying from the issuer on a firm commitment basis and reselling to institutional purchasers. In such underwritten deals, no direct

83. See *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1065-71 (1995) (implying that § 12(2) does not apply to private placement offering brochures or documents other than prospectus contained in registration statement filed with SEC).

84. See *Central Bank v. First Interstate Bank*, 114 S. Ct. 1439, 1445-55 (1994).

85. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1995), may actually create a disincentive that deters issuers and others from engaging in due diligence. Because its scienter requirement requires at least proof of recklessness, the defendant who is ignorant — even as a result of gross negligence — is in theory safe, while the defendant who conducts a factual investigation and learns from it enough to be deemed consciously aware of a material risk of inaccuracy may be far more exposed. Perversely, under such a structure, ignorance becomes bliss.

privity exists between the issuer and the institutional investors who buy its securities.

Puzzling as it may be that the formal structure of the transaction determines the issuer's actual liability, the net result is nonetheless that the issuer has an incentive to prefer private deals, in which its liability is less. A possible explanation for this puzzle may be that in private transactions the purchaser, or its agents, has a greater opportunity to conduct "hands-on" due diligence and to receive private information (forecasts, estimates, and valuations) that the issuer would feel uncomfortable including in a registration statement. This greater opportunity for verification and forward-looking information may be more important to some investors than the differential in liability rules between private and public transactions. Indeed, the recent popularity of PIPE transactions — in which an issuer places equity securities privately with institutional investors but agrees to register immediately their stock for resale under a shelf registration statement⁸⁶ — could be evidence of this preference. If so, the bottom line is that there may be multiple incentives leading issuers today to use private markets — and thus to be reluctant to adopt a system that requires them to forego such use.

What policy responses therefore make sense? On the simplest level, proposals to curb the severity of Section 11's *in terrorem* threat are at least reasonably related to the need to make company registration more attractive to seasoned issuers. Once again, however, the chief problem lies in how far the SEC can go in this direction in the absence of legislation. Presumably, any SEC proposal to soften Section 11 would focus on outside directors, rather than the issuer, insiders, or underwriters. Those who have studied securities litigation report an uneasy sense that settlements occur on a basis that is unrelated to the actual merits of the litigation, apparently, they believe, because of the risk aversion of individual defendants.⁸⁷ Even if these assessments have sometimes been overstated, such risk aversion is perfectly rational and should be most pronounced in the case of the outside directors. If directors face personal liability which they can escape by causing the corporation to reach a settlement with the plaintiff's attorneys (which settlement need not benefit shareholders), it is perfectly rational in economic terms for defendant directors to use the shareholders' money to settle their own personal liabilities — even when the risk of liability is modest, at least if we assume that the directors are not substantial shareholders in the cor-

86. See *supra* note 16 and accompanying text (explaining PIPE transactions).

87. See Janet C. Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 566-68 (1991).

poration.⁸⁸ The result could be that high potential liability for directors may produce excessive litigation that does not advance, and may injure, shareholder interests. Of course, the optimal level of liability is difficult to prescribe in theory and probably impossible to specify in practice.

Nonetheless, there is at least a plausible case for mitigating the liability of directors and an even higher probability that, absent such an effort, company registration will prove unattractive to many companies. What can be done in practical terms? When the SEC first implemented integrated disclosure, it made a valiant but seemingly futile effort in adopting Rule 176. Essentially, Rule 176 identifies a limited number of factors that constitute "relevant circumstances" for the purpose of determining whether a defendant has satisfied the "due diligence" defense provided by Section 11(b)(3) of the '33 Act.⁸⁹ At best, Rule 176 is an ineffective provision, which appears never to have produced a pre-trial dismissal in a reported case since its adoption more than a decade ago.⁹⁰

Still, Rule 176 could be strengthened. Unfortunately, there seems no way to shift the burden to the plaintiffs on due diligence because the burden is specified by the statute itself. Nonetheless, one possibility is to accord outside directors a reliance defense resembling that under state law where a committee of directors — possibly the audit committee or a subcommittee thereof — has attempted to verify the adequacy and accuracy of the company's '34 Act filings.⁹¹ Such a defense would be available to the other

88. As defendants become larger shareholders, they bear more of the cost of a corporate-funded recovery. Even as a group, directors are usually not substantial shareholders in a seasoned S-3 level company. In contrast, they may be in IPOs, and thus this justification does not apply as well in that context.

89. See 17 C.F.R. § 230.176 (1995). For the release proposing Rule 176, see Treatment of Information Incorporated by Reference Into Registration Statements, Securities Act Release No. 6335, 1981 WL 31062 (Aug. 6, 1981).

90. I base this statement on a word search of "Rule 176" in the LEXIS "Genfed" and "Fedsec" libraries. It is, of course, possible that there are unreported decisions involving Rule 176 or decisions not picked up by LEXIS.

91. In some state jurisdictions, the reliance defense has been codified in the state corporations code. See, e.g., N.Y. BUS. CORP. LAW § 715(h) (McKinney 1986); DEL. CODE ANN. tit. 8, § 141(e) (Michie 1991); REVISED MODEL BUSINESS CORP. ACT ANN. § 8.42(b) (Comm. on Corp. Laws, Am. Bar Ass'n, Supp. 1995). The reliance defense has long been recognized by the case law. See PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.02 (Am. Law Inst. 1994); *Spirit v. Bechtel*, 232 F.2d 241, 247 (2d Cir. 1956); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1174-75 (Del. 1995). Reliance, of course, must be reasonable to be protected, and it must be in good faith. The reliance defense is today partially recognized by Rule 176(f), which does not, however, refer to board committees. 17 C.F.R. § 230.176(f) (1995).

directors even if the "due diligence" actually performed was inadequate; the issue rather would be the reasonableness of the delegation of authority and the absence of evidence from which these directors should have inferred that adequate efforts were not being made.

Grafting such a "reasonable reliance" defense onto Section 11(b)(3) is, however, a delicate matter because the "due diligence" defense provided in that section requires not only that the director have a "reasonable ground to believe" in the accuracy of the registration statement's factual statements, but that the individual director conducted a "reasonable investigation" in reaching that conclusion.⁹² In short, some inquiry must have been made by the outside director; good faith alone is not enough. Possibly, however, the defense could be crafted so that the outside directors would receive annual or periodic reports from the auditors, outside counsel, and the disclosure committee about their activities in verifying the company's interim '34 Act filings. Such an inquiry could be defined by the SEC to constitute a "reasonable investigation" in the absence of contrary information.

A related and supplementary protection would be to state expressly in Rule 176 that the size of the offering is a factor to be considered in evaluating the adequacy of due diligence efforts.⁹³ Put simply, cost considerations cannot be ignored in this context.

Even if such an updated and revised "due diligence" defense were adopted, it is uncertain whether it would be sufficiently attractive to issuers to lead them to adopt company registration. First, the issuer still has strict liability under Section 11. Second, some outside directors would have to serve on this special committee and they might perceive their role to resemble that of sacrificial lambs for the rest of the board. In truth, however, this proposal is more than a cosmetic defense — it is an attempt to institutionalize a permanent "due diligence" organ within any corporation that elects a company registration model. In this light, its most basic premise is that specialization is necessary if the modern board of directors is to be able to meet the standards specified for due diligence in the '33 Act. Of course, such a committee would be voluntary and not mandatory, but those corporations that did not create such an organ would receive only the very modest, and probably negligible, protections of current Rule 176.

92. 15 U.S.C. § 77k(b)(3) (1994).

93. This suggestion was made as a formal recommendation at the Fifth Annual Government-Business Forum on Small Business Capital Formation in 1987, but was never acted upon by the SEC. See Fifth Annual Government-Business Forum, Securities Act Release No. 6689, [1987 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,102, at 88,520 (Feb. 6, 1987).

*V. An Alternative Approach: Deregulating the
Private Placement Exemption*

A. The Uncertain Tradeoff Between Liability and Illiquidity

Faced with a substantial prospect of liability under the '33 Act if it makes a public offering of its equity securities, an issuer that is eligible to use company registration will predictably compare the costs and risks of a public offering under the '33 Act against those of the most logical alternatives: a private placement or some other exempt offering such as an extra-territorial offering under Regulation S. The comparison may well be a close one, in part because of a factor not yet assessed. Although an issuer who conducts a private placement in conformity with Regulation D or an extra-territorial offering under Regulation S thereby avoids the prospect of potential liability under both Section 11 and Section 12(2),⁹⁴ the use of these exemptions is not costless to the issuer. In each case, the buyer must accept a period of illiquidity before it can resell the securities purchased in a private placement or Regulation S offering in the U.S. secondary markets. Consequently, there is usually an illiquidity discount that the issuer of privately placed securities bears. The resulting trade-off between liability and illiquidity seems uncertain.

Once, when privately placed securities could not be safely resold for a period of three years or more, this discount was substantial. With the adoption of Rule 144, however, the period of illiquidity was reduced to two years⁹⁵ and the discount has correspondingly shrunk. In 1995, the Commission proposed to reduce the holding period under Rule 144 from two years to one year for non-affiliates of the issuer.⁹⁶ If this proposal is adopted, the illiquidity discount will shrink even further. In consequence, private placements may become an even more attractive alternative.

If the Commission wished to reduce the size of the illiquidity discount, there is an obvious policy prescription by which it could do so. Under Rule 144A, certain institutional purchasers of privately placed securities, known

94. Until recently, private placements were subject to § 12(2). However, in *Gustafson v. Alloyd Co.*, 115 S. Ct. 1061, 1063 (1995), the Supreme Court found that § 12(2) applies only to the prospectus contained within the registration statement.

95. See Rule 144(d)(1), 17 C.F.R. § 230.144(d)(1) (1995). Moreover, the current holding period allows a holder of the restricted securities to "tack" the holding periods of earlier holders of the same security, who have made private sales to such person.

96. See *Revision of Holding Period Requirements in Rule 144*, Securities Act Release No. 7187, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 85,638, at 86,882 (June 27, 1995).

as "Qualified Institutional Buyers" (QIBs), can freely trade restricted securities among themselves.⁹⁷ As a result, when equity securities are sold to QIBs, there is believed to be little or no discount because the buyers do not truly accept any significant period of illiquidity. However, not all equity securities qualify for Rule 144A. Surprisingly, small non-reporting U.S. firms and foreign issuers can use Rule 144A, but not domestic companies that have a similar class of equity securities listed on a stock exchange or NASDAQ.⁹⁸ Known as the "fungibility" exclusion, this rule has the paradoxical effect of permitting secondary trading among QIBs in non-public companies, about whom there is little current information publicly available, but precluding such trading in cases where precisely such information is available.

On its face this seems backward: Securities in a high-risk venture capital company can today freely trade among QIBs, but not the common stock of IBM, G.M. or AT&T. Liberalized secondary trading of restricted securities seems most appropriate in the case of seasoned companies about whom abundant information is publicly available. The SEC has taken this contrary and illogical position basically because the SEC fears the creation of shadow private markets in which securities that are also traded in public would trade at lower prices.⁹⁹ Politically, it could embarrass the SEC if a class of securities could be purchased by QIBs at a lower price in private markets than the public investor could buy in the public markets. Allegations might then be raised of favoritism. Also, the stock exchanges, a powerful interest group, opposed extending Rule 144A to publicly traded securities for fear of losing illiquidity in transactions from their markets.¹⁰⁰ Thus, to protect itself, the

97. See Rule 144A, 17 C.F.R. § 230.144A (1995). The definition of "qualified institutional buyer" is in Rule 144A(a)(1) and requires the institution to own and invest on a discretionary basis at least \$100 million in securities that are not affiliated with the institution. *Id.* § 230.144A(a)(1).

98. See Rule 144A(d)(3)(I), 17 C.F.R. § 230.144A(d)(3)(I) (1995). For an explanation of the Commission's rationale, see Resale of Restricted Securities, Securities Act Release No. 6839, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,427, at 80,221 (July 11, 1989) (discussing fears that "side-by-side" public and private markets would develop, but indicating Commission's view that this development was "unlikely").

99. See Resale of Restricted Securities, Securities Act Release No. 6839, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,427, at 80,221 (July 11, 1989).

100. In contrast, NASDAQ established "The Portal Market" to trade restricted securities eligible for Rule 144A. Between its inception in June 1990 and August 1994, NASDAQ has processed over 1,000 applications for listing in Portal. See Rule Change Relating to Security Application Fee for the Portal Market, Exchange Act Release No. 34,562, 1994 WL 466868, at *3 (Aug. 19, 1994).

SEC made Rule 144A available only for securities that do not trade in public markets. This restriction prevents arbitrage between these two markets with institutions buying low in private markets and reselling high in public ones.

Still, the SEC's underlying scenario is flawed. The perceived unfair advantage that QIBs receive by being able to buy more cheaply in private markets results chiefly from the fact that they also bear a period of illiquidity. In general, the greater or lesser the liquidity restriction imposed by law, the greater or lesser the price discount that institutions will demand and receive from issuers. Thus, if this period of illiquidity were reduced, the illiquidity discount would also predictably decline and the gap between the public and private prices would largely close in the case of seasoned companies.¹⁰¹ Hence, shortening the holding period for privately placed securities under Rule 144 and rescinding Rule 144A's fungibility doctrine so as to permit active secondary trading among QIBs, even during that reduced holding period, might represent a very sensible public policy, at least to the extent that it could make private markets more attractive to some issuers. Some illiquidity discount might remain, but the higher transaction costs and liability concerns associated with public offerings might make issuers content to bear this discount.

In short, if the goal is to encourage capital formation, it is not self-evident that company registration will produce greater gains than those that might result from liberalizing the private placement exemption. Company registration has been partially in force since the early 1980s, and the marginal gains of extending it across the board today might be small. Conversely, however, the capacity of private markets to handle any sizeable increase above the volume of equity securities that they today absorb is also uncertain. These two alternatives — company registration and the expanded availability of private markets — are not necessarily mutually exclusive. No public choice is necessary between them, and both approaches could in principle be pursued at once.

B. Curtailing the Private Placement Exemption

Nonetheless, the predictable bureaucratic response to the possibility that corporate issuers might prefer to use private markets than to adopt company

101. Some discount might remain to reflect the lower transaction costs in private placements and/or the lower liability risks faced by issuers in such deals. In theory, the issuer would pass on some of its cost savings to the investors in these transactions to induce them to purchase in private deals.

registration is to preclude any choice. Put simply, an eligibility condition to company registration could be imposed that denied issuers the ability to make private sales of equity based on statutory exemptions. Some on the SEC Advisory Committee favor this approach, which could be enforced by requiring those who elect company registration to forego use of statutory exemptions, for equity sales; the penalty would be a two-year suspension of the availability of shelf registration if this condition were violated. Once again, however, the net result may be to make a company registration system unattractive to most eligible issuers.

Although the SEC seemingly has the power to condition shelf registration on virtually any terms it wants that are related to the purposes of the federal securities laws, such a draconian approach seems unwise. To begin with, there are a variety of reasons unrelated to litigation risks or cost savings why a corporate issuer may reasonably want to make private sales. One such example involves a company in possession of private material information about itself that it does not wish to disclose to the world for sensible business-related reasons, but which it is willing to disclose to purchasers in a private transaction.¹⁰² Forcing such a transaction to occur under a shelf registration statement seemingly forces the company either to disclose to the world, in order to avoid a material misrepresentation, or to forego the transaction. No policy reason seems evident why companies should be forced to so choose.

There is, however, a carrot as well as a stick that can be used to attract issuers to a company registration system. Basically, a much narrower definition of "affiliate" could be adopted by the SEC with regard to issuers that elect company registration. Under the last sentence of Section 2(11) of the '33 Act, any person who purchases from "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer" becomes an underwriter, who therefore must register resales of the same securities or find a statutory exemption.¹⁰³ Thus, any "affiliate" of the issuer — including senior executives, directors or substantial shareholders — cannot easily or safely resell securities, even if the sale to them was registered, because their buyer becomes a statutory underwriter.¹⁰⁴ The exemption usually relied upon to solve this problem is

102. An example could be information about a pending acquisition that it is making or then negotiating, but does not wish to disclose publicly. Today, a corporation is under no duty in most instances to disclose such negotiations, but may not misrepresent them. *See Basic, Inc. v. Levinson*, 485 U.S. 224, 232-33 (1988).

103. *See Securities Act of 1933* § 2(11), 15 U.S.C. § 77b(11) (1994).

104. The term "affiliate" is defined by Rule 405 to mean a person who controls, is con-

that provided by Rule 144, which requires the affiliate to "trickle" his or her shares into the market under a volume restriction.¹⁰⁵ Rule 144 solves the problem of insider resales, but only with great complexity.

Similarly, if insiders, institutional investors or other accredited investors purchased securities in a private placement, their ability to resell during the two-year period in which Rule 144 keeps such "restricted securities" out of the public markets is also uncertain. Essentially, holders of restricted securities may make private sales to other sophisticated purchasers, but this is often a highly illiquid market.

Company registration potentially could solve both problems at a single stroke by registering all outstanding restricted securities and all issuer securities held by affiliates for resale. However, there are some obvious problems in this approach. First, the company would have to pay the SEC's registration fee and might find it difficult to recoup this amount from its shareholders. Second, the company might not want to give this degree of liquidity to insiders and others because it would create a substantial "overhang" that would depress current securities prices.¹⁰⁶ Third, and most serious, the company would have apparent liability under Section 11 for sales made by affiliates and statutory underwriters under such a "resale" registration statement. This would be particularly problematic when such a shareholder sold into the public market at a time between the issuer's '34 Act filings when material nonpublic information about the company existed, which information may well not have been known to the selling shareholder.

None of these problems are beyond practical solution, but each requires some complexity that detracts from the vision of a greatly streamlined and simplified system. Resales by affiliates, for example, could be restricted to certain "window" periods when the company had updated its financial and other periodic disclosures. More significantly, the concept of "controlling person" or "affiliate" could be more narrowly defined, at least for '33 Act

trolled by, or is under common control with the person specified (here, the issuer). *See* Rule 405, 17 C.F.R. 230.405 (1995). Even criminal penalties may be levied for a violation of the requirement that affiliates not resell without registration or a special exemption. *See, e.g.,* *United States v. Wolfson*, 405 F.2d 779, 782 (2d Cir. 1968), *cert. denied*, 394 U.S. 946 (1969).

105. *See* Rule 144(e), 17 C.F.R. § 230.144(e) (1995).

106. In initial public offerings, it is common for the underwriters to obtain commitments from insiders that for a specified period they will not sell shares held by them in the issuer under Rule 144, or otherwise, so as not to flood the market for the new company. Of course, contractual restrictions would still be possible even if the shares were freed from statutory legal restrictions.

purposes, so that it reached only senior executives, very substantial shareholders, and those acting in concert with them.¹⁰⁷

To sum up, some of the complexity surrounding the resale of restricted securities and securities held by affiliates can be easily and desirably simplified. But to do so, it is not necessary to deny issuers the availability of the private placement exemption or to make use of that exemption costly. Indeed, to do so may be self-defeating, because issuers might well hesitate to use company registration if they had to forego the private placement exemption to obtain only marginally quicker access to the market.

Overshadowing all these practical reasons, however, is a still more important justification for the continued availability of the private placement exemption — the rising importance of institutional investors.

C. Institutional Investors as the New Gatekeepers

The possibility that institutional investors might buy in private markets and resell in public ones has been perceived by many as a vice — indeed, as a reason not to further liberalize Rule 144A and eliminate its "fungibility" restriction. Yet, this possibility can equally be presented as a virtue. Typically, those concerned about institutional resale into public markets present it as a form of arbitrage — one under which institutional investors obtain a special privileged status. Largely for these reasons, or for their public relations impact, both Rule 144A and shelf registration were modified, in the former case by the fungibility exclusion and in the latter case by the underwriter requirement.¹⁰⁸

The fear in both cases is that institutional investors will enrich themselves by playing a short-term arbitrage game, buying from the issuer at a discount and then quickly reselling into the public markets to realize an immediate gain. Presumably, the underlying harm to public investors in such cases is that they are denied the opportunity to buy under the shelf registration statement because the institutions used either their leverage or ability to make quicker investment decisions to exclude public investors.

107. The current definitions of "affiliate" and "control" are in Rule 405 and are sweeping. See 17 C.F.R. § 230.405 (1995). "Affiliate" might be redefined, for example, so that only inside directors and other shareholders owning more than 20% were presumptively deemed affiliates, unless clear and convincing evidence demonstrated otherwise. There are very different issues involved in carrying this same restricted definition over to the '34 Act context, where corporate control transactions loom larger. Thus, I urge only a narrowing of the '33 Act's use of the term "affiliate," principally to reduce the number of persons who can be deemed statutory underwriters for purposes of § 2(11) of the '33 Act.

108. See *supra* notes 69-75 and accompanying text.

This already happens both in registered public offerings that are essentially "bought deals" and in PIPE transactions that begin as private placements. Even more frequently, when an offering is oversubscribed, institutional investors have the leverage, and it is likely to be small investors that are cut back or excluded from an IPO. The exclusion of small investors as a result of such an "institutionalization" of the primary offering process presents at least a plausible scenario of harm to small investors.

However, this same scenario does not play out as logically in the private placement context. Institutions do not exclude or "squeeze out" individual investors from this context because individuals do not generally qualify to participate in private placements.¹⁰⁹ More importantly, institutions cannot quickly resell, but must hold for a minimum holding period of two years (one year under a proposed rule change to Rule 144).¹¹⁰ Thus, quick turn-around arbitrage is not possible and the institution must bear the economic risk of its investment for a significant period.

As a result, institutions do engage in often significant due diligence efforts before buying equity securities in private placements. In turn, this means that they are in a position to play a gatekeeping role. To note this possibility is not to predict the demise or even the gradual "withering away" of underwriters. Underwriters will continue to sell equity securities to institutional investors and others, but as the size of the typical deal declines, as it should with company registration, and as the timing of transactions becomes less predictable, the underwriters' ability and incentive to engage in costly monitoring of the issuer will correspondingly decline. In contrast, institutional investors are the repeat player with the stronger incentives to monitor, and with fewer conflicts of interest with regard to the issuer to dissuade them from doing so. Although institutions may monitor issuers in both the public and private markets, their incentive to do so is greater in the private market context, where their ability to exit into a public market is at least marginally constrained.¹¹¹

109. Under § 4(2) of the '33 Act, private placements may be made only to sophisticated investors who do not stand in need of the '33 Act's protections. *See SEC v. Ralston Purina*, 346 U.S. 119 (1953). For the current definition of such persons as "accredited . . . investor[s]," see Rule 501(a), 17 C.F.R. § 230.501(a) (1995).

110. Rule 144(d) requires a two-year holding period, but permits tacking between holders so long as private sales are made. Thus the SEC has proposed to shorten this two-year period to one year for non-affiliates. *See supra* notes 95-96 and accompanying text.

111. I refer here to the familiar "exit" and "voice" distinction first made by Albert Hirschman. *See ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* (1970) (noting two ways management learns of problems — customers stop buying firm's goods or members quit the firm (exit), or

More importantly, in the case of seasoned issuers, public investors can freeride to a degree on these monitoring activities by institutional investors. This would not be the case if institutions could immediately bail out at the first sign of trouble and dump their shares into the market, as they can under a company registration system; but so long as some significant period of liquidity remains, whether two years or one, institutions that buy in private placements have a stronger incentive to monitor and perform due diligence investigations than those that buy otherwise equivalent securities in public markets. To be sure, this relative illiquidity will result in some discount in the purchase price, but the effect on the institutional investor of some modest degree of illiquidity may have a social value that exceeds any cost or perceived unfairness to public investors from this discount. Some informed commentators believe excessive securities trading today wastes social resources,¹¹² while others argue that shareholders, including institutional investors, have a myopically short-term time horizon within which they seek to maximize profits.¹¹³ Under either diagnosis, it makes sense to encourage institutions to buy in private markets and hold for some minimum term. From either perspective, it is thus counterproductive to discourage private placements by seasoned issuers.

Independent of these concerns, the possibility also arises that institutional investors may be in a position to fill precisely the due diligence void created by the inability of underwriters to perform such a monitoring role in

customers or members express dissatisfaction to management directly or indirectly (voice)); see also John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1342-45 (1991).

112. Proponents of the "noise trader" model argue that there is excessive securities trading today and that, as a result, a stock transfer tax would promote overall market and social efficiency by reducing such excessive trading. See Lawrence H. Summers & Victoria P. Summers, *When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax*, 3 J. FIN. SERVS. RES. 261 (1989); Joseph E. Stiglitz, *Using Tax Policy to Curb Speculative Short-Term Trading*, 3 J. FIN. SERVS. RES. 101, 113 (1989). The case for a transfer tax is controversial to say the least. An alternative is a legal regime in which substantial investors have an incentive voluntarily to accept a period of illiquidity. Either way, of course, the counter-intuitive claim is being made that it is not necessarily wise as a matter of social policy to reduce all transaction costs and barriers to the free trading of securities.

113. For recent critiques taking this perspective, see MICHAEL E. PORTER, *CAPITAL CHOICES: CHANGING THE WAY AMERICA INVESTS IN INDUSTRY* (1992); *THE REPORT OF THE TWENTIETH CENTURY FUND TASK FORCE ON MARKET SPECULATION AND CORPORATE GOVERNANCE* (1992); and *COMM. ON TIME HORIZONS AND TECHNOLOGY INVESTMENTS, NATIONAL ACADEMY OF ENGINEERING, TIME HORIZONS AND TECHNOLOGY INVESTMENTS* (1992).

fast-paced or very small equity offerings. Realism, however, requires a cautionary and qualifying observation. The rate of private placement activity in equity securities has remained relatively stable for some time,¹¹⁴ and the popularity of PIPE transactions suggests that, although institutions will buy in private markets, they still desire immediate liquidity. Hence, it is uncertain which will prove dominant: the institutions' preference for liquidity or the issuer's preference for a reduced liability risk. All that is offered here is the observation that a legal regime that tended to lock-in substantial and sophisticated investors for some intermediate period of time, say one to two years, could offer social benefits. As exit is restrained, voice is activated.

VI. Conclusion

Because this Article antedates the final report of the SEC's Advisory Committee, it cannot offer specific criticisms (and has not sought to). However, it can offer general guidelines.

As a starting point, it agrees that administrative integration of the '33 and '34 Acts can sensibly reduce the '33 Act's requirements in the case of seasoned issuers. However, full and functional integration probably requires legislative action. The basic focus of the '33 Act should be on the IPO and similar transactions involving smaller issuers.¹¹⁵

To the extent that the SEC pursues a voluntary company registration model administratively, it must avoid the danger of allowing the costs associated with this option to exceed its benefits. A model that is exclusive — that is, that denies those electing it the ability to use private placements or Regulation S for equity sales — has real costs compared with less certain benefits. Not surprisingly, then, there are already signs that the principal constituencies affected by SEC actions are uncertain to skeptical about the benefits of

114. Investment Dealers' Digest reports annual totals in all components of the private placement market, both debt and equity. Between January 1, 1994 and December 31, 1994 there were 384 private placements of "plain vanilla" equity tabulated by it, for a total principal amount of \$20,058,200,000. Over the corresponding period in 1993, there were 347 similar deals for a total principal amount of \$19,281,400,000 — less than a 5% difference. See Jeffrey Keegan, *Beset by Change and Erosion, Private Placements Endure*, INVESTMENT DEALERS' DIGEST, Feb. 27, 1994, at 14, available in LEXIS, News Library, Curnws File. Outside of the Rule 144A context, there has been some decline in traditional private placement activity over recent years. See generally *id.*

115. In closing, it bears repeating what the Supreme Court has said: "[I]t is true that the 1933 Act was primarily concerned with the regulation of new offerings . . ." United States v. Naftalin, 441 U.S. 768, 777-78 (1979). The Court went on in *Naftalin* to observe that § 17 of the '33 Act had additional concerns, but this recognition of the '33 Act's focus should be the starting point. *Id.* at 778.

company registration. Underwriters fear it will lead to further erosion in due diligence and their gatekeeper role, while issuers do not like the obligation to register sales by affiliates and the "flow back" from foreign offerings, plus the risk of Section 11 liability. To be sure, these expressed reservations may partially mask other concerns; for example, underwriters may fear loss of their special relationships to their traditional issuer clients and dislike increased competition, while issuers may simply want additional "sweeteners." Nonetheless, they suggest a need to rethink the process of administrative implementation.

In closing, this Article would recommend that three ground rules be kept in mind by the SEC as it moves toward a company registration model:

1. *Exclusivity is to be avoided.* Company registration should be one alternative among others on a menu of options. Rules which would attempt to mandate that all equity sales had to be made pursuant to a "universal" shelf registration, or that imposed some penalty on such transactions, seem unnecessarily mandatory. Perhaps, in the light of a low-cost alternative of company registration, private markets for equity securities will wither away as unnecessary, but this should not be assumed. It remains a puzzle why equity shelf registration has been unpopular, while Rule 144A offerings have soared. But in light of this disparity, it must be recognized that private markets may well have a survival capacity that has been underestimated. Indeed, to the extent that gatekeepers can function well within them, they have a positive social value.

2. *The incentives to adopt company registration are questionable. Therefore, the costs of company registration should be taxed to shelf registration generally, not to the use of any new universal shelf registration statement.* A strong case can be made for enhancements to the '34 Act's disclosure system before issuers are given complete freedom to substitute continuous '34 Act disclosure for transaction-specific '33 Act disclosure. In particular, "MD&A" reporting requirements for interim periods could be strengthened, and any specific issuance by the issuer might require a Form 8-K filing at least the day before to increase market transparency. Such a Form 8-K requirement would both alert the market to the offering and provide an opportunity for underwriters to discuss the adequacy of existing disclosures with the issuer in the context of a specific filing requirement. But to impose this obligation only on those electing company registration would be a mistake, because it would place a regulatory tax on the new approach and thus weaken the incentive to adopt it. Instead, such enhanced disclosure requirements should either be imposed on all reporting companies or, more likely, on all companies that elect to use Form S-3. Then, those

who face the decision whether to elect company registration would not face a close balance between its costs and benefits. Rather, the benefits would be clear — for example, no SEC prior review of the new registration form, a narrowed definition of "affiliate," and unlimited market access — while the costs would already have been taxed on all firms electing any form of shelf registration or incorporation by reference of subsequently filed '34 Act reports. As a practical matter, this approach reduces the prospect that few would elect company registration because they perceive its advantages over existing forms of shelf registration to be only marginal at best.

Alternatively, a low ceiling (say two or three percent of outstanding voting stock) could be placed on the use of shelf registration by companies not electing into the company registration system. Thus, on this basis, election of company registration would offer an issuer greater flexibility in the future and thus respond to the current shortfall in incentives.

3. *Liability must be addressed legislatively.* Although administrative rules are possible, Section 11 needs legislative re-examination because it fits with any system of shelf registration like the proverbial square peg with the round hole. To be sure, Section 11 works well for IPOs and other super-material offerings that should command the board's attention. But, because it requires an extraordinary and costly level of diligence by the corporation's gatekeepers, it meshes poorly with a system in which repetitive, small equity offerings are contemplated. Important as due diligence is, it must be proportional to the size of the offering. If legislation is sought, a basic compromise seems desirable — Section 11 should be cut back so that it applies primarily to IPOs and to other higher-risk issuers and probably to very substantial offerings, but correspondingly Section 12(2) liability should be restored to cover sales in private markets and to reach all offering materials employed by the issuer.¹¹⁶ To be sure, Section 12(2) also has a due diligence defense, but its differences from Section 11 are important: (1) It does not normally apply to secondary participants, such as officers and directors,¹¹⁷ and (2) it does not impose strict liability on even the issuer, but allows any seller to establish its due diligence defense of "reasonable care." Such a reduced obligation seems closer to being proportional to smaller offerings.

116. This means in substance that *Gustafson v. Alloyd Co.*, discussed *supra* notes 83 and 94, should be legislatively reversed. Another desirable legislative change would be to give the SEC statutory authority to waive the prospectus delivery requirement.

117. Persons who solicit the sale, as well as those in actual privity, have liability under § 12(2) of the '34 Act, at least if they do so out of financial interest. See *Pinter v. Dahl*, 486 U.S. 622 (1988).

In all likelihood, the debate over company registration will be contentious. Those entering it might well begin by considering whether and why they agree or disagree with the foregoing three generalizations.