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PROPOSALS TO AMEND THE REGISTRATION AND PROSPECTUS REQUIREMENTS OF THE SECURITIES ACT OF 1933

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Adoption of the Securities Act of 1933¹ was widely heralded in the law reviews and other periodicals.² Amendments in 1934 were also duly noted.³ But amendment proposals in 1941 and 1947 outlining substantial changes in the registration and prospectus requirements of the Act have passed largely unnoticed. This may simply mean that what was important and interesting in 1933 does not necessarily deserve comment in 1948. We believe, however, that in a private enterprise economy the basic problem with which the amendment proposals deal—how to protect public investors “with the least possible interference to honest business”⁴—merits the attention of the legal profession.⁵ Also,

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1. 48 STAT. 74 (1933), 15 U. S. C. § 77a *et seq.* (1940), hereinafter cited by section number only.

2. *E. g.*, Chamberlain, *The Securities Act of 1933*, 19 A. B. A. J. 643 (1933); Douglas and Bates, *Federal Securities Act of 1933*, 43 YALE L. J. 171 (1933); Hanna and Turlington, *The Securities Act of 1933*, 28 ILL. L. REV. 482 (1933); Tracy, *New Federal Securities Act*, 31 MICH. L. REV. 1117 (1933); Berle, *High Finance: Master or Servant*, 23 YALE REV. 20 (1933); Frankfurter, *The Federal Securities Act: II*, 8 FORTUNE 53 (1933); Landis, *Securities Act of 1933*, 127 BANKERS' MAG. 653 (1933); Noyes, *Wall Street Faces the New Securities Act*, 137 NATION 20 (1933).

3. *E. g.*, Ballantine, *Amending the Federal Securities Act*, 20 A. B. A. J. 85 (1934); Chilgren, *Federal Securities Act of 1933, As Amended*, 2 JOHN MARSHALL L. Q. 105 (1936); James, *Amendments to Securities Act of 1933*, 32 MICH. L. REV. 1130 (1934); Dean, *The Amended Securities Act*, 10 FORTUNE 80 (1934); Flexner, *Fight on the Securities Act*, 153 ATL. MONTHLY 232 (1934); Seligman, *Amend the Securities Act*, 153 ATL. MONTHLY 370 (1934).

4. “The purpose of the legislation I suggest is to protect the public *with the least possible interference to honest business.*” (Italics supplied.) Message of President Franklin D. Roosevelt to Congress recommending enactment of securities legislation, 77 CONG. REC. 937 (1933).

5. In the capitalistic economy of the United States, capital funds must be made available to business enterprises so that optimum employment and production levels

we are not unmindful that public investors are for the most part unorganized, and that except in rare cases of public catastrophe such as the 1929 market crash and ensuing depression, their influence on the legislative process is likely to be negligible. Perhaps an appraisal by persons not associated with either the securities industry or the administrative agency involved will be of some assistance to the legislators who eventually must resolve the problem.⁶

The amendment proposals are designed to cope with difficulties disclosed by experience under the Act. Those difficulties can best be understood in light of the business and legal setting out of which they arise. Our discussion of the proposals, therefore, is preceded by a consideration of the background and structure of the Securities Act and the problems which experience under the Act has disclosed.

I. BACKGROUND AND STRUCTURE OF THE SECURITIES ACT

At the time of the adoption of the Securities Act, the primary conduit through which American corporate enterprises secured capital funds from public investors was the investment banker, and the investment banking process for securing investment funds from the public included the steps of (1) origination, (2) formation of purchase and banking groups, and (3) formation of a selling group.⁷ Although there were variations in the procedure, these steps may be briefly summarized as follows:⁸

may be achieved and maintained. The investing public and retained earnings of the enterprise have been the principal sources of capital funds; quantitatively, the latter has been the more important source. ABBOTT, *FINANCING BUSINESS DURING THE TRANSITION* 13 (1946). See also ALTMAN, *SAVING, INVESTMENT AND NATIONAL INCOME* 62 (TNEC Monograph 37, 1941).

6. This calls for disclosure of our associations and the origin of this paper. Although Mr. Byse was a member of the staff of the Commission in 1941-42 and 1945-46, he did not in any way participate in the amendment program. Mr. Bradley has never been employed by or associated with either the Commission or the securities industry. The paper is an outgrowth of a seminar on the Securities Act conducted by Mr. Byse and attended by Mr. Bradley.

7. See National Association of Securities Dealers, Inc., *Securities Exchange Act Release No. 3700*, June 13, 1945, pp. 32-39.

8. Our efforts to present a succinct recital of the process of syndicate distribution may have produced an oversimplified description of the process. The reader who desires amplification is referred to National Association of Securities Dealers, Inc., *Securities Exchange Act Release No. 3700*, June 13, 1945, pp. 32-39; testimony of SEC Commissioner Ganson Purcell, *Hearings before Committee on Interstate and Foreign Commerce on Comparative Print Showing Proposed Changes in the Securities Act of 1933 and the Securities Exchange Act of 1934 and H. R. 4344, H. R. 5065, and H. R. 5832*, 77th Cong., 1st Sess. 7-17 (1941), hereinafter called "*Hearings*"; BISHOP, *THE FINANCING OF BUSINESS ENTERPRISES* c. 21 (1929); 2 DEWING, *FINANCIAL POLICY OF CORPORATIONS* bk. IV, cc. 7, 8 (4th ed. 1941); GALSTON, *SECURITY SYNDICATE OPERATIONS* (Rev. ed. 1928) *passim*; Bates, *Some Effects of the Securities Act Upon Investment Banking Practices*, 4 *LAW & CONTEMP. PROB.* 72 (1937); Gourrich, *Investment Banking Methods Prior to and Since the Securities Act of 1933*, 4 *LAW & CONTEMP. PROB.* 44 (1937).

(1) *Origination.* A corporation needing capital funds would approach, or be approached by, an investment banker.⁹ Negotiations between the corporation and the banker concerning the character and other details of the financing would ensue.¹⁰ The culmination of these negotiations generally would be a firm commitment by the banker to purchase the issue of securities at a stated price.¹¹ As soon as the negotiations reached a stage of finality, or while they were being conducted, the banker would initiate the second step in the process.

(2) *Formation of purchase and banking groups.*¹² Because the originating banker wished to spread the risk involved in his commitment to the issuer, and perhaps also because of the hope for reciprocal treatment in the distribution of issues to be originated by members of the group, or to return past favors, he generally organized a small group of investment bankers to assist in the purchase of the securities to be issued. This assistance usually took the form of the execution and performance of an agreement to purchase the securities from the originating banker after he had purchased them from the issuer. In order to compensate and reward the originator, the price to the purchase syndicate customarily was slightly higher than the price paid by the originator to the issuer. Further spreading of the risk attached to the purchase and distribution of the securities was achieved by the formation of a larger group of investment bankers, called the banking or underwriting group, to purchase the issue from the purchase group, again at a slightly advanced price. The originator and other members of the purchase group generally became members of the banking group.

9. Speaking generally, the relationship between originating broker and corporate issuer was not sporadic. On the contrary, established issuers had definite, continuing relationships with investment banking firms, and other bankers ordinarily would not compete for the business of an issuer having such relationship. 24 *Hearings before Temporary National Economic Committee pursuant to Pub. Res. No. 113 (75th Cong.)*, 76th Cong., 3rd Sess. 12482-12487 (1940); LYNCH, *THE CONCENTRATION OF ECONOMIC POWER* 84 (1946); Gourrich, *supra* note 8, at 46.

10. During the negotiation stage the careful banker would make an exhaustive investigation of the issuer in order to determine whether he should underwrite the issue and to ascertain the price and character of the security which should be issued. Sometimes, however, the investigation was unduly perfunctory; and sometimes also ". . . investment bankers with no regard for the efficient functioning of industry forced corporations to accept new capital for expansion purposes in order that new securities might be issued for public consumption." H. R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933); see also Gourrich, *supra* note 8, at 46-47.

11. But not always. The banker might limit his obligation to an agreement to take up any securities which the corporation was unable to sell to its own security holders, or the banker might promise merely to use his "best efforts" to distribute the issue; and even in those instances where the banker agreed to purchase at a fixed price, the contract might contain a "market out" clause which privileged the banker to cancel the agreement in the event of unusual changes in the market.

12. For supporting and amplifying authority, see generally sources cited note 8 *supra*.

(3) *Formation of selling group.*¹³ Distribution of the securities to the public was effected by the selling group or syndicate, which consisted of selected members of the securities industry having distributive capacity. Included in the selling syndicate would be (a) those members of the banking group who had retailing departments and wished to participate in the distribution to the public, (b) other investment bankers with retailing organizations, and (c) securities brokers and dealers whose primary business was the purchase and sale of securities for their own account or the account of others. Members of the selling group would agree to purchase for resale a stated number of securities at the price specified by the banking group, and a member's liability was limited to taking up the amount of securities for which he had subscribed.

The dominant characteristic of this system of selling new issues of securities was *speed of distribution* and the consequent minimization of risks and liabilities incident to carrying an inventory of securities. Unlike many businesses, an inventory in the case of a distribution of new securities was and is anathema. The objective was and is to "get off the hook" as quickly as possible. Or better yet, not to get on in the first place, which may be accomplished by securing commitments from purchasers down the distribution line before becoming committed to a seller up the line. Accordingly, in the 'twenties there were a number of instances in which the issue or a large part of it was sold to the selling syndicate almost simultaneously with its purchase from the issuer, and retailers not unnaturally used similar tactics in selling to the public.¹⁴

A related anti-social aspect of securities distribution practices prior to the Securities Act was the inadequacy and falsity of information on which the public was expected to base a decision whether or not to participate in the new issue; reputable as well as "fringe" members of the financial community distributed new issues of securities by means of misleading and inadequate selling literature.¹⁵ Thus the public investor was subject not only to the selling pressure engendered by the emphasis on speedy distribution but also he was not given information on the basis of which to reach an intelligent decision concerning the security. These and other abuses in the distribution

13. *Ibid.*

14. Testimony of SEC Commissioner Ganson Purcell, *Hearings, supra* note 8, at 9; H. R. REP. NO. 85, 73rd Cong., 1st Sess. 3 (1933); ATKINS, EDWARDS AND MOULTON, *THE REGULATION OF THE SECURITY MARKETS* 36 (1946); Saperstein, *Governmental Regulation of Investment Banking*, FUNDAMENTALS OF INVESTMENT BANKING § 8, p. 7 (Investment Bankers Association of America 1947).

15. Testimony of Commissioner Purcell, *Hearings, supra* note 8, at 12-14; H. R. REP. NO. 85, 73rd Cong., 1st Sess. 3 (1933); SEN. REP. NO. 47, 73rd Cong., 1st Sess. 2 (1933); TWENTIETH CENTURY FUND, INC., *THE SECURITY MARKETS* 566 (1935). See also *Equitable Life Insurance Co. of Iowa v. Halsey, Stuart & Co.*, 312 U. S. 410 (1941).

process,¹⁶ coupled with the stock market debacle of 1929, the ensuing depression, and the demonstrated ineffectiveness of state regulation, gave rise to the Securities Act of 1933.

The Securities Act is directed primarily at securities *distribution* as distinguished from securities *trading*, and is designed to remedy the abuses in securities distribution discussed above. The basic means for achieving that objective are the registration and prospectus requirements of Section 5 of the Act. Broadly speaking, Section 5 as implemented by other sections of the Act¹⁷ makes it unlawful for issuers, underwriters, and dealers to distribute a new issue of securities to the investing public by use of the mails or channels of interstate commerce unless "a registration statement is in effect as to" the issue. Nor may such persons use the mails or channels of commerce to transmit selling literature concerning a registered security (*i. e.*, a security as to which a "registration statement is in effect"), or to deliver a registered security after sale, unless the selling literature or security is accompanied or preceded by a prospectus summarizing the more essential information contained in the registration statement.¹⁸ The objective of the registration and prospectus requirements of the Act is outlined in the report of the Interstate and Foreign Commerce Committee recommending enactment of the Securities Act: "The purpose of these sections is to secure for potential buyers the means of understanding the intricacies of the transaction into which they are invited. The full revelations required in the filed 'registration statement' should not be lost in the actual selling process. This requirement will undoubtedly limit the selling arguments hitherto employed. That is its purpose. . . . Any objection that the compulsory incorporation in selling literature and sales argument of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision. The rank

16. *E. g.*, the practice of pegging or stabilizing the price of a new or secondary distribution of securities. See generally, Securities Exchange Act Release No. 2446, March 18, 1940.

17. See especially §2(3) defining "sale" and kindred terms, note 65 *infra*; §2(10) defining "prospectus"; §4 exempting certain transactions from the provisions of §5; §10 specifying the information to be contained in a prospectus.

18. There are two exceptions to this broad prohibition: the so-called "tombstone advertisement" and the newspaper prospectus. The former is a ". . . notice, circular, advertisement, letter, or communication in respect of a security . . . [which] states from whom a written prospectus meeting the requirements of section 10 may be obtained and, in addition, does no more than identify the security, state the price thereof, and state by whom orders will be executed." §2(10). A newspaper prospectus is defined by the Commission as ". . . an advertisement of securities in newspapers, magazines, or other periodicals which are admitted to the mails as second-class matter and which are not distributed by the advertiser." "Instructions as to Newspaper Prospectuses" of Form S-1. The "Instructions" permit condensation and omission of certain information required to be included in a prospectus meeting the requirements of Section 10.

and file of securities buyers who have hitherto bought blindly should be made aware that securities are intricate merchandise."¹⁹

A security may be registered by filing with the Commission a registration statement containing information concerning every essentially important element attending the issue of the new security.²⁰ The registration statement does not become effective until twenty days after it has been filed with the Commission.²¹ If within the twenty-day period an amendment to the registration statement is filed, the entire statement is deemed to have been filed on the date the amendment was filed, thereby starting the running of a new twenty-day period.²² However, if the amendment is filed with the "consent . . . or pursuant to an order of the Commission," the twenty days is measured from the date of the original filing of the registration statement.²³ Therefore, during the twenty days after filing—longer if amendments were filed and the Commission failed to "consent" or "order"—detailed information concerning the security to be issued is filed with a Government agency²⁴ and is available for public inspection.²⁵

As understood by the draftsmen of the Act, the purpose of the twenty-day "waiting" or "cooling" period was to arrest the high pressure distribution practices then in vogue: "The compulsory . . . [20-day] inspection period before securities can be sold is deliberately intended to interfere with the reckless traditions of the last few years of the securities business. It contemplates a change from methods of distribution lately in vogue which attempted complete sale of an issue sometimes within one day or at most a few days. Such methods practically compelled minor distributors, dealers, and even salesmen, as the price of participation in future issues of the underwriting house involved, to make commitments blindly. This has resulted in the demoralization of ethical standards as between these ultimate sales outlets and the securities-buying public to whom they had to look to take such commitments off their hands. This high-pressure technique has assumed an undue importance in the eyes of the present generation of securities distributors, with its reliance upon delicate calcula-

19. H. R. REP. No. 85, 73rd Cong., 1st Sess. 8 (1933).

20. Sections 6 and 7.

21. As originally enacted section 8(a) provided, as stated in the text, that the effective date of the registration statement would be the twentieth day after filing. However, the section was amended in 1940 to give the Commission discretionary authority to accelerate the effective date under certain circumstances without regard to the original 20-day period. See page 619 and note 48 *infra*.

22. Section 8(a).

23. *Ibid.*

24. The period may be less than twenty days if the Commission exercises its discretionary authority to accelerate the effective date. See note 21 *supra*.

25. Rules 120 and 121 of General Rules and Regulations under the Securities Act of 1933, 17 CODE FED. REGS. §§ 230.120, 230.121 (Cum. Supp. 1943).

tions of day-to-day fluctuations in market opportunities and its implicit temptations to market manipulation, and must be discarded because the resulting injury to an underinformed public demonstrably hurts the Nation. It is furthermore the considered judgment of this committee that any issue that cannot stand the test of a waiting inspection over . . . [a 20-day] average of economic conditions, but must be floated within a few days upon the crest of a possibly manipulated market fluctuation, is not a security which deserves protection at the cost of the public as compared with other issues which can meet this test.”²⁶

The structure of the Act and its legislative history make it clear that speed of distribution was to be curbed by the waiting period. The same sources demonstrate that the related evil of distributing securities to public investors through the use of inadequate, misleading, and false information was to be remedied by requirements (enforced by administrative,²⁷ civil liability,²⁸ injunctive,²⁹ and criminal³⁰ sanctions) that new issues be registered and that the more essential information contained in the registration statement be furnished to purchasers in the form of a prospectus complying with rather rigorous statutory and administrative standards.

Wherein, if at all, have these apparently admirable remedial measures failed? Why is it that in 1947 the Chairman of the Commission could say, “We do not think the laws passed in 1933 are working as they were intended to work,”³¹ and another member of the Commission, “. . . [the] basic intention [of the Act] is frustrated”?³² Why have members of the securities industry, although expressing full agreement with the objectives of the Act, pressed for revision?³³ Answers to these questions may be found in the problems and difficulties—ap-

26. H. R. REP. No. 85, 73rd Cong., 1st Sess. 7-8 (1933).

27. Sections 8(b) and 8(d). See also §§ 15(b) and 15A(1)(2) of the Securities Exchange Act of 1934, 48 STAT. 895 (1934), as amended, 15 U. S. C. § 780(b) (1940) and 52 STAT. 1075 (1938), 15 U. S. C. § 780-3(1)(2) (1940), providing that the Commission may deny or revoke the registration of any broker or dealer or suspend or expel from the National Association of Securities Dealers, Inc., any member of the Association if it finds that the broker, dealer or member “. . . has wilfully violated any provision of the Securities Act of 1933 . . . or of any rule or regulation thereunder. . . .”

28. Sections 11 and 12.

29. Section 20(b). See also § 17.

30. Section 24. See also § 17.

31. Statement of Chairman James J. Caffrey, reported in Ayers, *Hope Dims for the Early Revision of the Securities Act*, FINANCE 27, 28 (April 25, 1947).

32. Statement of Commissioner Robert K. McConaughy in an address before the American Society of Corporate Secretaries, Inc., Chicago, Illinois, March 26, 1947, p. 5 of mimeographed release of address.

33. REPORT ON THE CONFERENCES WITH THE SECURITIES AND EXCHANGE COMMISSION AND ITS STAFF ON PROPOSALS FOR AMENDING THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 BY THE REPRESENTATIVES OF INVESTMENT BANKERS ASSOCIATION OF AMERICA, NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., NEW YORK CURB EXCHANGE, AND NEW YORK STOCK EXCHANGE (1941), hereinafter called “INDUSTRY REPORT.” See note 61 *infra*.

parently unforeseen, or if foreseen, not fully appreciated, by the draftsmen of the statute—which experience under the Act has disclosed.

II. PROBLEMS DISCLOSED BY EXPERIENCE UNDER THE ACT

The legislative history of the Act indicates that the Congress intended that public investors should be provided with a prospectus containing full information concerning a registered security before buying the security, and that until the registration statement was in effect no attempts should be made to dispose of a security. Complete attainment of these objectives has been thwarted by the following factors: (1) the so-called "oral loophole"; (2) the difficulties inherent in the "dissemination-solicitation" distinction established by the Act; and (3) "gun beating."³⁴

A. *The So-called "Oral Loophole"*

Section 5 (b), as implemented by Sections 2 (3) and 2 (10), closes the mails and channels of interstate commerce to all *written* offers or attempts to dispose of a registered security, unless the writing is accompanied or has been preceded by a prospectus meeting the requirements of Section 10. However, if the offer or attempt to dispose of the security is made *orally*, either in personal conversation or by telephone, the only requirement imposed by the Act is that if the mails or channels of commerce are used to deliver the security to the purchaser, a Section 10 prospectus must accompany or precede the security.³⁵ Consequently, where the seller does not utilize written communications in selling the security, the buyer need receive no prospectus until the security is delivered to him after he has purchased the security. And, of course, if the seller does not use the mails or channels of interstate commerce in making offers or sales or in delivering the security, either before or after the effective date, the prohibitions of Section 5 are inapplicable.³⁶

34. An additional factor hampering full realization of the objective of the Act "to place adequate and true information before the investor," SEN. REP. No. 47, 73rd Cong., 1st Sess. 1 (1933), has been the inordinate size and complexity of many prospectuses. An analysis of prospectuses registered with the Commission during the year 1940 showed that the average prospectus was a document of 41 pages. Testimony of R. McLean Stewart, Chairman, Securities Act Committee, IBA. *Hearings, supra* note 8, at 144, 169. The ordinary investor probably will not carefully peruse a document of that magnitude; and, of course, to the extent that he is deterred from doing so, the objective of the Act is not realized.

35. See §§ 5(b), 2(3) and 2(10).

36. That intrastate offerings are often made before effectiveness may be inferred from the following statements of the securities industry: "When a registration statement relating to a proposed new issue of securities is filed with the Commission, the Commission makes a practice of announcing the fact immediately in the press. If the contemplated offering is one of attractive quality, investors throughout the country turn at once to their security dealers to seek information concerning it and possibly to ask that offerings be made to them at the appropriate time. The great majority of conversations as to such securities, which occur prior to the effective date of a regis-

To the extent that new issues are sold through oral negotiations,³⁷ the Act's professed objective of providing public investors with sufficient information to reach informed judgments is not effectuated. Although detailed data concerning the percentage of newly issued securities sold orally is not available, the following statement of the securities industry is revealing: "With respect to the greatest percentage of new issue securities measured by dollar amount . . . business between buyer and seller is normally conducted by telephone."³⁸ This opinion by qualified observers indicates that despite the existence of the Securities Act, a large number—perhaps, in the language of the industry statement, "the greatest percentage"—of public investors purchase newly issued securities without full benefit of the disclosure provisions of the Act.³⁹

The Commission apparently believes that the failure to regulate interstate oral offerings of registered securities represents a Congressional oversight and error in draftsmanship.⁴⁰ The securities industry, pointing to the deletion of provisions in earlier drafts of the Act which would have regulated oral offerings, argues that Congress deliberately chose not to impose such "an unnecessary and perhaps impossible restriction . . . upon business."⁴¹ We do not think it necessary to attempt a resolution of this controversy. The point is that under the Act a multitude of public investors still are not provided

tration statement, ordinarily take place in personal interviews or over local telephones. They do not involve the use of any means or instrumentality of interstate commerce or of the mails. Consequently they are now, and have always been, permissible under the provisions of the Securities Act." INDUSTRY REPORT, *supra* note 33, at ix. See also text at note 38 *infra*; and see note 59 *infra*.

37. Or where the Act is inapplicable because the jurisdictional means of the mails or channels of interstate commerce are not utilized. See note 36 *supra* and text thereat.

38. INDUSTRY REPORT, *supra* note 33, at viii; testimony of R. McLean Stewart, *Hearings, supra* note 8, at 144. See also suggestions for Revision of the Securities Act of 1933 and the Securities Exchange Act of 1934 of the Committee on Security Regulation of Commerce and Industry Association of New York, Inc., March 28, 1947, p. 2: ". . . the general practice is to send the prospectus to the investor with the confirmation of sale, that is *after* he has bought the security. . . . Hence, the investor generally makes his commitment to buy in reliance solely upon the oral representations of the salesman." See also note 36 *supra*.

39. The recent Kaiser-Frazer stock offering provides a graphic example of the importance of supplying purchasers with prospectuses before they are committed to purchase. The public offering date of the 900,000 share issue at \$13.00 per share was February 4, 1948. On February 3, the issuer in stabilizing transactions purchased 186,200 shares of its stock, holding the price to \$13.50 per share. At noon on February 4, the underwriters announced that the entire 900,000 shares had been placed at the offering price of \$13.00. That afternoon, after stabilizing transactions no longer were supporting the price, the stock fell to \$11.25 per share, closing at \$11.75. As credulous as public investors may be, it seems clear that many offerees of this stock who agreed to purchase it would not have done so had they been informed that the volume of the stabilization was approximately 20% of the total issue. See N. Y. Times, Feb. 4, p. 33, col. 5; Feb. 5, p. 33, col. 5; Feb. 15, § 3, p. 1, col. 7, p. 3, col. 4.

40. SEC, REPORT ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, 5 (1941), hereinafter called COMMISSION REPORT. See note 61 *infra*.

41. Testimony of R. McLean Stewart, *Hearings, supra* note 8, at 139-140. See also INDUSTRY REPORT, *supra* note 33, at viii.

with information concerning the securities they are asked to purchase. Any program of revising the registration and prospectus requirements of Section 5 and related sections must give consideration to this fact.

B. *The Dissemination-Solicitation Distinction*

Until the effective date of a registration statement, it is unlawful to use the mails or channels of interstate commerce to offer to sell, attempt to dispose of, solicit an offer to buy, or offer to buy the security.⁴² But a major purpose of the Act is to provide investors with information. It is proper, therefore, to disseminate information concerning the proposed issue to prospective purchasers prior to the effective date.⁴³ But if the dissemination of information actually constitutes an "offer to sell," "an attempt or offer to dispose of a security," or a "solicitation of an offer to buy," then Section 5 has been violated and the violator is subject to civil, injunctive, criminal, and administrative sanctions.⁴⁴ What then should be the course of action by a prudent securities dealer who has received information from an investment banker (with whom he has enjoyed friendly and profitable business relations in the past) that the banker is participating in the underwriting of a new issue of securities? Should he disseminate information concerning the issue to his customers and thereby take the risk that a jury, judge, or administrative agency viewing the transaction from the vantage point of hindsight will determine that he was not merely disseminating information but really had made "an attempt to offer or to dispose of" the security or a "solicitation of an offer to buy"? Although there is little or no evidence that this risk has deterred dealers from disseminating information to their customers, one must sympathize with the complaint of a spokesman for the industry: "In practice the present law has created an extremely unsatisfactory situation. . . . It has made honest men feel ashamed of themselves by compelling them to resort to subterfuges, obliging them to ask their best friends, with whom they deal, to believe them when they go to them and give them information, but at the same time say to them: 'Look, we are not trying to sell you a security. We do not want to offer a security to you. We do not want you to make us an offer to buy. We merely want to supply you with information.'"⁴⁵

42. Sections 5(a) and 2(3).

43. See H. R. REP. No. 85, 73rd Cong., 1st Sess. 12-13 (1933): "The bill . . . is not concerned with communications which merely describe a security. It is, therefore, possible for underwriters who wish to inform a selling group or dealers generally of the nature of a security that will be offered for sale after the effective date of the registration statement, to circulate among them full information respecting such a security." See also Securities Act Release No. 70, November 6, 1933, and Securities Act Release No. 464, August 19, 1935.

44. See §§ 5 and 2(3) and notes 27-30 *supra*.

45. Testimony of R. McLean Stewart, *Hearings, supra* note 8, at 136-137.

Far more serious has been the effect on underwriters' practices. They too are subject to the risk that a dissemination to prospective members of the selling group may later be determined to have been an attempt to dispose of the security or a solicitation of an offer to buy. As a result, in the past some underwriters have not disseminated any information until the effective date.⁴⁶ It may be argued that the apprehensions of this group were unjustified, that they need have had no fear if in fact they were merely disseminating information. But justifiable or not—and certainly the line between dissemination and solicitation is not so clear and precise that the action of this group of underwriters can be termed unreasonable—the point is that underwriters' failure or reluctance to disseminate information makes it increasingly difficult for the securities industry and the investing public to appraise the security before the actual selling process begins; and this, of course, is contrary to the objective of the Act to facilitate appraisal of the security during the waiting period.⁴⁷

Further impetus to non-dissemination of information during the waiting period was provided by action taken by the Commission in 1945. In 1940, Section 8 (a) was amended to give the Commission discretion to reduce the waiting period to less than twenty days in appropriate instances.⁴⁸ On April 30, 1945, the Commission issued a statement of general policy outlining the way in which it would exercise the discretion vested in it by the amendment, in passing upon requests for acceleration in cases in which a so-called "red-herring" prospectus⁴⁹ had been circulated in a form which did not meet the standards of disclosure required by the Securities Act. The statement provided in part: "In considering a request for acceleration of the effective date of a registration statement in a case where a 'red-herring' prospectus which was inaccurate or inadequate in material respects has been circulated the Commission considers that the statutory standards of this section [8 (a)] have not been met. Accordingly, the Com-

46. INDUSTRY REPORT, *supra* note 33, at 89.

47. Cf. Saperstein, *supra* note 14, at 15.

48. 54 STAT. 857, 15 U. S. C. § 77h(a) (1940). The amendment directed the Commission, in exercising its discretion on applications to reduce the waiting period, to give ". . . due regard to the adequacy of information respecting the issuer theretofore available to the public, to the facility with which the nature of the securities to be registered, their relationship to the capital structure of the issuer and the rights of holders thereof can be understood, and to the public interest and the protection of investors."

49. A "red herring" prospectus is a document which describes the security in approximately the same terms as it is described in a prospectus conforming to the requirements of Section 10; often the red herring is incomplete in that it does not contain information concerning price and the other items listed in note 53 *infra*. The name "red herring" comes from the practice of printing in red letters diagonally across every page of the prospectus, or along the margin, the statement that the prospectus is not an offer of the security or a solicitation of an offer to buy, and that it is for informative purposes only.

mission will not order acceleration in such a case until it has received satisfactory assurances that by appropriate means the nature of the material amendments to the registration statement have been communicated to those persons to whom the 'red-herring' prospectus was distributed."⁵⁰

The objective of this procedure was to discourage the circulation of inadequate red herrings and to correct misapprehensions resulting from deficient red herrings. But compliance with its terms was no easy task: because, if dealers to whom red herrings had been forwarded further distributed them to their customers, it would be extremely difficult for the underwriter to give the required "satisfactory assurances" that corrections had been communicated to all the recipients of the red herring. This would be especially true in cases of large issues in which the red herrings had received nationwide distribution. "Accordingly, underwriters grew more and more reluctant to jeopardize the granting of requests for acceleration by setting in motion a process which made it difficult for them to supply satisfactory assurances that later amendments had been communicated to all persons to whom the red herrings were distributed. It was simpler, many underwriters believed, to abandon the red herring altogether."⁵¹

The Commission's move to remedy this unsatisfactory condition was adoption of Rule 131, effective December 6, 1946.⁵² Rule 131 provides that sending or giving to any person, before a registration statement becomes effective, a copy of the proposed form of prospectus (*i. e.*, the red-herring prospectus) filed as a part of the registration statement, shall not in itself constitute an offer or attempt to dispose of a security or solicitation of an offer to buy if the proposed form of prospectus contains substantially the information required to be set forth in a Section 10 prospectus, or contains substantially all that information with certain exceptions.⁵³ The Commission announcement of adoption of the Rule also indicated that unless copies of the proposed form of prospectus were distributed, a reasonable time in advance of the anticipated effective date, to all underwriters and dealers who might be invited to participate in the distribution, the Commission would re-

50. Securities Act Release No. 3061, April 30, 1945.

51. Saperstein, *supra* note 14, at 17. See also Parlin, *Security Issues and Exchanges*, ANNUAL SURVEY OF AMERICAN LAW, 530, 533 (1946).

52. Securities Act Release No. 3177, December 5, 1946. The Release stated that the Rule would be effective for a trial period of six months. On July 10, 1947, the Commission announced continuation of the Rule. Securities Act Release No. 3240, July 10, 1947.

53. The exceptions pertain to information concerning the offering price, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices, or other matters dependent upon the offering price.

fuse to accelerate the effective date of the registration statement.⁵⁴ Because acceleration often is crucially important to a registrant,⁵⁵ the sanction of non-acceleration has generally been sufficient to induce underwriting groups to distribute copies of the proposed form of prospectus to prospective members of selling groups.

Notwithstanding the general effectiveness of this solution of the unsatisfactory situation precipitated by the policy announcement of April 30, 1945, the basic problems inherent in the dissemination-solicitation distinction still remain. Underwriters and dealers still are subject to the risk that a hindsight determination will reveal that their dissemination activities fell within the prohibited area of attempt or solicitation. To the extent that distributors of securities feel that this is a substantial risk, they very likely will limit their dissemination to the minimum necessary to secure acceleration. At the other extreme, the Act's authorization of dissemination of information during the waiting period facilitates evasion of the prohibition against attempted disposition and solicitation, and may result in an unfair discrimination against the law-abiding member of the securities industry in favor of the law-evading member. This aspect of the dissemination-solicitation problem, which receives special treatment in the following discussion of "gun beating," is of far greater consequence than the phases of the problem discussed above.

C. "Gun Beating"

"Beating the gun" consists of offering or otherwise attempting to dispose of newly issued securities before the date of the public offering.⁵⁶ Prior to the Securities Act, the practice constituted a breach of the syndicate agreement; and because purchase group members were in a position to secure detailed information concerning the new issue before the same information was made available to other members of the selling group, gun beating apparently was more widely engaged in by retail departments of members of the purchase syndicate than by smaller securities dealers, whose participation in the distribution was

54. The Release also stated that the Commission would continue its policy enunciated in Release No. 3061 of refusing acceleration where materially inaccurate or inadequate red herrings have been circulated until corrected information has been communicated to those persons to whom the deficient red herring had been distributed.

55. Dean, *The Lawyer's Problem in the Registration of Securities*, 4 LAW & CONTEMP. PROB. 154, 168 n. 29 (1937): "Inasmuch as underwriters do not like to carry commitments for any longer period than is necessary and since the time factor is of tremendous importance in the success of an issue, it is essential that amendments be cleared with the Commission as rapidly as possible and their consent obtained to the filing thereof. Otherwise, the filing of each amendment (and delay usually causes change in the public offering price) would start a new twenty-day period running so that, unless the consent of the Commission be obtained, the statement would never become effective."

limited to membership in the selling group.⁵⁶ After the Act, the practice constitutes a violation of Section 5;⁵⁷ and because the Act and Commission regulations encourage dissemination of information concerning the issue to prospective members of the selling group during the waiting period, smaller securities dealers, as well as the larger retail departments, are now able to beat the gun.

Dissemination of information during the waiting period thus facilitates gun beating, and gun beating is directly contrary to the objective of the Act that the waiting period should be a time for appraising, not for selling. Paradoxically, then, dissemination of information, encouraged by both the Act and Commission regulations, is conducive to violations of the Act. If gun beating is a common practice in the distribution of new issues of securities, the Act is in a measure self-defeating, because the procedure, clearly contemplated by the Act, of disseminating information during the waiting period becomes the vehicle for a return to the high pressure, blind buying practices which the Act was designed to eliminate.

We do not know how pervasive gun beating is. Investment bankers and securities dealers do not announce from housetops that they have not conformed to the law of the land. Nor can the Commission charged with the task of enforcement be expected to state publicly that the statute is commonly violated.⁵⁸ Yet, we feel that the available evidence supports the judgment that gun beating is widespread.⁵⁹ The general availability of information concerning new

56. GALSTON, *op. cit. supra* note 8, at 123-124; WILLIS AND BOGEN, INVESTMENT BANKING 482 (Rev. ed. 1936).

57. Because the effective date and the public offering date generally coincide, and assuming, of course, that the jurisdictional means of the mails or channels of interstate commerce are used.

58. But see N. Y. Times, Aug. 7, 1936, p. 23, col. 8, "SEC Says 60 Firms 'Beat Gun' in Sales."

59. We are not in possession of the facilities which would enable us definitely to confirm our belief that gun beating is widespread. Definite corroboration of that belief would involve a thorough investigation undertaken pursuant to statutory authority providing for the issuance of subpoenas and for immunity from subsequent prosecution on account of any transaction concerning which the subpoenaed individual might produce evidence. See, *e. g.*, Sections 19(b) and 22(a) of the Act. However, as stated in the text, we are convinced that the practice is pervasive. Our conviction rests upon the following:

(1) *Information secured from members of the securities industry and members of the Commission's staff.* Although not all those questioned were responsive, none affirmed that gun beating was not widespread, and several stated that it was very prevalent.

(2) *Statements by industry and Commission representatives.* See, *e. g.*, statement of SEC Commissioner Robert K. McConnaughey: "Although it would probably be difficult to prove in particular cases, it is not uncommon for underwriters to make their commitments to issuers, to invite orders or indications of interest from dealers, and for dealers to solicit orders for their allotments and make allocations to ultimate investors before registration becomes effective." Address before the American Society of Corporate Secretaries, Inc., Chicago, Ill., March 26, 1947, p. 5 of mimeographed release of address. See also REPORT OF SECURITIES ACT COMMITTEE OF INVESTMENT

issues, the understandable reaction of otherwise law-abiding members of the securities business to meet the competition of gun beaters with more gun beating, the natural reluctance of a securities dealer to reject the importunacies of investors avid for new issues, the tenuous distinction between solicitation and dissemination, the difficulty of proving

BANKERS ASSOCIATION OF AMERICA 9, 44 (June 1, 1940); address of John J. Burns, then General Counsel of the Commission before the Securities Traders Association, Cincinnati, Ohio, August 1, 1935, p. 5 of mimeographed release of address; address of Murray Hanson, General Counsel, Investment Bankers Association of America, before the Eleventh Annual Central States Group Conference Investment Bankers Association of America, Chicago, Ill., March 14, 1947, text reported in 165 COMM. & FIN. CHRON., March 20, 1947, pp. 1513, 1530.

(3) *Statements in public and trade press. E. g.*, 165 COMM. & FIN. CHRON., May 8, 1947, p. 2522: "In a sense, both the underwriters and the SEC realize that the whole system of underwriting new security issues involving the use of the prospectus to safeguard, supposedly, the interests of the investor has broken down completely. Permission to seek 'intention to buy' . . . [from prospective purchasers, *i. e.*, to beat the gun] would in effect only legalize prevailing trade custom even now, trade custom, by the way, which even the SEC has sanctioned with one eye closed so to speak." See also Investment Dealers' Digest, April 22, 1940, p. 3, quoted in 2 DEWING, *op. cit. supra* note 8, at 1134 n. k; N. Y. Times, Aug. 7, 1936, p. 23, col. 8.

(4) *Comments of students of the investment banking process. E. g.*, Ayers, *SEC Proposes to Amend Heart of Securities Act*, FINANCE, June 10, 1947, pp. 25, 41: "[The proposal] . . . legalizes a practice which has been widespread even though it was contrary to the law, namely the conversations between salesmen and prospective customers between registration and effective date." Heilbron, *Strengthen the Securities Act of 1933* (undated monograph) 3: "Where such a hair-line distinction was drawn between 'informative' and 'selling' literature, it was not unreasonable to learn of violations. 'Jumping the gun' became fairly common." See also Bates, *Some Effects of the Securities Act Upon Investment Banking Practices*, 4 LAW & CONTEMP. PROB. 72, 73 (1937); Kuhn, *The Securities Act and Its Effect Upon the Institutional Investor*, *id.* 80, 83; 2 DEWING, *op. cit. supra* note 8, at 1133-1134, note k; WEISSMAN, *THE NEW WALL STREET* 235-236 (1923).

See also In the Matter of Van Alstyne, Noel & Co., Securities Exchange Act Release No. 3791, Feb. 28, 1946, 56 YALE L. J. 156 (1946). Approximately a month and a half before filing of the registration statement, Van Alstyne, Noel & Co. (hereafter called "respondent") arranged with Andrew J. Higgins to underwrite 900,000 shares of Higgins, Inc. About three weeks later respondent arranged for widespread publicity concerning the issue to be disseminated by means of the Dow-Jones ticker and the newspapers; respondent also communicated with a large number of dealers throughout the country to inform them concerning the issue and to inquire whether they wished to participate. Shortly thereafter respondent completed the formation of a nationwide selling group of about 160 dealers; some dealers who communicated with respondent were allotted specific amounts of stocks totalling 104,500 shares, and they in turn allotted specific amounts to their customers. Also, respondent through its own retail department received offers from its own customers, and entered on its books "buy" orders for an aggregate of 2,600 shares. Finally, the registration statement was filed. The Commission then instituted proceedings pursuant to Sections 15(b) and 15A(1)(2) of the Securities Exchange Act to determine whether respondent had wilfully violated Section 5 of the Securities Act. See note 27 *supra*. The Commission found that respondent had wilfully violated Section 5.

We do not know whether the procedure followed by the Van Alstyne, Noel firm in the Higgins underwriting is representative of underwriting practices generally. Perhaps the firm made its mistake in utilizing the Dow-Jones ticker and the newspapers in publicizing its violations of Section 5. The Commission could hardly be expected to disregard such a flouting of the Act. It is not without interest and possibly of considerable significance that in a statement to the press, Richard C. Noel, a senior partner in the firm, stated, "In forming the underwriting group to purchase and publicly offer stock of Higgins, Inc., our procedure was in all respects in line with our regular course of business and was, we believe, the same procedure followed by substantially all other underwriting houses doing a similar business." N. Y. Times, Feb. 7, 1946, p. 33, col. 3.

oral and telephone conversations, the reluctance of a purchaser, especially if he be a member of the securities industry, to "welsh" on his commitment, and the deeply rooted desire of underwriters and dealers to minimize their risks by securing commitments down the distribution line before committing themselves to their vendors—all these factors, in our opinion, have contributed to a general disregard of the provisions of the Act which proscribe selling activities before the effective date. Although the analogy is far from perfect, the situation is not unlike that of prohibition. A law designed to effect drastic changes in human conduct fails when the standard of conduct established by the law deviates too far from the mores of the community.⁶⁰

Assuming that our opinion concerning the extensiveness of gun beating is substantially correct, the following are factors which a program of revision should take into consideration:

(1) Under the present Act, because of the oral loophole and the distributive practices of the business, public purchasers generally are committed to buy before they have had an opportunity to examine a statutory (*i. e.* Section 10) prospectus.

(2) The tenuous character of the solicitation-dissemination distinction has made some members of the securities industry reluctant to disseminate information during the waiting period. The distinction also presents serious enforcement problems and has contributed to the growth of gun beating.

(3) Gun beating, which violates the Act if the jurisdictional means of the mails or channels or commerce are used, should either be curbed or legalized.

(4) The public investor who so desires should be given sufficient information to enable him to reach an intelligent decision whether to purchase a security.

(5) Although public investors must be protected, remedial measures must be adjusted to the basic needs and practices of the American economy; the measures must be neither so restrictive or expensive as to impose unjustified or impractical burdens on the investment process, nor so divergent from the mores of the regulated community as to exceed the limits of effective legal action.

60. Cf. address of John J. Burns, then General Counsel of SEC, before Convention of IBA, White Sulphur Springs, W. Va., October 28, 1935, p. 5 of mimeographed release of address: "Theoretically, perhaps, some might say that if the law declares certain conduct to be unlawful, the discussion is ended. One has but to choose his place with the saints or sinners. But as a practical matter, we all recognize that the statutory regulation of human conduct must lean heavily upon the normal attitudes and actions of men and that the sanction of law rests largely on the inherent reasonableness of the statute itself."

III. SUMMARY OF AMENDMENT PROPOSALS

Of the various suggestions that have been advanced for amending the registration and prospectus requirements of Section 5 and related sections of the Securities Act, the following,⁶¹ which have received the greatest attention from Congress, the securities industry

61. The background of these proposals is as follows: In 1940 Representative Clarence F. Lea requested the Commission to comment on bills proposing amendments to the Securities Act which had been referred to the Committee on Interstate and Foreign Commerce, of which he was Chairman. Replying to this request, the Commission suggested that its comments be deferred until it had discussed the proposed amendments and other proposals to amend the Securities Act and the Securities Exchange Act of 1934 with representatives of the securities industry. The President of the Investment Bankers Association of America (IBA) wrote Mr. Lea expressing agreement with the Commission's suggestion. Representatives of the Commission, of IBA and of the National Association of Securities Dealers, Inc. (NASD) thereafter reached agreement concerning a proposal to amend § 8(a) of the Securities Act. This proposal was embodied in H. R. 10276, 76th Cong., 3d Sess. and became law on August 22, 1940, as Title III of Pub. L. 768, 76th Cong., 3d Sess., 54 STAT. 857, 15 U. S. C. § 77h(a) (1940).

Following this, discussions were resumed between representatives of the Commission, IBA, NASD, the New York Stock Exchange and the New York Curb Exchange concerning the proposed amendments to the Securities Act and the Securities Exchange Act. Although these discussions brought agreement with respect to some proposed amendments, the Commission and the securities industry, represented by the above groups, were unable to reconcile their differences concerning a number of proposals, including revision of the registration and prospectus requirements of Section 5 and related sections of the Securities Act. At the conclusion of their conferences, the Commission and the industry each submitted a detailed statement of its position to the House Committee on Interstate and Foreign Commerce: COMMISSION REPORT, *supra* note 40; INDUSTRY REPORT, *supra* note 33.

The proposals of the Commission and of the industry were embodied in a COMPARATIVE PRINT SHOWING PROPOSED CHANGES IN THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, 77th Cong., 1st Sess., hereinafter called "COMPARATIVE PRINT." The House Committee on Interstate and Foreign Commerce began hearings on the COMPARATIVE PRINT on October 28, 1941. *Hearings, supra* note 8.

After compiling a record of over 1500 pages, the Committee closed the hearings on January 27, 1942. Presumably because of the exigencies of the war, the Committee made no recommendation to the House of Representatives, and no legislation resulted. On January 17, 1947, the Commission announced resumption of the program interrupted by the war for joint study of the Securities Act and the Securities Exchange Act with groups of persons interested in the operation of those Acts. Securities Act Release No. 3188, January 17, 1947. Between that date and June 6, 1947, the Commission and members of its staff conferred with interested representatives of the securities industry and with other interested persons; unlike the 1940-41 conferences, which considered a wide range of amendment proposals (forty-eight proposals relating to the Securities Act and thirty-six relating to the Securities Exchange Act) the principal subjects of the 1947 discussions have been the registration and prospectus requirements of Section 5 and related sections of the Securities Act.

On June 6, 1947, the Commission made public an ". . . outline of tentative proposals for amending the registration and prospectus requirements of Section 5 and related Sections of the Securities Act of 1933." Securities Act Release No. 3224, June 6, 1947. The outline was prepared by a committee appointed by the Commission from members of its staff to give special attention to the amendment program. In releasing the outline of tentative proposals, the Commission emphasized that the document did not purport to express either unanimous or final views of the staff committee; the Commission also requested comment from interested persons. It is our understanding that IBA, NASD, and other interested parties did inform the Commission concerning their views of the proposals. However, up to the time this article went to press, no further information had been made public concerning the nature of the comments submitted or concerning the views of the Commission or its staff.

There is set forth below the membership of the Commission during the two general periods, 1940-41 and 1947, in which amendment proposals have been the subject of discussions between the Commission and the securities industry.

and the Commission, merit further consideration here: (1) Industry proposals of 1941; (2) Commission counter-proposal of 1941; and (3) Commission staff proposals of 1947.

A. Industry Proposals of 1941⁶²

(1) *During the Waiting Period*⁶³

The industry was perturbed over the uncertainties engendered by the dissemination-solicitation distinction.⁶⁴ Its proposals, therefore, were in part designed to remove those uncertainties. To do so, the industry recommended that Section 2 (3) of the Act be amended to separate the definition of the term "offer to sell" from that of the term "sale."⁶⁵

(a) *Offers.* The industry then proposed to change Section 5 so as to permit "offers" during the waiting period.⁶⁶ Such offers could be made by means of an "identifying statement"; or in other written or oral forms, provided that the "offer" was incorporated in, accom-

June 1, 1940-Dec. 31, 1941	1947
Jerome Frank, Chairman (resigned 4-30-41)	James J. Caffrey, Chairman (resigned 12-31-47)
Robert E. Healy	Robert K. McConnaughey
Leon Henderson (resigned 7-8-41)	Richard B. McEntire
Edward C. Eicher, Chairman, vice Mr. Frank	Edmond M. Hanrahan
Sumner T. Pike	Harry A. McDonald (from 3-26-47)
Ganson Purcell (from 6-11-41)	
Edmund Burke, Jr. (from 8-1-41)	

Other suggestions for amending the registration and prospectus requirements of Section 5 and related sections of the Act may be found in address of John J. Burns, then General Counsel of SEC, before Convention of IBA, White Sulphur Springs, W. Va., Oct. 28, 1935; Bates, *The Waiting Period Under the Securities Act*, 15 HARV. BUS. REV. 203 (1937); S. 3985, 76th Cong., 3rd Sess., May 14, 1940; H. R. 10013, 76th Cong., 3rd Sess., June 6, 1940, the House counterpart of S. 3985; H. R. 4344, 77th Cong., 1st Sess., April 14, 1941; address of Commissioner McConnaughey before the American Society of Corporate Secretaries, Inc., Chicago, Ill., March 26, 1947.

62. See note 61 *supra* for the background of these proposals.

63. The industry proposals would continue the present limitations on offering and selling activities in the period before the filing of a registration statement. The only activity now permitted in that period is negotiation between an issuer and any underwriter; this is accomplished by excepting such negotiation from the definition of offer and sale in Section 2(3) of the Act. The Commission agreed to this phase of the industry's proposals.

64. INDUSTRY REPORT, *supra* note 33, at 87-89; Testimony of R. McLean Stewart, *Hearings*, *supra* note 8, at 136-137.

65. Section 2(3) now provides: "The term 'sale,' 'sell,' 'offer to sell,' or 'offer for sale' shall include every contract of sale or disposition of, attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value; except that such terms shall not include preliminary negotiations or agreements between an issuer and any underwriter. . . ."

The industry proposal would revise this part of Section 2(3) to read as follows: "(a) The term 'sale' or 'sell' includes every sale or other disposition of a security or interest in a security for value, and every contract to make any such sale or disposition. (b) The term 'offer to sell' or 'offer for sale,' or 'offer' includes every attempt or offer to dispose of, or solicitation of an order or offer to buy, a security or interest in a security for value." COMPARATIVE PRINT, *supra* note 61, § 2(3) (a), (b), p. 2, lines 14-21.

66. *Id.* § 5(b) (2), p. 29, line 23 to p. 30, line 5.

panied by, or had been preceded within thirty days by a "limited prospectus" or a "general prospectus."⁶⁷ Thus, during the waiting period it would be unlawful to make offers solely by means of an oral communication.

The "identifying statement" would contain somewhat more elaborate information than that now found in the "tombstone advertisement";⁶⁸ but unlike the "tombstone advertisement," it could be distributed to investors before the effective date. The "limited prospectus" would be a rather abbreviated selling circular of one to six pages corresponding in scope and content to the present "newspaper prospectus."⁶⁹ The "general prospectus" would be similar to the statutory (*i. e.* Section 10) prospectus now in use: a rather extensive summary of all material information concerning the security offered for sale.⁷⁰ But there would be two significant changes concerning its contents and use. First, any of the information otherwise required to be set forth in the general prospectus could be omitted which the Commission might by rule, regulation or order designate.⁷¹ Second, in order that the "general prospectus" could be utilized during the waiting period, there could be omitted from the prospectus, when it was circulated during the waiting period, information as to the offering price, underwriting arrangements and related data.⁷² Thus the "general prospectus" in its pre-effective date form would be very similar to the present red-herring prospectus;⁷³ however, although the existing procedure provides that a person who receives a red herring prior to the effective date must be given a complete prospectus at or before the delivery of the security to him, the proposed amendments would re-

67. *Ibid.*

68. The "identifying statement" would be a document which states from whom a general prospectus could be obtained and in addition does no more than state by whom orders will be executed; identify the security; state its price, yield, and conversion and redemption privileges, if any; indicate the legality of the security as an investment for banks, insurance companies, and fiduciaries; state the extent to which the issuer will pay any tax on the income derived therefrom; and contain such other information as the Commission may by rule or regulation permit. COMPARATIVE PRINT, § 2(10) (d), p. 5, line 14, to p. 6, line 8. The present "tombstone advertisement" is described at note 18 *supra*.

69. INDUSTRY REPORT, *supra* note 33, at 123; COMMISSION REPORT, *supra* note 61, at 12; HEARINGS, *supra* note 8, at 326. By Sections 2(10) (b) and 10(b) (7) of the COMPARATIVE PRINT the Commission could classify prospectuses for use as "limited prospectuses" and prescribe for each class the form and contents which it may find appropriate to such use and consistent with the public interest and protection of investors. The present "newspaper prospectus" is described at note 18 *supra*.

70. Section 2(10) (a) of the COMPARATIVE PRINT defines a "general prospectus" as a prospectus, filed with the Commission, which on its face meets the requirements of Section 10, but not including a "limited prospectus." In this paper the terms "general prospectus" and "statutory prospectus" are used interchangeably. See discussion of prospectuses under the existing Act, at note 34 *supra*.

71. COMPARATIVE PRINT, § 10(b) (1). The purpose of this proposal is to eliminate the present difficulties inherent in the "general prospectus" because of its bulkiness and unreadability. See note 34 *supra*.

72. COMPARATIVE PRINT, § 10(b) (2), p. 43, line 3, to p. 44, line 2.

73. The "red herring" prospectus is described at note 49 *supra*.

quire that a person who received a "general prospectus" need only be supplied with the omitted information.⁷⁴

(b) *Sales*. The industry proposals would continue the present prohibition against "sales" during the waiting period.

(2) *After the Effective Date*

(a) *Offers*. Under the amendments advanced by the industry to govern distributive activities after the effective date, oral "offers" would be permissible to the same extent as they now are under the present statute.⁷⁵ In other words, oral offers might be made before the purchaser had seen a copy of an identifying statement, a limited prospectus or a general prospectus. Written offers, however, could only be made by means of an identifying statement or in other written forms provided that the offer was incorporated in, accompanied by, or had been preceded within thirty days by a limited or general prospectus.⁷⁶

(b) *Sales*. "Sales" would be divided into two classes: (i) those made within seven days of the first date on which the security "was bona fide offered to the public," and (ii) those made after seven days of the same date.⁷⁷ As to the latter, it would be unlawful to sell a security, deliver any security for the purpose of sale, or after sale, or collect or receive payment of any part of the purchase price unless the purchaser was sent or given a general prospectus so that it would normally be received by him not more than thirty days before the sale and not later than the business day before such collection or receipt.⁷⁸

74. COMPARATIVE PRINT, § 10(b) (2). This omitted information would have to be given to the purchaser of the security prior to the sale; if given orally, it would have to be confirmed in writing at or before the completion of the transaction.

75. This is accomplished by Section 5(b) (3) of the COMPARATIVE PRINT, p. 30, lines 6-12, which prohibits offers by any *written* means other than an "identifying statement," unless incorporated in, accompanied by, or preceded by a "limited" or "general" prospectus.

76. COMPARATIVE PRINT, § 5(b) (3), p. 30, lines 6-12.

77. The industry, in making this division, urged that in the case of sales made more than seven days after the effective date, an individual investor is less in need of the protection furnished by the general prospectus than he is when he purchases immediately after the effective date. The argument was advanced that when a purchase is made a week or more after the effective date, the individual is not buying in competition with such professional investors as banks, insurance companies and other like institutions; that he will be helped in his appraisal of the security by the success, or lack of it, which the issue has enjoyed during the days immediately following the effective date; and that considerable information about the security will have become available throughout the financial community because of the length of time during which knowledge of the issue has been public. INDUSTRY REPORT, *supra* note 33, at 93; Testimony of R. McLean Stewart, *Hearings, supra* note 8, at 195.

78. COMPARATIVE PRINT, § 5(a) (2), p. 27, line 22, to p. 28, line 5. This is similar to the selling procedure which exists under Section 5(b) (2) of the present Act. However, the industry urged that in being furnished a prospectus at least a day before collection or receipt of the purchase price, the purchaser is receiving more protection than under existing procedures in which he usually receives the prospectus concurrently with the delivery of the security. INDUSTRY REPORT, 94. See note 38 *supra*. But this is a rather dubious argument, because in both cases the purchaser would be committed before he has had an opportunity to examine a complete prospectus.

As to the former, *i. e.*, within seven days of the public offering date, it would be unlawful to sell a security, deliver the security for purpose of sale or after sale, or collect or receive payment of any part of the purchase price unless the sales were effected pursuant to *either* of the following two procedures.⁷⁹

Procedure (I): A general prospectus had been sent or given to the purchaser so that it would normally be received by him not more than thirty days, and not later than the business day, before the sale.⁸⁰

Procedure (II): (i) A general prospectus had been sent or given to the purchaser, accompanied or followed by a written confirmation of the sale; (ii) the confirmation had been sent or given not later than the first business day after the day of the sale; and (iii) the confirmation contained a statement, in such form as the Commission should prescribe, that "it is a term or condition of the sale that it shall not become effective if the purchaser, not later than noon . . . on the first business day after the day on which such written confirmation was received . . . advises the seller that he has examined the general prospectus and that he elects not to proceed with the purchase." It would be unlawful for the seller to deliver the security or to collect or receive payment of any part of the purchase price prior to the expiration of the period during which the purchaser might elect not to proceed with the purchase.⁸¹

B. Commission Counter-proposal of 1941

The Commission in its 1941 Report to Congress condemned the procedure proposed by the industry to govern offering and selling activity in the waiting and post-effective periods as unfair to public investors and contrary to the basic objectives of the Securities Act.⁸² The principal target of the Commission's objections was the selling procedures advocated by the industry. Accordingly, the Commission advanced a counter-proposal on this point: that in the case of all sales, regardless of when they occur, the purchaser must receive the statutory prospectus at least twenty-four hours before he contracts to buy.⁸³ Moreover, the Commission stated that if this requirement were

79. COMPARATIVE PRINT, § 5(a) (3), p. 28, line 6, to p. 29, line 15.

80. This method of making sales is in accordance with the procedure suggested by the Commission for all sales regardless of when they occur. Cf. COMPARATIVE PRINT, § 5(a) (2), p. 26, lines 13-20. The industry stated that even if its proposals were adopted, this method would be the one most usually followed since most underwriters and dealers would not want to bear the risk involved in making sales subject to an election on the buyer's part to rescind. Testimony of R. McLean Stewart, *Hearings*, 174, 197.

81. COMPARATIVE PRINT, § 5(a) (3) (B), p. 28, line 17, to p. 29, line 15.

82. COMMISSION REPORT, *supra* note 40, at 7-9.

83. *Id.* at 9. See COMPARATIVE PRINT, § 5(a) (2), p. 26, lines 13-20, and note 80 *supra*.

accepted, it would concur (with but one exception) in the other phases of the industry's proposed offering and selling procedure. The exception was that aspect of the industry recommendations which would leave unchanged the present permission to make oral offers after the effective date without prior use of any written material.⁸⁴

C. Commission Staff Proposals of 1947

Early in 1947 the Commission resumed its program of joint study of the Securities Act with industry representatives and other interested groups. There emerged from these discussions a plan of amendment put forward by a committee appointed by the Commission from members of its staff to give special attention to the amendment program.⁸⁵ The staff proposals, which deal only with Section 5 and related sections, differ from the Commission's 1941 position in several respects.

(1) *During the Waiting Period*⁸⁶

(a) *Offers.* The staff recommendations would permit offers to be made orally or in written form. Written offers, unless made by means of an "identifying statement," would have to be preceded or accompanied by a statutory prospectus, complete except for price and related data. The "identifying statement" apparently would be somewhat more limited in scope than the "identifying statement" proposed by the industry in 1941; the statutory prospectus, on the other hand, would correspond to the "general prospectus" of the 1941 proposals.

It will be noted that the staff recommendations differ in two respects from the Commission's 1941 position. Whereas the Commission previously was opposed to oral offers unless preceded or accompanied by a statutory written document,⁸⁷ the staff would permit them without such restriction. In addition, the staff proposal contains no provision for a "limited prospectus."

(b) *Sales.* The staff proposals would continue the present prescription of "sales" during the waiting period.

84. COMMISSION REPORT, 11. The Commission urged that the same procedure for making offers should be followed both before and after the effective date, *i. e.*, offers could be made by means of an "identifying statement" or in any other written or oral form if incorporated in, accompanied by, or preceded within thirty days by a "limited prospectus" or "general prospectus." See Testimony of Commissioner Purcell, *Hearings*, *supra* note 8, at 345. In the industry's opinion if oral offers after the effective date were not permitted without any restriction, "the whole process of trading in a security after the effective date would be made impracticable, if not impossible." INDUSTRY REPORT, *supra* note 33, at 90.

85. Securities Act Release No. 3224, June 4, 1947; see note 61 *supra*.

86. As in 1941, no change is contemplated in the activity permitted before a registration statement is filed. See note 63 *supra*.

87. Under the industry's 1941 proposals oral offers during the waiting period could be made only if preceded or accompanied by a "limited" or "general" prospectus. The Commission conditionally agreed to this but objected to the industry's suggestion that oral offers be permitted after the effective date without restriction, COMMISSION REPORT, *supra* note 40, at 11. See also note 84 *supra*.

(2) *After the Effective Date*

The staff's 1947 recommendations for selling procedure after the effective date are a substantial deviation from the Commission's 1941 position, and in many respects, follow the pattern established by the industry's 1941 proposals.

(a) *Offers.* Offers after the effective date would be made in the same fashion as during the waiting period, *i. e.*, orally, by means of an "identifying statement," or in any other written form if preceded or accompanied by a statutory prospectus.⁸⁸ The prospectus would have to be complete in every regard; but the pre-effective prospectus could be used if there were attached thereto the price and related data which had been omitted.⁸⁹

(b) *Sales.* The staff proposals outline three alternative methods for making sales: (i) A sale could be made after effectiveness to a purchaser who had been sent or given a statutory prospectus, complete except for price and related data, so that it would normally have been received at least two business days before the effective date, provided the omitted information were supplied to the purchaser at any time prior to the sale.⁹⁰ (ii) Where no pre-effective prospectus had been supplied, a sale could be made if the purchaser had been sent or given a statutory prospectus, complete in all details, so that it would normally have been received at least two business days before the making of the sale or the contract to sell. (iii) If neither of the above methods were followed, a sale could be made but the purchaser would have the unqualified right, within two business days after a complete prospectus would normally have been received, to notify the seller of his election not to proceed with the purchase. The prospectus and the confirmation of the sale would have to bear a legend notifying the purchaser of this right.

It can be seen that procedures (i) and (ii) taken together are equivalent to the procedure advocated by the Commission in 1941 for all sales, except that they contemplate the furnishing of a prospectus at least two days, instead of twenty-four hours, before the making of a sale. Procedure (iii) is substantially the same as the industry's 1941 proposal except that the right to rescind could be exercised within two days after the receipt of the prospectus instead of by noon of the next

88. Permission to make oral offers without restriction in the post-effective period is a departure from previous Commission policy. See note 87 *supra*.

89. The staff recommends that the Commission be allowed by rule or in individual cases to require that a complete final prospectus be used after the effective date.

90. See note 74 *supra*. Here also the Commission would have the authority either by rule or in individual cases to require that a complete prospectus be used, along with a specification of the data omitted from the pre-effective prospectus, where "in its opinion the public interest and the protection of investors required such action."

business day, and would apply whether the sale was made within seven days after the effective date or more than seven days after such date.

IV. APPRAISAL OF THE PROPOSALS

The attitude of the Commission and of the industry concerning the problems disclosed by experience under the Act—the oral loophole, the dissemination-solicitation distinction and gun beating—may readily be discerned from the above proposals. The fundamental concern of the Commission and its staff was to plug the oral loophole and to make the statutory prospectus the main selling document. The industry, on the other hand, while not unwilling that the statutory prospectus should play a more important role than theretofore, was primarily interested in eliminating the dissemination-solicitation distinction and in being able to continue to do business on an oral basis. Elimination of the dissemination-solicitation distinction, and the accompanying legalization of gun beating, was acceptable to the Commission and its staff provided the industry would agree to adoption of additional safeguards designed to make the statutory prospectus the main selling document. The industry and the Commission were unable to reconcile their differences in 1941; nor did they do so in 1947. Our resolution of those differences follows.

A. *During the Waiting Period*

(1) *Offers.* The objective of the Securities Act that information concerning the security should receive widespread dissemination during the waiting period seems unassailable. But the desirability of the accompanying proscription of all efforts to dispose of the security during the waiting period is not equally apparent. The established procedure of underwriting in the United States generally involves a commitment by the investment banker or syndicate to purchase the issue at a price slightly less than the public offering price.⁹¹ If the banker is to gauge the market accurately, he should be permitted to secure from the dealers, who will sell the security to the public, information concerning the likely reception of the issue; and the dealers in turn should be permitted to consult their customers in order to acquire the desired data. Reasonably accurate information concerning the likely public reception of the issue assists the banker to reach an intelligent and informed decision concerning the price to be paid to the issuer. The information secured from the investing public thus performs a useful economic function in that it helps the banker to make an informed

91. See p. 611 and note 11 *supra*.

price judgment.⁹² If information concerning the security is to be disseminated to the public, and if information concerning its likely reception is to be relayed back to the banker, it would be impracticable as well as undesirable to prohibit all efforts to dispose of the security during the waiting period. Impracticable, because the prohibition would not be obeyed, as experience under the present Act has rather conclusively demonstrated.⁹³ Undesirable, because (i) such a prohibition would act as a deterrent to dissemination of information, again, as experience under the present Act has shown,⁹⁴ and (ii) governmental legislation interfering with individual freedom of action should extend as far as, but no farther than, is necessary to achieve the objective of the legislation—and in this instance the objective can be accomplished by less restrictive means.⁹⁵

For these reasons it seems advisable to accept the industry's 1941 proposal to separate "offers" from "sales," and to permit offers during the waiting period. Although there is obvious merit in the industry's recommendation that oral offers be prohibited unless accompanied or preceded by a limited or general prospectus, we are inclined to believe that the staff's 1947 proposal unconditionally to permit oral offers in the waiting period should be adopted. In the first place, it is doubtful whether a prohibition of oral offers could effectively be enforced. The same pressures responsible for gun beating under the present Act very likely would lead to similar violations of the prohibition against oral offers. Second, since a major portion of the securities business is conducted over the telephone,⁹⁶ it seems unwise to attempt to limit the traditional procedure for doing business unless the objective of the limitation can only or best be achieved by such a limitation; and, as will be pointed out below, the safeguards proposed to govern sales in the post-effective period should provide adequate protection.⁹⁷ Finally, we believe that the industry proposal for making oral offers during the waiting period would tend to make the "limited" rather than the "general" or "statutory" prospectus the important selling document. Because the limited prospectus would be cheaper to prepare and disseminate than the general prospectus, underwriters and dealers desiring to make oral offers naturally would distribute the limited rather than

92. It might be urged that it is the responsibility and function of an investment banker to have sufficient knowledge concerning the capital market to enable him to price the issue without resort to the procedure described in the text. Our reply to this argument is that undoubtedly the banker does have general information concerning the market, but that the most useful and accurate information concerning the marketability of the offering in question can best be secured in the manner we have described.

93. See part II C of this paper, especially note 59 *supra*.

94. See part II B of this paper, especially note 46 *supra*.

95. See part IV B(2) of this paper.

96. Text at p. 617 and note 38 *supra*.

97. See part IV B(2) *infra*.

the general prospectus prior to or contemporaneously with the making of the oral offer.⁹⁸ Investors thus would be deciding whether to purchase the security on the basis of that abbreviated document instead of upon the general prospectus which contains in condensed form all of the material information concerning the security. Investors' judgments of whether or not to purchase a security should be based on the complete document, rather than on a necessarily inadequate summary of it. If present prospectuses are too bulky and complex, the answer is to improve their quality, not to create an inadequate substitute.⁹⁹

It may plausibly be urged that if oral offers are not to be regulated, a similar freedom should be extended to written offers. But there are differences which may warrant different treatment of the two classes of offers. The existence and character of written offers may be proved with greater facility than in the case of oral offers; and it is a much less burdensome interference with normal business practices to impose the following requirement in the case of written offers than it would be to impose it in the case of oral offers. Accordingly, we agree with the staff's 1947 requirement that if a seller wishes to communicate with a prospective purchaser in writing, the writing must be either (i) an identifying statement or (ii) any other writing provided it is accompanied or was preceded by a statutory prospectus (which could omit price and related data if unknown at the time). As stated in the staff's memorandum, "The 'identifying statement' would be limited in content so that it would serve not as a selling document but purely as a screening device to ascertain what persons were sufficiently interested to warrant delivery to them of the statutory prospectus."¹⁰⁰

(2) *Sales.* The prohibition of the present Act against sales during the waiting period should, of course, be retained in the amended version of the Act.

B. *After the Effective Date*

(1) *Offers.* The procedure to govern oral and written offers after the effective date should, we believe, be the same as that which we have recommended above concerning offers during the waiting period, and for essentially the same reasons: it represents the least possible interference with normal business practices, does not involve virtually insuperable enforcement difficulties, and is supplemented by the safeguards imposed on the procedure for making sales in the post-effective period.

98. INDUSTRY REPORT, note 33 *supra*, at 90.

99. Proposals to empower the Commission to issue orders authorizing or directing omissions from a general or statutory prospectus are more promising means for coping with the problem of bulky prospectuses. See note 71 *supra* and text *thereat*.

100. Securities Act Release No. 3224, June 6, 1947.

(2) *Sales.* The recommended abandonment of existing limitations on offering activities during the waiting period, and the proposal to permit oral offers after effectiveness, underscore the necessity of evolving an appropriate procedure to govern sales after the effective date. That procedure should protect public investors through practicable controls which will involve a minimum of interference with normal business practices. The devices for achieving this objective that have figured most prominently in the discussions between the Commission and the industry are (i) conferring upon the purchaser a power not to continue with the purchase in the event a statutory prospectus had not been delivered a stated period before the sale took place (hereinafter sometimes referred to as the "out clause") and (ii) requiring the seller to deliver a statutory prospectus to the purchaser a stated period—say 24 hours—before the sale takes place (hereinafter sometimes referred to as the "24-hour requirement").¹⁰¹ Enactment of either of these proposals would be a long stride toward correction of existing abuses and realization of the original objective of the Securities Act that public investors should be enabled to reach informed judgments concerning security offerings. As between the two, however, the 24-hour requirement embodies the preferable procedure.

Under the out clause procedure advanced by the industry in 1941 and by the staff committee in 1947, an investor who had "purchased" a security before receiving a statutory prospectus could, within a stated period after being furnished a prospectus, notify the seller of his election not to continue with the purchase. It might be interesting, but not particularly relevant or helpful, to speculate whether delivery of a prospectus and the purchaser's failure to notify of his election not to proceed with the purchase is a "condition precedent" to the existence of a legal "sale," or whether non-delivery of the prospectus (or delivery and notification of an election not to proceed) is a "condition subsequent" to the "sale." For purposes of appraising the out clause, analysis of the legal relations existing between purchaser and seller must give way to the average purchaser's reaction; and it seems clear that under either the industry's or the staff's version of the out clause, the average purchaser's reaction would be, "Yes, I have made a deal

101. It should be noted that all of the proposals require not *actual* delivery of the prospectus to the purchaser, but a sending of the prospectus "so that it normally would be received" by the purchaser within the stated period. The risk of interruption in ordinary mail service and risks of a similar character thus are imposed on the purchaser rather than the seller. Underlying this provision is the thought that the seller should not be required to insure receipt of the prospectus. This appeals to us as a reasonable limitation on the seller's liability.

For ease of expression we shall, as we did in the text above, utilize the phrases "prospectus has been delivered," "delivery of a prospectus," etc., rather than the cumbersome phrase "sending a prospectus so that it normally would be received by the purchaser not less than ——— hours before. . . ."

with the seller. I have bought the security. But I can get out, if, within a certain period after I receive the prospectus, I notify the seller that I want to call the deal off." ¹⁰²

If, as we are firmly convinced, investors would react in this manner, the out clause is fatally defective in that it would permit securities salesmen to induce investors to purchase on the basis of inadequate information orally conveyed. After the investor had made up his mind to buy, he would then be given information on the basis of which he could make up his mind to cancel his commitment. As SEC Commissioner Ganson Purcell stated before the House Committee in 1941: "There is a fundamental difference between forming a judgment on the basis of complete information and upsetting a judgment once formed. The suggestion is to let the investor commit himself and then get out of his commitment, if time and circumstances permit, when that commitment has been based in the first instance on admittedly incomplete information. . . . As a matter of fact, I suppose it is an attribute common to man that once one has made up his mind on a matter he takes a certain pride in his decision and hesitates to reverse himself. There would indeed be an inertia on the part of an investor who had decided he wanted to buy a security which would militate against his studying the matter further after he had given his word to buy." ¹⁰³

A related weakness of the out clause procedure arises from the requirement that in order to take advantage of the out clause the purchaser must give notice. Although the purchaser's inaction might be due to other reasons—*e. g.*, lack of time to examine the prospectus because of pressure of other business, or failure to receive the prospectus because of absence from home or office—he would nevertheless be committed to purchase if he failed to act within the specified time, which in the case of the industry's 1941 proposal might be a very short period.¹⁰⁴ If it is desired that purchasers reach informed judgments concerning securities, a procedure permitting, perhaps encouraging, inaction seems an inappropriate means for realizing the objective.

102. It should be noted that the industry's 1941 proposal provides that the buyer may elect not to proceed with the purchase "if, the purchaser, not later than noon . . . on the first business day after the day on which the confirmation was received. . . . advises the seller *that he has examined the general prospectus* and that he elects not to proceed with the purchase." (Italics supplied.) The requirement of "examination" might be interpreted to require the purchaser to justify his election not to proceed on the basis of information contained in the prospectus. A purchaser might not have had time to examine the prospectus and might therefore feel he was not justified in electing not to proceed. See *Hearings*, 344. The staff's 1947 "out clause" proposal does not contain the requirement of "examination" and therefore is preferable to the industry's version in this respect.

103. *Hearings*, 343.

104. ". . . not later than noon . . . on the first business day after the day on which . . . [the] confirmation [which might be accompanied by the prospectus] was received by him. . . ." COMPARATIVE PRINT, *supra* note 61, at 28-29.

An additional defect in the out clause procedure is the danger that a purchaser who elects not to proceed with the purchase will be branded a "welsher" and blacklisted from participating in future offerings. It is, of course, hazardous to predict the action of the industry or of a substantial percentage of the members of the industry in the event purchasers did utilize the out clause. But it seems highly probable that the purchaser who took advantage of the out clause would find that he was not invited to participate in future desirable offerings. This, at least, was the opinion of the Commission in 1941.¹⁰⁵ In any event, it cannot be doubted that apprehension that he would be branded a welsher and therefore excluded from future desirable offerings, would deter many investors from taking advantage of the out clause.

The foregoing observations apply equally to the industry's 1941 and the staff's 1947 versions of the out clause. The industry's version is defective for still another reason: under the industry's out clause procedure purchasers who had acquired securities after the first seven days of the offering would not be covered by the out clause. Successful issues are often marketed within a very few days. Distributions extending beyond a week would surely call for increased sales effort. Precisely at that point purchasers should be afforded the maximum protection.¹⁰⁶ Yet, it would be precisely at that point that the industry would withdraw the protection of the out clause.

It is for these reasons that we are convinced of the inadequacy of any amendment program based on an out clause procedure. Fortunately, the 24-hour requirement offers greater promise of providing reasonable investor protection without imposing undue burdens on the process of distributing new issues of securities.

Under the 24-hour requirement procedure it would be unlawful to sell the security unless the purchaser had been furnished a statutory prospectus¹⁰⁷ at least 24 hours before the sale.¹⁰⁸ In broad outline the

105. COMMISSION REPORT, *supra* note 40, at 8; *Hearings, supra* note 8, at 343.

106. See the statement of Commissioner Purcell at the House hearings: "It seems to me that this [7-day] limitation withdraws protection from the investor in the very situation where he is most in need of it and where the limitation of a 24-hour period would be the least hindrance to the seller." *Hearings, supra*, 344.

107. The prospectus might omit price and related data if unknown at the time of delivery of the prospectus—which would almost always be the case if the prospectus were distributed during the waiting period. Underwriters are unwilling to take risks of market changes for any extended period and issuers also wish to take advantage of any last minute market changes. Accordingly, the usual procedure is to file a registration statement which does not contain price terms. Then, a few days before the date of the public offering, price terms are filed as an amendment to the registration statement and the Commission is requested to "consent" to the filing or otherwise accelerate the effective date. See text at p. 614 and notes 21 and 22 *supra*. During the time between the original filing of the registration statement and the filing of the price amendment, the prospectus cannot, of course, set forth price and related data. Such a prospectus is often referred to as a "priceless prospectus" or a "red-herring" prospectus.

108. See second paragraph of note 101 *supra*.

proposal would operate approximately as follows: Immediately after a registration statement had been filed with the Commission, the underwriters would circulate copies of the identifying statement among dealers and public investors.¹⁰⁹ The underwriters also would make extensive use of the telephone to communicate with dealers and the public. Dealers in turn would distribute identifying statements to their customers and discuss the offering with them in face-to-face and telephone conversations. The identifying statements and oral communications would evoke expressions of interest from investors and dealers, thus enabling dealers and underwriters to gauge the likely demand for the issue. Underwriters also would be able to reach a general decision concerning the dealers who would be available for inclusion in the selling group. Then, after the Commission's staff had examined the registration statement and had informed the registrant concerning any deficiencies in the statement, copies of the prospectus (complete except for unknown price and related data) would be sent to interested dealers, and by them to investors who had expressed interest in the security.¹¹⁰ Perhaps two or three days before the effective date, price and related data would be filed with the Commission in the form of an amendment to the registration statement¹¹¹ and also communicated by the underwriters to the dealers and by them to their customers.¹¹² On the effective date, dealers would effect telegraphic purchases of their allotment from the underwriters and would immediately telephone or personally visit customers who had already received the prospectus and the omitted price data at least 24 hours before. Sales could then be made, or if the time schedule were such that the omitted price data could not be furnished to dealers or investors at least 24 hours before effectiveness, the proposal would permit a sale to be made to any purchaser who had received the "price-

109. They might also distribute copies of the "priceless prospectus" (note 107 *supra*) at that time.

110. Assuming the prospectus had not been distributed previously, note 109 *supra*.

111. Note 107 *supra*.

112. See COMMISSION REPORT, *supra* note 40, at 10-11: "If the 24-hour condition suggested by the Commission were added to the proposal that offers be permitted before the effective date, it would be possible for the Commission to concur in most of the collateral suggestions made by the securities industry. Thus, to prevent the 24-hour requirement from unduly delaying the marketing of securities, the Commission could concur in the proposal by representatives of the securities industry to permit, before the effective date of the registration statement and subject to certain conditions, the distribution of the general prospectus complete except as to price, underwriters' commissions, and other related data not at that time available. Under this plan the receipt of such a prospectus would start the 24-hour period running and would permit the underwriters to set their machinery in motion before the effective date. Thus immediately upon the registration statement's becoming effective an underwriter could take a firm commitment from any investor or dealer to whom he had given a prospectus 24 hours earlier, provided he furnished the omitted information at the time of the firm commitment."

less prospectus" at least 24 hours before, provided that the omitted data was furnished immediately prior to the time of the sale. The same general procedure would be followed in the post-effective period except that then the prospectus would contain the price data, and therefore there would be no omitted information to be furnished immediately prior to the time of the sale.¹¹³

The 24-hour requirement, in making the statutory prospectus the main selling document, rather than an "unselling" document as under the out clause procedure, provides adequate protection for the public investor. It is difficult to see how the requirement would impose impracticable or undue burdens on the process of distributing new issues of securities. But in the 1941 hearings the industry advanced two principal objections to the 24-hour requirement.

The industry first pointed out that a somewhat inconvenient situation would arise in the case of an unsolicited offer to buy received by a dealer after the effective date.¹¹⁴ In such a case, the dealer could not conclude the transaction but would have to furnish the prospective purchaser with a prospectus and advise him to repeat his offer to buy after a lapse of twenty-four hours. If the buyer did this or the dealer was able to re-establish contact with him, then the sale could be made if the securities were still available.¹¹⁵

There is implicit in this objection the idea that securities in a great measure sell themselves. But the industry's efforts to secure greater latitude in the activity permitted during the waiting period

113. The problem of a seller's acceptance of a firm offer to buy made during the waiting period deserves a word. We incline to the belief that underwriters and dealers ought not be permitted to accept offers to buy made in the waiting period unless there were some further action by the buyer after effectiveness. If this view were adopted it would mean, of course, that a "firm offer to buy" actually constitutes only a statement of intention to offer to buy, or to accept an offer to sell, after effectiveness. Our reluctance to approve a procedure which would enable buyers to make firm offers in the waiting period is based on the belief that under such a procedure buyers would be subject to pressures to make such offers, which would then ripen into binding contracts of sale after effectiveness. Even if it be assumed that such offers might be revocable until accepted, we fear that purchasers would be reluctant to exercise the power of revocation—for the same reasons they would be reluctant to utilize the "out clause" procedure. The waiting period, it bears repeating, is not to be a period for making sales.

114. INDUSTRY REPORT, *supra* note 33, at 94. Testimony of R. McLean Stewart, *Hearings, supra* note 8, at 187, 188.

115. Of course, some dealers might conclude the sale without waiting the required 24 hours. To this extent the 24-hour requirement contains an incentive to "gun beating." However, consummation of the transaction would be a violation of the Act and would subject the dealer to civil liability, criminal prosecution and administrative action, and should be easier to detect and prove than present "gun beating" practices. Moreover, violations of the 24-hour requirement in the post-effective period would tend to be at a minimum since most dealers would try to get prospectuses into the hands of purchasers during the waiting period so as to be ready to conclude sales immediately upon the effective date. The incentive for a dealer to get rid of his allotment as speedily as possible can probably be counted on to override any desire he might have to avoid circulation of the prospectus.

indicates that this notion is in large measure contrary to the facts. In the relatively few instances in which the prospective purchaser would take the initiative no great burden would be imposed upon the dealer since it is unlikely that the purchaser would be discouraged unless what he read in the prospectus influenced him to change his mind.¹¹⁶ There is, of course, the possibility that an individual investor might find that all of the securities had been sold when he renewed his offer to buy. But the protection afforded to investors as a group by the 24-hour requirement is well worth the price of these few individual disappointments.

The industry's second objection was that even in the most carefully managed distributions "it is improbable that . . . a sufficient supply of prospectuses" would be in the hands of all dealers in time to enable them to get the prospectuses to their customers twenty-four hours in advance of the effective date, and that this in turn would create a tendency to dispose of new securities, especially those of high quality, only in large financial centers where it would be comparatively easy to distribute prospectuses during the waiting period.¹¹⁷ However, we do not believe that the evidence advanced by the industry in the 1941 hearings demonstrates the impossibility of making adequate dissemination of prospectuses during the waiting period.

Perhaps the underlying basis of this industry objection is that rather than being impossible to circulate prospectuses adequately, (i) it would increase costs¹¹⁸ and (ii) might delay the distribution procedure to some extent.¹¹⁹ There was considerable testimony by industry representatives in the 1941 hearings concerning the extent to which distribution costs had been increased by the existing statutory

116. The dealer would be held up for another 24 hours in making the sale and thus disposition of his allotment might be delayed. However, the primary purpose of the Act is to protect investors even if this must be done by sacrificing some of the speed with which distribution is accomplished. See note 122 *infra*.

117. INDUSTRY REPORT, *supra* note 33, at 95; Testimony of Edward H. Hilliard of J. J. B. Hilliard & Son of Louisville, Ky., *Hearings, supra* note 8, at 209-213; Testimony of Rush S. Dickson, President of R. S. Dickson & Co., Inc., of Charlotte, N. C., *id.* at 229-232.

This solicitude for "interior" investors is somewhat suspect. The statistics cited by R. McLean Stewart of the Investment Bankers Association of America and the tenor of his testimony indicate that it is a practice to sell securities as fast as possible and that this is best accomplished in large financial centers. *Hearings, supra* note 8, at 198-208. Moreover, the 24-hour requirement, as its operation was envisaged by the Commission, would not have the effect which the industry seems to think it would. Testimony of Commissioner Purcell, *id.* at 335-341.

118. See Testimony of Joseph W. Scribner of Singer, Deane & Scribner of Pittsburgh, Pa., *Hearings, supra* note 8, at 228.

119. Delay would result in the case of sales initiated after the effective date because the seller would have to wait at least twenty-four hours after his original contact with the purchaser before concluding the transaction. In addition, acceleration of the effective date might be refused or postponed if the Commission were not satisfied that there had been adequate circulation of the prospectus to prospective purchasers.

requirements, and the tendency of such increase to divert desirable offerings from public to institutional purchasers.¹²⁰ The Commission, on the other hand, took the position that any increase in costs had been more than offset by reduction in underwriters' fees brought about by the full disclosure provisions of the Act; the Commission attributed the growth in institutional purchases to other factors.¹²¹ As a whole, therefore, the testimony on this point of increased costs was inconclusive. Evidence of a much more compelling character should be adduced before it is concluded that the 24-hour requirement would entail such additional costs as to make it impracticable. The objection that the 24-hour proposal would delay distribution should not be given serious consideration unless it can be demonstrated that the delay would reach such proportions as substantially to burden the distribution process.¹²² And, as previously stated, the 24-hour requirement should not have this effect.¹²³ In our opinion, therefore, the industry's objections do not go to the heart of the 24-hour requirement.

Although, for the reasons outlined above, the 24-hour requirement is to be preferred over the out clause, adoption of either proposal would be a significant advance. In either case, underwriters and dealers would endeavor to disseminate the "priceless prospectus" to investors during the waiting period. They would then be in a position to make the sale on the day of, or shortly after, effectiveness by supplying the omitted price data immediately prior to the time of sale. To the extent that sales were effected in this manner, investors would be furnished the necessary information and the distribution period

120. See *e. g.*, Testimony of Edward B. Twombly, Counsel for Committee on Re-employment of Men and Money of the Commerce and Industry Assoc. of New York, *Hearings, supra* note 8, at 120-129, 479-481; Testimony of Frayser Jones of the National Association of Manufacturers, *id.* at 490-492; Testimony of R. McLean Stewart, *id.* at 167-169; Testimony of Paul W. Loudon (representing investment bankers of Minnesota), *id.* at 623-634.

121. Testimony of Commissioner Purcell, *id.* at 292-304, 571-601; see also Testimony of Bernard J. Reis, Executive Director of the American Investors Union, New York, *id.* at 639-646; Address of ex-SEC Commissioner George C. Matthews before the Minnesota Statistical Assoc., Oct. 24, 1940; Margraf, *Does Securities Regulation Hinder Financing Small Business*, 11 LAW & CONTEMP. PROB. 301 (1945).

122. Originally it was thought that the twenty-day waiting period would serve to slow down the speed of distribution which was considered an evil of the American securities business. However, the oral loophole, gun beating and acceleration have succeeded in preventing the waiting period from accomplishing this objective. The proposals discussed above which would permit offerings of a security before effectiveness both orally and in written form are another concession to this almost insatiable desire for haste. One wonders if this mania for speed has not gone far enough. If the 24-hour requirement does apply some slight braking pressure to the distribution process, it would be a step forward toward the goal which Congress considered desirable in 1933. Also since, as stated by industry representatives at the 1941 hearings (*Hearings, supra* note 8, at 174, 177), the industry would generally endeavor to distribute prospectuses at least 24 hours before the effective date, delay in the instances in which it was not possible to make advance distribution should be rather inconsequential.

123. See pp. 638, 639 *supra*.

would not be delayed. In the ordinary case, then, of a distribution by an underwriting group which had secured the issue through individual negotiations with the issuer, either proposal would be practicable. But when the issuer-underwriter arrangements result from competitive bidding for the issue, difficulties would be encountered under either proposal. In this situation the issuer files the registration statement before bids are invited. Various underwriter groups then submit sealed bids, and the award is made to the highest bidder. During this time, the waiting period is expiring. On the day the successful bidder is selected, or the day after such selection, the registration statement usually becomes effective and the public offering begins. It would be uneconomic for each group of bidding underwriters to distribute identifying statements and "priceless prospectuses" to dealers and for the dealers in turn to distribute those documents to their customers: since only one group of bidding underwriters will be successful, the documents distributed by the unsuccessful bidders would largely be wasted. Also, the exceedingly short period between the date the successful bidder is determined and the public offering begins does not provide adequate time for distribution of identifying statements and prospectuses. Therefore, in a competitive bidding situation, underwriters and dealers could not, as a practical matter, disseminate "priceless prospectuses" during the waiting period. Distribution of the issue thus would be delayed, and underwriters and dealers would themselves be "on the hook" for a longer period than otherwise.

Reference has already been made to the fact that the American underwriting business is geared to speedy distribution, to minimization of risk, to being "on the hook" for no longer than is absolutely necessary.¹²⁴ The administration of the Securities Act has neither sought nor achieved substantial reform of this phase of the underwriting business.¹²⁵ Underwriters still make their final commitments to issuers only a few days before the security is offered to the public.¹²⁶ They still endeavor to carry the risk for the least possible time. Accord-

124. *Supra* part II, especially page 612. See also note 122 *supra*.

125. The Commission could have drastically altered American underwriting practices by refusing to "consent" to the filing of price amendments to registration statements. Had it done so, the filing of a price amendment would begin a new 20-day waiting period during which the underwriter would be committed to buy. See Dean, *supra* note 55. Since the underwriter would be taking the risk of market changes for that extended period, he would naturally exact a greater compensation than for a shorter period. Or the usual pattern of distribution of new securities might have become one of "best efforts" (*supra* note 11). However, the Commission did not bring about such a basic change. Instead, it sought to encourage maximum dissemination of information concerning the issue during the waiting period, and usually gave its "consent" to price amendments. COMMISSION REPORT 4. See also note 122 *supra*.

126. *Supra* note 107. See also testimony of R. McLean Stewart, *Hearings, supra* note 8, at 159.

ingly, any amendment suggestion which would increase the underwriters' period of risk by as much as 24 hours—as would be the case under either the 24-hour requirement or the out clause proposal in a competitive bidding situation¹²⁷—undoubtedly will be resisted by the industry.

Perhaps the short answer to such an objection is that the public interest in being informed outweighs underwriters' private interest in minimizing risks. At the other extreme, it might be urged that securities required to be sold through the competitive bidding procedure are of such a character and subject to such supervision by governmental agencies that public investors being offered those securities do not require the protection of the 24-hour requirement or of the out clause. Or an intermediate procedure might be evolved.¹²⁸ In any event, the fact that exception or modification might be necessary in the case of issues subject to competitive bidding requirements does not, in our opinion, detract from the essential soundness of the 24-hour requirement.¹²⁹

C. Miscellaneous Related Proposals

There were, in addition to the proposals discussed above, two other amendment recommendations which are sufficiently related to the main proposals to warrant a word here.

The first pertains to expanding the jurisdictional base of Section 5. Under the existing statute, a seller who does not use the mails or channels of interstate commerce in making offers or sales or in delivering the security, either before or after the effective date, is not subject to the registration and prospectus requirements of the Act. An amendment recommended by the industry would make these requirements applicable if the mails or any means or instrumentality of interstate commerce were used at any time, or in any way, in offering a security for sale, selling it, delivering it for the purpose of sale or after sale, or collecting or receiving payment of any part of its purchase price.¹³⁰ It is hardly necessary to state that the Commission and the staff ap-

127. Possibly less than 24 hours in the case of the industry's version of the "out clause."

128. The various underwriting groups bidding for the issue might be required to submit to the issuer or an independent representative of the underwriters the names of the dealers to whom they wished to distribute "priceless prospectuses." Elimination of duplications on the lists might bring it down to manageable size. The issuer might also exercise a reasonable discretion to refuse to supply prospectuses to bidding groups whose record in similar competitive bidding offerings indicated that they were very unlikely to be awarded the issue. Prospectuses could then be made available for the rest of the dealers on the list. With all the eliminations, however, it is almost certain that more prospectuses would be necessary than in the case of a negotiated sale. But the interests of the investing public may well justify the additional expense.

129. We would make the same observation with respect to offerings of open end investment companies, for which particular provision also would be required. See *Hearings, supra* note 8, at 180-181, 320, 1394-1396.

130. INDUSTRY REPORT, *supra* note 33, at 87, 95.

proved the recommendation. We too approve the proposal, and we think its merits are sufficiently manifest that further discussion is unnecessary.

The other miscellaneous related proposal involves suggested changes in the requirements applicable to transactions by securities dealers. The industry, Commission and staff were unanimous in their approval of the provision of the present Act which requires a dealer to comply with the prospectus requirements of the Act so long as he retains any portion of an unsold allotment of an issue in which he was a participant in the distribution. There was similar unanimity in the disapproval of the provision of the present Act which requires all dealers, whether or not members of the selling group, to comply with the prospectus provisions for a period of one year after the date on which the security was first offered to the public.

The industry proposed substituting for the one year requirement a provision which would subject a dealer to the prospectus and out clause requirements of Section 5 only so long as he (i) retains the security purchased by him as a participant in the distribution group, or (ii) still is participating in the distribution of the security by selling it on behalf of an issuer or underwriter, or (iii) still is participating in a stabilizing account in connection with the distribution of the security.¹³¹ The staff's substitution for the one year requirement would oblige a dealer in the selling group to comply with the prospectus and out clause provisions of the Act for a period of three months after the effective date; in addition, such a dealer would be required to comply with those provisions so long as he retained any portion of his allotment or the price of the security was being stabilized.¹³² The staff's proposals would require dealers not in the selling group to use a prospectus in making written offers during the first three months after effectiveness; but the staff took no position as to whether dealers not in the selling group would be required to comply with the out clause procedure during the three month period.¹³³

131. INDUSTRY REPORT, *supra* note 33, at 49. None of the proposals contains a definition of the term "participating in a distribution." The industry's understanding is that the term is intended ". . . to include a selling group member . . . any dealer to whom an allowance or concession is made by a selling group member, . . . [and] a dealer purchasing from an issuer or an underwriter offering to dealers on a first-come, first-served basis at a flat price under the market price. [It] would *not* include a dealer acting as a broker for his customer, a dealer engaged in trading rather than in distribution, or in general any dealer not engaged in the process of distribution." *Id.* at 51. (Italics supplied.)

132. Securities Act Release No. 3224, June 6, 1947.

133. It is our belief that so long as the initial distribution of the security is continuing, and under the staff proposal that period would be deemed to include the first three months after effectiveness, investors who purchase securities from members of the securities industry should be given all the benefits of Section 5, whatever form they may eventually take.

It will be noted that the industry proposal would exempt from both the prospectus and out clause requirements offers and sales by a dealer who acquired securities for his own account even though the security was being distributed by the selling group at the time he made such offers or sales. So long as the security is in the process of distribution to the public, a purchaser should receive the same protection regardless of whether he buys from a dealer who is a member of the selling group or from one who is not. In both cases it would be difficult for the purchaser to form an intelligent judgment without the information contained in the prospectus. The activities carried on by the distribution syndicate, such as advertising and stabilizing, benefit both classes of dealers. For these reasons the staff proposal to subject all dealers to the prospectus requirements for a period of three months is to be preferred to the industry recommendation.

V. SUMMARY AND CONCLUSION¹³⁴

The declared objectives of the Securities Act of 1933 were to retard the speedy securities distribution practices in vogue in the 'twenties and to provide the public investor with sufficient information concerning the security to enable him to reach an informed decision whether to purchase the security. Complete attainment of these objectives has been thwarted by the "oral loophole," the difficulties inherent in the dissemination-solicitation distinction of the Act, and the practice of "gun beating." The proposals advanced by the Commission and the securities industry would cope with these defects by authorizing oral and written selling efforts in the waiting period and requiring sales to be effected in accordance with either the procedure of the out clause or that of the 24-hour requirement.

Oral efforts to dispose of securities should be permitted both during the waiting period and after effectiveness because the securities business has traditionally been conducted on an oral basis and because other safeguards are provided. Although the out clause would be an

134. The emphasis of this paper on weaknesses in the registration and prospectus requirements of the Securities Act should not be permitted to obscure the Act's important contribution to investor protection. Because of the Act and Commission action under it, hundreds of defrauding sellers of securities have been enjoined, and hundreds of others have been indicated and convicted. 10 SEC ANN. REP. 29, 189-190 (1945). Nearly 200 stop orders suspending deficient registration statements have been issued, and thousands of other registration statements have been subjected to the careful scrutiny of the Commission's expert staff. *Id.* at 18. More important, probably, than its formal actions have been the reforms effected by the Commission, through informal procedures, in regard to responsibilities of directors, underwriting methods, accounting techniques, and disclosure of corporate practices. *Cf.* LANDIS, *THE ADMINISTRATIVE PROCESS* 109 (1938). But despite these significant accomplishments, the optimum in investor protection will not be realized until remedial legislation has corrected existing defects in the registration and prospectus provisions of the Act.

advance over existing practices, it is seriously defective in that it makes the prospectus an "unselling," rather than *the* selling, document. The 24-hour requirement, although not representing the millenium, would provide adequate protection to the public investor while not unduly burdening the process of distributing securities issues.

The procedures we have recommended would effectively close the "oral loophole," eliminate the dissemination-solicitation distinction, and enable the Commission and the courts to curb illegal "gun beating." The net effect would be to provide the investing public with the data needed to reach an informed decision whether to purchase the security. And because the recommended procedures are adjusted to the needs and practicalities of the securities business, the procedures should command the respect and obedience of the industry. Current underwriting practices designed to minimize risks would not be substantially affected by the procedures. But since the investor would always have at least 24 hours to study the prospectus, the objectionable aspects of the high pressure, blind buying practices of the 'twenties should not recur.¹³⁵

135. In recommending enactment of remedial legislation, we do not overlook the drastic changes in underwriting practices which will be effected if the Government is successful in the anti-trust action now pending against prominent investment bankers. *United States v. Henry S. Morgan et al.*, Civil Action No. 43-757 (S. D. N. Y., October 30, 1947). In the first place, there is no assurance that the Government will be successful; second, successful conclusion of the action will only come after a hard-fought, protracted contest extending over a period of years; and finally, any of the changes in underwriting practices sought to be effected through the judicial process in the anti-trust action can be achieved by appropriate legislation enacted by Congress at the time it amends the registration and prospectus provisions of the Securities Act.