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GOING PUBLIC — PRACTICE, PROCEDURE AND CONSEQUENCES

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INTRODUCTION

IT IS THE PURPOSE of this article to focus on those sections of the Securities Act of 1933[1] (the " '33 Act") dealing with registration as it applies to corporations selling securities to the public for the first time — "going public." Consequently, our aim is to cover the practice and procedure, as well as certain important consequences, of going public. In a nutshell, the '33 Act is designed to prohibit the public distribution of securities without disclosure of relevant information to the investor. In this context, distribution refers to a public offering by the company itself — a "primary offering." The '33 Act also covers certain offerings by existing security holders, who may or may not be those persons who control the company — "secondary offerings" or, more opprobriously, "bailouts."

ADVANTAGES AND DISADVANTAGES OF GOING PUBLIC

Among the more common advantages of going public are the following:

1. Funds are obtained from the offering. When the securities are sold for the account of the company, the money derived may be used for such common purposes as increasing working capital, performing research and development, expanding plant and equipment, retiring existing indebtedness or diversifying company operations. In a secondary offering the proceeds, of course, go to the selling security holders.

2. Through public ownership of its securities, the company may gain prestige, become better known and thereby improve its business

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1. 15 U.S.C. § 77(a) (1964).

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operations. In addition, the company's customers and suppliers often become shareholders and thus acquire an interest in purchasing its products or services. This reason for going public is especially applicable to companies distributing consumer goods or otherwise dealing with the public at large.

3. Many companies contemplate expansion through acquisitions of other businesses. A company with publicly traded stock is in a position to make acquisitions for its own securities, without depleting its cash.

4. The business may be better able to attract and retain personnel if it can offer them stock having a public market, or options to purchase such stock which might make possible the accruing of capital gain benefits.

5. A public offering will usually improve net worth enabling the company to borrow capital on more favorable terms. Once a public market is created and if the stock performs well in the continuing after-market, substantial additional equity capital can be raised from the public and also privately from institutional investors on favorable terms. The company can offer investors a security with liquidity and an ascertainable market value. Thus, management's future financing alternatives are increased following an initial public offering.

6. By establishing a public market for the stock of a company the owners usually achieve a psychological sense of financial success and self-fulfillment as well as a high degree of liquidity for their own investment. Before going public, ownership of a fractional part or even the whole of a closely held business is normally an asset with no ready market. Once the company becomes publicly owned there will be a ready market for as little as 100 shares, or even less, which may represent a fraction of 1 percent of the outstanding equity. As noted below, however, controlling shareholders may not sell the securities of the company they control as freely as securities in other corporations in which they are not in control. There are some very important limitations to such disposition and considerable advanced planning is often required when a disposition is to be made.

Among the disadvantages of going public, aside from the relatively high expense, are the following:

1. Once the public is admitted to ownership information must be disclosed. Owners may be reluctant to make public such information as salaries and transactions with management. Owners of a privately held business often fear that disclosure of such information as sales, profits, competitive position, mode of operation and material contracts would place them at a severe competitive disadvantage,

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although there are rarely the significant adverse consequences which were envisioned.

2. By incurring a responsibility to the public the owners of a business lose some flexibility in management. There are practical, if not legal, limitations on salaries and fringe benefits, relatives on the payroll and many other operating procedures. Opportunities which might have been personally available to the former owners may have to be turned over to the company they control. Ability to act quickly may be lost, especially where approval is required of shareholders or outside directors.

3. There are many additional administrative problems and expenses for a publicly owned company. Routine legal and accounting fees can increase materially. Recurring expenses are incurred for the preparation and distribution of proxy material and annual reports to shareholders, the preparation and filing with the Securities and Exchange Commission (the "SEC" or "Commission") of reports under the Securities Exchange Act of 1934[2] (the "'34 Act"), and the expenditure of fees for a transfer agent, registrar and public relations consultant. There is also a cost in terms of executive time devoted to shareholder relations.

4. The owners of a privately held business are often in high tax brackets and prefer that the company pay either no or low dividends, whereas the underwriters may require otherwise. Such problems are often resolved in the underwriters' favor with the owners arranging to waive some or all dividends for certain periods.

5. Once a company is publicly owned, management inevitably will consider the impact on the market price of its stock when making various decisions. For example, a decision whether to undertake a research and development program which can adversely affect income in the short run or a decision whether to risk a strike in a labor negotiation might now be considered in light of its impact on the stock. While it is felt that management's preoccupation with day to day stock market price fluctuations is unwholesome and should be avoided, there are no doubt some situations where a legitimate concern for stock market impact properly limits the practical alternatives of a public company.

6. Insiders may be threatened with the loss of control of the company if a sufficiently large proportion of the shares are sold to the public. The number of shares to be sold is a matter of negotiation between the owners of the company, who are fearful of a dilution of management control, and the underwriters, who are hopeful of assuring a sufficiently large floating supply of the stock after the offering.

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2. 15 U.S.C. § 78(a) (1964).

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In addition, once the public is admitted to ownership, progressive dilution of the insiders' holdings by subsequent public offerings, secondary financings and acquisitions must be contemplated. Control is often bolstered by creating several classes of stock and offering the public a more limited voting security as well as by entering into voting trust agreements.

7. One frequently mentioned advantage of going public is to have an equity interest in the business which can be converted readily into cash to pay estate taxes. It is often noted that a public market tends to simplify the question of valuation. It should not be overlooked, however, that a public offering also can be very disadvantageous from an estate tax point of view. Where the public evaluates the security, as it often does, at a great many times its book value and at a very high multiple of earnings, the estate tax valuation which is determined at least in part by reference to the public market price, may be considerably higher than the valuation which would have been established if the business were privately owned.

ELIGIBILITY FOR PUBLIC FINANCING

In evaluating the advisability of going public, as well as pricing the company's stock, the underwriters will consider the amount and trend of the company's sales and earnings (as compared with the trend in its industry), the adequacy of its present and projected working capital and cash flow positions, the experience, integrity and quality of its management (and the likelihood of management's being able to accept the burden of responsibility to a public shareholder group), and the growth potential of its business. Other factors evaluated are the nature and number of its customers, its sources of supply, its inclination and ability to diversify and its relative competitive position. There is often a direct relationship between the company's sales and earnings record and the existence of growth potential in the company's industry — the less growth potential for the industry, the more earnings required. On the other hand, underwriters may require little or no earnings record or, in some cases, little or no history of operations for a company in a glamor industry with high growth potential.

There are also fads among investors. In "hot" industries, investors may gobble up new offerings and thereafter ascribe values to them which seem totally unrelated to their intrinsic worth measured by more rational criteria of valuation. Within the hot industry some companies may survive and prosper to the point where their securities become realistically valued in the market. However, most fads

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spawn many ill-conceived public ventures. There is an inevitable shakeout period, with a high incidence of business failures or acquisitions of newly public companies by larger concerns, with such acquisitions tending to be merely salvage operations.

SELECTION OF AN UNDERWRITER

Once the decision has been made to go public, the parties immediately face perhaps the most important decision to be made — selecting the managing underwriter. Investment banking firms vary widely in prestige, financial strength and ability to provide the various services which the company can expect. Some underwriters are not ordinarily interested in first offerings, while others handle very few issues other than first offerings. Some underwriters have particular stature and experience in specific industries. Underwriters may have pre-existing relationships with customers, suppliers or competitors of a prospective company going public, which can be both an advantage and a disadvantage from varying points of view. In short, a managing underwriter appropriate for one company may be wholly inappropriate for another.

In selecting the underwriters, advice should be obtained from experienced advisers who have a background in the area of public offerings. The company's attorneys, auditors and bankers may be helpful in making the selection. Some advisers, particularly underwriters themselves, warn of dire consequences from "shopping" an offering, and suggest dealing with a single underwriter at a time. Opinions on this subject vary. There are some small and speculative offerings where the trick is to find any underwriter, and there may be little chance for selection. Additionally, among smaller underwriters, there may be a reluctance to evaluate, negotiate and otherwise develop an underwriting prospect unless the company is dealing exclusively with the particular firm at that time.

On the other hand, if the proposed offering is good enough to appeal to the larger underwriters, management may be best advised to select a few firms, possibly three to five, with which to begin preliminary discussions more or less simultaneously. If the offering has merit, the larger underwriters normally are most willing to spend time investigating the company to decide whether or not they wish to proceed, and thereafter to sell themselves and their proposal if they do wish to handle the transaction. It is important to deal in candor. Each prospective underwriter should be told that other underwriters are being considered. For offerings of genuine merit, this element of competition may well whet the appetite and stand the

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company in good stead. This is not to suggest, however, that a company should put itself in an auction, trying to get each bidder to top the others.

Finally, it must be stressed that price is not the sole element of comparison, nor is it necessarily advantageous for the stock to be sold for the very top dollar which any prospective underwriter will offer. If the initial offering price is set too high, the issue may have a poor reception and a weak after-market for some time to follow. Some underwriters will frankly advise the company to set the initial offering price slightly under the projected after-market price, perhaps 5 percent to 10 percent below, simply to assure a good reception for the stock. For companies with a good history and earnings record, the proper pricing of the issue often must be determined by the market conditions prevailing at the offering date. Therefore, many underwriters will indicate during the preliminary negotiations the price, or price range, at which the offering could be made if it were being made at that time, with the express reservation that final pricing will be determined by prevailing conditions on the offering date which is normally at least a few months in the future. Thus, the managing underwriter is often selected at a time when the parties have not yet fixed the specific offering price.

Before the underwriters are selected, the company should investigate the after-market performance of the underwriters' prior offerings. Some companies go public only to find limited after-market interest following completion of the underwriting, with the result that the stock does not reach the price levels which the company projects on the basis of the performance of comparable issues. The managing underwriter should have a good record in forming syndicates which provide strong after-market interest and support for their offerings.

Several services can be expected from the underwriters. Initially, the managing underwriter will take the lead in forming the underwriting syndicate. The underwriters are also expected to provide after-market support for the security being sold. They may serve as over-the-counter market makers which stand ready to purchase or sell the stock in the inter-dealer market; they may purchase the stock for their own account; and they may take the initiative in bringing the stock to the attention of public investors, including their own customers. Ideally, the company should seek a managing underwriter which customarily makes a continuous inter-dealer market for the issues it manages, although there are some managing underwriters that do not perform this function themselves.

In addition, the managing underwriter traditionally supplies other investment banking services to the company following the offering. They will assist in obtaining additional financing from public or private sources as the need arises, advise the company concerning possible acquisitions and generally make available their expertise as financial institutions. In many cases they will recommend or furnish experienced men to become members of the company's board of directors, or to serve as officers or key employees of the company.

All things considered, it is best for the company to select as manager the strongest underwriter willing to handle the offering, subject to an important qualification. If the company aims too high, and selects a firm which might consider the company an unimportant client, the underwriter may not have the necessary interest in the company and may not take the time to supply the follow-up services. Thus, for a relatively small offering, the company may do best with a relatively small firm or a strong regional firm based in its area, rather than a giant Wall Street firm. The company should be an important client to its investment banker, a client which will have top personnel assigned to it and receive the most prompt and effective service which the investment banker can render.

STRUCTURE OF THE OFFERING

Once a company has decided to make a public offering, it must determine, in consultation with its managing underwriter, what class of securities should be offered. Most first offerings include common stock. Some first offerings consist of a package including other securities such as debentures, which may or may not be convertible into common stock, or warrants to purchase common stock. It is normally not practicable to have a publicly traded security convertible into common stock or a publicly traded warrant to purchase common stock unless a public market exists for the underlying common stock.

There are two other interrelated variables to consider, the number of shares offered and the offering price for the shares. It is generally felt that a minimum of 200,000 to 250,000 shares, and preferably 300,000 shares or even slightly more, is desirable in the public "float" to constitute a broad national distribution and to support an active trading market thereafter. As to price level, many of the larger investment banking firms and many investors are not particularly interested in dealing with securities offered at less than $10. The $5 level is often another psychological break point below which many investment bankers and investors lose interest. Any offering

with an initial offering price of $20 or more is likely to import a prestige image.

For an offering of $3,000,000, 300,000 shares at $10 per share would be considered in the optimum range. If the offering is below $2,000,000 a decrease in the offering price per share is recommended, rather than a reduction in the number of shares offered below 200,000. These are matters of judgment, however, which should be reviewed carefully with the underwriters in each specific fact situation. In determining the amount of public investment which can be profitably employed in the business, the underwriters will normally evaluate the company's needs for funds and the dilution in earnings per share to result from the issuance of additional stock. If the optimum level of proceeds to the company would constitute too small an offering, it may be desirable for existing shareholders to sell some of their own shares as part of the offering in order to increase its size. Sometimes the underwriters will suggest, or even insist, on a partial secondary offering with some shares to be sold by existing shareholders even though the shareholders would prefer to retain all of their shares.

THE REGISTRATION STATEMENT

The registration statement is the disclosure document required to be filed with the SEC in connection with a registered offering. It consists physically of two principal parts. Part I of the registration statement is the prospectus, which is the only part that normally goes to the public offerees of the securities. It is the legal offering document. Part II of the registration statement contains supplemental information which is available for public inspection at the office of the SEC.

The registration "forms" contain a series of detailed "items" and instructions, in response to which disclosures must be made. But, they are not forms in the sense that they have blanks to be completed like a tax return. Traditionally, the prospectus describes the company's business and responds to all the disclosures required in narrative rather than item-and-answer form. It is prepared as a brochure describing the company and the securities to be offered. The usual prospectus is a fairly stylized document and there is a customary sequence for organizing the material.

In the typical first public offering, the items which are most difficult to respond to, and which require the most creative effort in preparation, deal with the description of the company's business, its properties, material transactions between the company and the insiders and how the proceeds will be used. Other matters required to be disclosed in the prospectus deal with the details of the underwriting,

the plan for distributing the securities, capitalization, pending legal proceedings, description of securities being registered, identification of directors and officers and their remuneration, options to purchase securities and principal holders of securities. There are also detailed requirements concerning financial statements and financial information concerning the company's product lines.

In Part II of the registration statement there is supplemental information of a more formal type which is not required to be given to each investor. Unlike the prospectus, Part II is prepared in item-and-answer form. One requirement which is sometimes troublesome calls for disclosure of recent sales of unregistered securities and a statement of the exemption relied upon. Counsel may discover that past issuances of securities violated the '33 Act. In some such cases, the result is that the company's financial statements must reflect a very large contingent liability under the '33 Act. If past violations have been too flagrant, the offering may have to be deferred. Part II also contains supplemental financial schedules, as well as a list of exhibits which are filed with the registration statement. Normally, the information in Part II is not seen by individual investors, although sophisticated analysts and financial services may make extensive use of it.

The SEC, which reviews the registration statement, has no authority to pass on the merits of a particular offering. The SEC has no general power to prohibit an offering because it considers the investment opportunity to be a poor risk. The sole thrust of the Federal statute is disclosure of relevant information. No matter how speculative the investment, no matter how poor the risk, the offering will comply with Federal law *if* all the required facts are disclosed. By contrast, many state securities or "blue sky" laws, which are applicable in the jurisdictions where the distribution takes place, do regulate the merits of the securities.

In preparing a prospectus, the applicable form is merely the beginning. The forms are quite general and apply to all types of businesses, securities and offerings except for a few industries or limited situations for which special forms have been prepared. In the course of administration over the years, the Commission has given specific content to the general disclosure requirements. It often requires disclosures on a number of points within the scope of the form, but not explicitly covered by the form itself. Furthermore, in addition to information that the form expressly requires, the company must add any information necessary to make the statements made not misleading.[3]

3. SEC Rule 408, 17 C.F.R. § 230.408 (1969).

Thus, the prospectus may not contain a half-truth — a statement which is literally true but misleading in context.

The Commission's views on many matters change from time to time. SEC practitioners, both legal and accounting, constantly exchange news of what the Commission is currently requiring as reflected in its letters of comments. The SEC has also promulgated a set of official "guides" relating to the preparation and filing of registration statements.[4] These, as well as the applicable registration form, should be reviewed in detail as each new filing is prepared.

The Commission has also evolved certain principles of emphasis in highlighting disclosures of adverse facts. As stated, it cannot prohibit an offering from being made, but it can make the offering look highly unattractive. In particular, if there are sufficient adverse factors in an offering, these are required to be set forth in detail in the very beginning of the prospectus under a caption such as "Introductory Statement" or "Risk Factors of the Offering."[5] However, many new issues of going businesses do not require this treatment and counsel must make a judgment in each case. Some of the adverse factors which may be collected under such a heading include: lack of business history, adverse business experience, operating losses, dependence upon particular customers, suppliers and key personnel, lack of a market for the security offered, competitive factors, certain types of transactions with insiders, a low book value for the stock compared to the offering price, potential dilution which may result from the exercise of convertible securities, options or warrants, and a small investment by the promoters compared with the public investment.

To the same end, the SEC has required that boldface reference be made to certain adverse factors on the prospectus cover page. The cover page statements must cross reference disclosures within the prospectus on such matters as high risk factors, immediate equity dilution of the public's investment and various forms of underwriting compensation beyond the normal spread. To add to the brew, the Commission sometimes insists that certain factors be emphasized beyond what the attorneys working on the matter consider to be their true importance. A usual example is that prominent attention must be called to transactions between the company and its management. Often matters of relative insignificance, in terms of amounts involved, are made to appear very important by the amount of space given and placement in the prospectus.

4. SEC Securities Act Release No. 4936 (Dec. 9, 1968).

5. *Id.*

The prospectus is a somewhat schizophrenic document, having two purposes which often present conflicting pulls. On the one hand, it is a selling document. It is used by the principal underwriters to form the underwriting syndicate and a dealer group, and by the underwriters and dealers to sell the securities to the public. From this point of view, it is desirable to present the best possible image. On the other hand, the prospectus is a disclosure document, an insurance policy against liability. With the view toward protection against liability, there is a tendency to resolve all doubts against the company and to make things look as bleak as possible. In balancing the purposes, established underwriters and experienced counsel, guided at least in part by their knowledge of the SEC staff attitudes, traditionally lean to a very conservative presentation. They avoid glowing adjectives, subjective evaluations and predictions about the future. The prospectus is limited to provable statements of historic fact. The layman frequently complains that all the glamor and romance has been lost. "Why can't you tell them," he says, "that we have the most aggressive and imaginative management in the industry?" It takes considerable client education before an attorney can answer this question to his client's satisfaction.

The quarterback in preparing the registration statement is normally the attorney for the company. He is principally responsible for preparing the non-financial parts of the registration statement. Drafts are circulated to all concerned. There are normally several major revisions before sending the job to the printer, and at least a few more printed drafts before the final filing. Close cooperation is required among counsel for the company, the underwriters' counsel, the accountants and the printer. Unless each knows exactly what is expected of him by each of the others, additional delay, expense and irritation are inevitable.

REVIEW BY THE SEC

After the registration statement is filed initially, the Commission reviews it to see that it appropriately responds to the applicable form and almost always finds some deficiencies which are communicated by its staff through the "deficiency letter" or "letter of comments." Amendments to the registration statement are then filed to meet the comments. When the deficiencies are cured, the SEC issues an order allowing the registration statement to become, to use the word of art, "effective." Only after the registration statement is effective may sales to the public take place.

If counsel, or the accountants, with respect to financial comments, feels that the staff's comments are inapposite or should not be met

for some other reason, he will discuss them with the staff, usually by telephone but in person if the matter is sufficiently serious. The Commission's staff is generally reasonable in dealing with counsel's objections. However, as a practical matter, an offering cannot usually come to market unless an accommodation has been reached on all comments. Therefore, the staff usually has the last word on when the company has adequately met the comments, even if they are not legally binding in the formal sense.

PRE-EFFECTIVE OFFERS

In the interval between the first filing with the Commission and the effective date, the so-called "waiting period," the company and the underwriters may distribute preliminary or "red herring" prospectuses. The term "red herring" derives from the legend required to be printed in red ink on the cover of any prospectus which is distributed before the effective date of the registration statement. The legend is to the effect that a registration statement has been filed but has not become effective, and the securities may not be sold nor may offers to buy be accepted prior to the effective date.

During the waiting period oral selling efforts are permitted but no written sales literature — that is, "free writing" — is permitted other than the red herring prospectus.[6] Tombstone advertisements, so-called because the very limited notice of the offering which is permitted is often presented in a form resembling a tombstone, are not considered selling literature and may be published during the waiting period, although it is much more common for them to be published after the effective date.[7] Through the use of a red herring prospectus or by making oral offers by telephone or otherwise, the underwriters may offer the security and may accept "indications of interest" from purchasers prior to the effective date. However, as indicated, no sales can be made during the waiting period.

Ideally, the investor should have the final prospectus available on which to base his decision whether to buy the security. Often this is not the case. It is theoretically possible to avoid entirely the requirements for delivering a prospectus to a purchaser without violating

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6. For SEC interpretations on permissible activities during the waiting period, as well as in the pre-filing and post-effective periods, see SEC Securities Act Release No. 5009 (Oct. 7, 1969); SEC Securities Act Release No. 4697 (May 28, 1964); SEC Securities Act Release No. 3844 (Oct. 8, 1957). Certain proposed new rules and rule changes relating to this subject generally are contained in SEC Securities Act Release No. 5010 (Oct. 7, 1969); Securities Exchange Act Release No. 8710 (Oct. 7, 1969).

7. SEC Rule 134, 17 C.F.R. § 230.134 (1969), regulates tombstone advertisements.

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the law. The requirements can be avoided if the completed transaction is consummated without using the mails or any means or instruments of interstate commerce for any step from initial offer to final payment by the purchaser. In the much more typical situation, the offer and acceptance is by telephone, and the buyer first receives the final prospectus in the mail with the confirmation of the sale. He is thereby informed, assuming that he reads the prospectus and can understand it, about what he has already purchased. However, the document arrives much too late to aid in his initial decision whether to buy the security. Indeed, one commentator has dubbed it a "retrospectus." In order to counteract this, the SEC has undertaken certain steps to insure that a final prospectus or a substantially final red herring will be sent in advance of the confirmation to those indicating an interest during the waiting period.[8]

THE UNDERWRITING AGREEMENT

The company often signs a "letter of intent" with its managing underwriter once the selection of the underwriter has been made. If used, the letter outlines the proposed terms of the offering and the underwriting compensation. However, it expressly states that it is not intended to bind either party, with the possible exception of a binding provision dealing with payment of expenses if one party abandons the transaction.

In a "firm commitment" underwriting agreement, the underwriters agree that they will purchase the shares being offered for the purpose of resale to the public. The underwriters must pay for and hold the shares for their own account if they are not successful in finding public purchasers. This form of underwriting is almost always used by the larger underwriters, and provides the greater assurance of raising the desired funds. In the other common type of underwriting arrangement, the underwriters agree to use their "best efforts" to sell the issue as the company's agent. To the extent that purchasers cannot be found, the issue is not sold. Some best efforts agreements provide that no shares will be sold unless buyers can be found for all, while others set a lower minimum such as 50 percent.

In either form of underwriting, the underwriters' obligations are usually subject to many conditions, various "outs" (*e.g.*, the right not to close in the event of certain specified adverse developments prior to the closing date) and compliance by the company with its numerous representations and warranties. The underwriters also condition their

8. SEC Securities Act Release No. 5010 (Oct. 7, 1969); SEC Securities Act Release No. 4968 (Apr. 24, 1969).

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obligations upon the receipt of certain opinions of counsel and representations, sometimes called a "cold comfort letter," from the company's auditors.

The binding underwriting agreement is not normally signed until within 24 hours of the expected effective date of the registration statement — often on the morning of effectiveness. Thus, throughout the process of preparing the registration statement and during the waiting period, the company has incurred very substantial expenses with no assurance that the offering will take place. Once preparation of the registration statement has begun, however, reputable underwriters rarely refuse to complete the offering, although this can occur with some frequency, especially for small and highly speculative offerings, if there is a sharp market drop during the waiting period. However, as indicated above, the underwriters must price the offering and organize the underwriting syndicate in relationship to market conditions prevailing at the time of the offering. Thus, if market conditions have worsened materially after the letter of intent stage, the issue must either come to the market at a price below that originally contemplated, or it must be postponed until conditions improve. On the other hand, sharply improved market conditions may result in a higher offering price than the parties originally anticipated.

Final settlement with the underwriters usually takes place seven to ten days after the registration statement has become effective, so as to allow the underwriters time to obtain the funds from their customers. At that time, the company receives the proceeds of the sale, net of the underwriting compensation.

PRELIMINARY PREPARATION

For the average first offering, a very substantial amount of preliminary work is required which does not relate directly to preparing the registration statement as such. To have a vehicle for the offering, the business going public normally must be conducted by a single corporation or a parent corporation with subsidiaries. In most cases, the business is not already in such a neat package when the offering project commences. It is often conducted by a number of corporations under common ownership, by partnerships or by combinations of business entities. Considerable work must be done in order to reorganize the various entities by mergers, liquidations and capital contributions. Even where there is a single corporation, a recapitalization is almost always required so that the company will have an appropriate capital structure for the public offering. To mention a few other common projects in preparing to go public, it is often neces-

sary to enter into, to revise or to terminate employment agreements, adopt stock option plans and grant options thereunder, transfer real estate, revise leases, rewrite the corporate charter and by-laws, prepare new stock certificates, engage a transfer agent and registrar, rearrange stockholdings of insiders, draw, revise or cancel agreements among shareholders and revamp financing arrangements.

TIMETABLE

Although laymen find it difficult to believe, the average first public offering normally requires six weeks to three months of intensive work before the registration statement can be filed. One reason so much time is required is the need to accomplish the preparatory steps just referred to at the same time the registration statement is being prepared. There are many important and often interrelated business decisions to be made and implemented, and rarely are all of these questions decided definitively at the outset. Some answers must await final figures, or negotiations with underwriters, and must be held open until the last minute. Inevitably, a businessman first exposed to these considerations will change his mind several times in the interim. Furthermore, drafting of the prospectus normally begins before the financial statements are available. Almost inevitably, some rewriting must be done in the non-financial parts after the financial statements are distributed in order to blend the financial and non-financial sections together. Laymen frequently have the frustrating feeling as the deadline approaches that everything is hopelessly confused. They are quite surprised to see that everything falls into place at the eleventh hour.

After the registration statement is filed with the Commission, the waiting period begins. It is during this interval that red herrings are distributed. The Commission reviews the registration statement and finally issues its letter of comments. There is a wide variation in the time required for the SEC to process a registration statement. One factor is the time of the year. There is normally a considerable rush of filings at the end of each calendar quarter, and particularly at the end of March for filings with financial statements as of December 31. At times the delay in receiving a letter of comments from the Commission has exceeded 100 days. At other times, for relatively simple and well prepared registration statements, or for registration statements of companies which have filed previously, the letter of comments may be received in less than two weeks.

The SEC has announced procedures for expediting the review of certain registration statements because of the substantial increase in

the backlog of pending filings.[9] Under the new procedure, an officer in the Commission's Division of Corporation Finance will make a cursory review of a registration statement promptly after filing and will make one of three decisions: (1) that it is so poorly prepared or presents such serious problems that no further review will be made prior to substantial revision, which if not made will result in the Commission issuing a stop order; (2) that the registration statement appears to be sufficiently well prepared so that it will not be further reviewed, and no written or oral comments will be provided; or (3) that the filing will be subject to the regular review process. It is this second decision which is often referred to as "expedited treatment" or "cursory review." If cursory review is granted, counsel may be notified to that effect by telephone within a week or two after the filing date. In such cases, the company's chief executive officer, the auditors and managing underwriters are then required to acknowledge this limited review in a letter to the Commission, as well as their awareness of their statutory responsibility under the '33 Act. Thereafter, the registration statement will be permitted to become effective. The extent of the continued use of this expedited treatment process will probably vary from time to time in relation to the Commission's backlog of unprocessed filings.

If cursory review is not granted, the time lapse between the beginning of preparation of the registration statement and the final effective date may well exceed six months, and will rarely be much less than three months.

EXPENSES

The largest single expense in going public is usually the underwriters' compensation. The underwriting cash discount or cash commission on a new issue generally ranges from 7 percent to 10 percent of the public offering price. The maximum has been coming down in recent years as a result of pressure from the National Association of Securities Dealers, Inc. ("NASD"), a self-regulatory agency which has effective controls on the amount of compensation which underwriters may receive.

Normally, the three largest additional expenses are legal fees, accounting fees and printing costs. Legal fees for a first offering in the range of several hundred thousand to several million dollars would generally be between $20,000 and $35,000. Fees above this range are probably more common than fees below if the very small offerings are eliminated. This amount includes not only the preparation of the registration statement itself, but also all of the corporate work, house

9. SEC Securities Act Release No. 4934 (Nov. 21, 1968).

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cleaning and other details which become necessary if the company is going public.

Accounting expenses can vary very widely, depending on the nature of the business, whether or not the audit required is a first audit and other factors. If there have been no prior audits and new accountants are engaged at the time of the offering, fees in the $20,000 to $30,000 range, and even higher, would not be unusual. Often the total legal and accounting fees are allocated and part of the amounts are attributed directly to the public offering. This portion is included in the registration statement's list of expenses of the offering and is charged to capital for accounting and tax purposes. The balance of the professional fees are often treated as charges for current services for work which is not related directly to the preparation of the registration statement. These latter charges are treated as current business expenses for accounting and tax purposes.

The printing expenses can also vary widely. With simple financial statements, few proofs and no pressing deadlines, printing expenses may be under $15,000. On the other hand, with corrections and last minute rush, printing expenses well in excess of $20,000 are not unusual for a first registration statement. Recently implemented policies of the SEC, as well as other pending proposals, designed to broaden the use of prospectuses will probably result in even larger printing expenses in the future.[10]

For each registration statement, there is a filing fee at the rate of 1/50th of 1 percent of the maximum aggregate offering price of the securities, with a minimum fee of $100. Among the other expenses to be borne are original issue and transfer taxes, if applicable, transfer agent and registrar fees, printing of stock certificates and "blue sky" expenses. Sometimes the company must pay an expense allowance to the underwriters. This is a negotiated figure which can be as high as $20,000 or possibly more. The company frequently pays the underwriters' counsel a special fee for "blue sky" work, which can range up to several thousand dollars, depending on the number and identity of the jurisdictions involved.

Indemnity insurance against '33 Act liability is sometimes required by the underwriters. However, it is difficult to obtain and is usually available only on the higher quality issues where it is least needed. Premiums are set on an individual basis, generally ranging about 1 percent of the amount of the coverage, which may be less than 100 percent of the total offering.

Thus, for a typical first public issue of several hundred thousand

10. *See* note 8 *supra*.

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to several million dollars, expenses between $50,000 and $90,000, exclusive of the underwriting discount or commission, would be common. They are rarely below $35,000. More than $100,000 is not uncommon, if liability insurance is purchased.

In addition to cash disbursements, there are other costs of going public to consider. As part of the arrangement underwriters sometimes bargain for "cheap stock" — securities which they purchase at less than the public offering price and often at a nominal price as low as a mill a share. Or, they may insist upon receiving options or warrants exercisable over a number of years to purchase the securities being offered at a price usually equal to or above the offering price. These benefits, most typical of the smaller offerings done by the smaller underwriters, introduce an element of dilution of the security. Here again the NASD imposes limitations on the amount of "cheap stock" which underwriters may receive.

Some underwriters, typically the smaller ones, bargain for first refusal rights to handle future financings. It had been quite common for underwriters to bargain for a right to representation on the company's board of directors. However, the trend toward increased liability on corporate directors has made board positions less attractive to underwriters, and many firms refuse to supply a board member even if requested by the company.

Another cost of going public arises out of the heavy burden and time demand it may impose on the company's administrative and executive personnel. Throughout the period of selecting the underwriters and preparing the registration statement, these activities can, and often do, absorb a significant amount of executive time.

LIABILITIES

Under the '33 Act and related statutes, civil and criminal liability may arise from material misstatements or omissions in a registration statement as it becomes effective, including the final prospectus; from failure to comply with applicable registration requirements; from failure to supply a final prospectus in connection with specified activities; and from engaging in fraudulent transactions. Under various provisions, directors, certain officers who must sign the registration statement, underwriters, controlling persons and experts (such as accountants but normally not attorneys) participating in the registration may also be subject to the same liabilities as are imposed upon the company. The parties named are jointly and severally liable and their potential civil liability is the full sales price of the security.

For at least the next few years parties in the process of preparing a registration statement will probably hear frequent references to the

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BarChris case.[11] *BarChris* was one of the very few cases going to final judgment on the question of liability since the Securities Act was passed in 1933, in which an effective registration statement was found to be materially deficient in a civil damage action, the court finding that the registration statement was misleading in many respects. The case attracted interest principally in holding that various defenses were not available to certain persons other than the company.

Under the '33 Act, the company is liable absolutely for deficiencies in the registration statement irrespective of good faith or the exercise of due diligence. However, certain "due diligence" defenses against liability are available to directors, officers who sign the registration statement, underwriters, experts and controlling persons if they neither knew of the deficiencies in the registration statement nor had reason to know of them upon the exercise of due diligence. In the *BarChris* case it was held that none of the parties subject to personal liability had established a due diligence defense. The court concluded that the parties had not exercised due diligence but left open the question of how far each party should have gone under the circumstances in order to establish his defense. Accordingly, there is still considerable uncertainty in this area. However, any person who is exposed to individual liability under the '33 Act for deficiencies in the registration statement should be thoroughly familiar with its contents. He should realize that he may not avoid his responsibility by simply relying on counsel or some other person to prepare the registration statement. Each person should consult with counsel concerning the scope of his individual responsibility.

EXEMPTIONS

There are several types of transactions and securities which are exempt from the registration requirements of the '33 Act.[12] In this section, three of the most common transactional exemptions will be discussed: the small public offering under Regulation A, the intrastate offering and the private offering.

Regulation A

Pursuant to statutory authority to exempt certain small public offerings, the SEC has promulgated "Regulation A"[13] which exempts

11. Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).
12. Transactions exempt from registration are not exempt, however, from anti-fraud provisions imposing liability for material misstatements or omissions in the sale of securities. Even completely private sales of securities of closely held companies may be subject to anti-fraud provisions.
13. Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1964), contains the statutory authority. Regulation A consists of SEC Rules 251–63, 17 C.F.R. §§ 230.251–63 (1969).

from registration public offerings for the account of a company which do not exceed $300,000 in the aggregate in any one year. If the securities are to be sold for the account of a holder other than the company, the aggregate offering price during any one year may not exceed $100,000.[14] Although Regulation A is technically an exemption from the registration requirements, considerable documentation is necessary to establish the exemption, and a Regulation A offering is sometimes referred to as a "short form" of registration. An offering circular, which is similar to a prospectus, must be supplied to each purchaser except for Regulation A offerings not exceeding $50,000.

The principal advantages of Regulation A offerings, as opposed to full registrations, are that the required financial statements are simpler and need not be certified, and the expenses are usually less. Regulation A offerings are reviewed by the regional offices of the SEC and not by the Division of Corporation Finance in Washington, D.C., as are full registrations. In some cases, Regulation A offerings have the advantage of being processed more quickly than full registrations, depending on the regional office and the time of year. There is, however, some prejudice in the financial community against Regulation A offerings and some reputable underwriters who participate in small intrastate issues will refuse to take part in Regulation A offerings.

The Intrastate Offering

There is an exemption from the registration requirements for public offerings within a single state, without any fixed limit on the size of the offering or the number of offerees. To qualify for this intrastate offering exemption, the company must be incorporated in the state in which it makes the offering, it must be doing business in the state and all of the offerees must be residents of the state.[15] The intrastate offering exemption is intended to make possible the local financing of local business entities. It is a difficult exemption upon which to rely where a wide distribution of securities is contemplated because the company has, in practical effect, an absolute liability to

14. In an internal SEC report entitled "Disclosure to Investors — A Reappraisal of Administrative Policies under the '33 and '34 Acts" (March, 1969), commonly known as the "Wheat Report," there are extensive proposals in Chapter VIII for expanding the use of Regulation A. Among other changes, the Wheat Report proposes that Regulation A be made available to the extent of $300,000 for secondary offerings.

15. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(11) (1964), exempts "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory." For a recent interpretation, *see* Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969). *See also* SEC Securities Act Release No. 4434 (Dec. 6, 1961).

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ascertain the residence of each purchaser. If a single share is sold to an out-of-state purchaser during the distribution period, the entire issue may be in violation of the '33 Act. Similarly, if a purchaser resides out-of-state, good faith is not a defense to company liability. Likewise, reliance on the statements of the purchaser concerning his residence will not insure against liability if the purchaser's statements are not true.

In addition, not only must the original purchasers of the securities be residents of the state involved, but also, they may not immediately resell the securities across state lines. The securities must continue to be owned by residents of the original state until the distribution is completed and the securities "come to rest in the hands of resident investors."[16] Even if all of the stock is sold at the outset, the actual distribution period may not end until several months after the offering date, and there is some authority that all of the stock must stay within the original state as long as a year or two. It is thus very difficult to properly police an intrastate offering unless it is limited to people the company knows do not expect to be trading the stock for some time. Where the company does know the purchasers and the sale is directly negotiated with them, however, the company may be able to rely on the intrastate offering exemption where the group of purchasers is too large for the offering to qualify as a private offering.

The Private Offering

The registration requirements of the '33 Act are inapplicable to private offerings or, in the language of Section 4(2), "transactions by an issuer not involving any public offering."[17] Neither the '33 Act nor the rules or regulations thereunder have a generally applicable definition of the statutory term "public offering." The principal criteria applied to determine whether an offering is public include: the number of offerees and their relation to the issuer (including their access to relevant information and their ability to fend for themselves in matters of investments), the number of units offered, the size of the offering and the manner of offering.[18]

With respect to the number of persons involved, it is the number of offerees which must be considered, not only the number of actual purchasers. There is no precise number which separates public from private offerings. As a very rough rule of thumb, if there are no more than 25 offerees who meet other applicable criteria, the offering will

16. SEC Securities Act Release No. 4434 (Dec. 6, 1961).
17. 15 U.S.C. § 77d(2) (1964).
18. SEC Securities Act Release No. 4552 (Nov. 6, 1962); SEC Securities Act Release No. 285 (Jan. 24, 1935).

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be considered private.[19] Even if the number of initial offerees is sufficiently small, the private offering exemption is unavailable unless all of the purchasers take the securities as investors rather than as conduits for immediate public resale. If anyone purchases and thereafter makes an immediate public resale, that purchaser becomes a statutory underwriter and the offering is no longer private.

Another important factor in identifying a public offering is the nature of the offerees and their relationship to the company. The purpose of the registration requirement is to afford investors protection through disclosure. Therefore, it is relevant to consider the extent to which the offerees are in a position to protect themselves.[20] Do they have, or can they obtain, relevant information without the aid of a registration statement? All other things being equal, an unregistered offering can be made to a larger number of offerees if they are insurance companies, banks and similar institutional investors, or if they are top executives of the company, as opposed to average unsophisticated investors. The theory is that top executives or institutional investors will have, or will be able to obtain for themselves, without a prospectus, the information they require in order to appraise the investment. There are no dollar or geographical limitations on private transactions.

INTEGRATION

Before leaving the topic of exemptions, brief mention should be made of the subject of "integration." A company considering going public will frequently suggest a two-step interim financing program. Under such a program the company may propose to make a private offering to investors in several states and then, more or less concurrently, make an intrastate public offering. Unfortunately, this will not work if the two offerings are found to be parts of a single financing plan. The two offerings may be lumped together and treated as a single overall transaction; that is, they may be integrated. In such a case, the first offering is not considered to be a bona fide private offering. It would be the first step in an integrated, interstate distribution program to be carried out in two stages. There are many other situations where an issuance, which would be exempt in isolation, becomes non-

19. The SEC has proposed a new Rule 181 which provides that in the very limited context of an acquisition transaction, an offering to not more than 25 offerees (including certain closely related holders as being the same offeree) is not a public offering. SEC Securities Act Release No. 5012 (Oct. 9, 1969); SEC Securities Exchange Act Release No. 8711 (Oct. 9, 1969).

20. *See* SEC v. Ralston Purina Co., 346 U.S. 119 (1953); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir.), *cert. denied,* 389 U.S. 350 (1967); SEC Securities Act Release No. 4552 (Nov. 6, 1962).

exempt if integrated with other transactions. It may be very difficult to determine whether integration principles will be applied to particular factual situations.

LISTING ON A STOCK EXCHANGE

In connection with the preparation for going public, many companies consider the listing of their securities on a stock exchange. If there is a firm intention to apply for listing, and the company has been given informal indications by the exchange that a listing application will be accepted, this fact should be disclosed in the prospectus.[21] If the company can meet the listing requirements of the New York Stock Exchange, generally it would be regarded as highly desirable to list on that exchange but very few companies can meet these tests after their first public offering. If the company can meet the somewhat lower listing requirements of the American Stock Exchange, it is normally advantageous to list on that exchange, following six months to one year of trading in the over-the-counter market to "season" the securities. For smaller issues, there are many advantages to be gained from listing on the "regional" stock exchanges, the principal regional exchanges being the Boston, Detroit, Midwest (in Chicago), Pacific Coast (in Los Angeles and San Francisco), and Philadelphia-Baltimore-Washington (in Philadelphia) Stock Exchanges.

Advantages of listing include: more prestige for the company with investors, customers and suppliers; a more desirable and attractive security for the purpose of attracting new employees and effecting acquisitions; a security which will have a higher and more readily ascertainable collateral value in the hands of the investor who may wish to borrow on the strength of the security; increased ability for the company to have its press releases and quotations widely disseminated by the news media; certain advantages under state law;[22] the existence of a specialist who is obligated by the exchange to make a fair and orderly market in the security by purchasing it and selling it for his own account if necessary; and typically closer spreads than normally prevail in the over-the-counter market between the bid and offered quotations.

21. SEC Securities Act Release No. 4936 (Dec. 9, 1968).

22. For example, under Section 262(k) of the General Corporation Law of the State of Delaware, DEL. CODE ANN. tit. 8, § 262(k) (Supp. 1969), appraisal rights which are otherwise available in a merger or consolidation become unavailable with respect to any security listed on a "national securities exchange." (For this purpose, the New York and American Stock Exchanges as well as most of the regional stock exchanges, including all of those named in the text above, are "national securities exchanges.") Section 515 L of the Pennsylvania Business Corporation Law, PA. STAT. ANN. tit. 15, § 515 L (1968), denies appraisal rights with respect to classes of securities listed on the New York or American Stock Exchanges.

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There is some feeling that listing on the American and regional exchanges may be disadvantageous in terms of the quality of the market although, as indicated above, it is felt that the advantages of listing generally outweigh the disadvantages following a seasoning period for the security. An actively traded over-the-counter stock, with several market makers, may command more broker-dealer interest and have a higher trading volume than certain listed stocks. Some brokers, especially those who are not members of the major stock exchanges, charge a higher commission for trading over-the-counter stocks than they do for listed securities. Smaller firms which are not members of the major exchanges may lose interest in a security after it is listed. Finally, under the so-called "1 percent" test referred to later, the sales permitted by controlling stockholders may be somewhat lower after listing if the reported weekly volume of trading on the exchange is less than 1 percent of the total amount of the security outstanding.

The two major stock exchanges have certain policies which should be taken into consideration in connection with a decision to list.[23] Most of these policies are announced as general guides by the exchanges, with each case to be considered on its individual facts in applying the policies. Even if a company determines not to apply for listing, the exchange policies serve as an excellent guide to good corporate practice which over-the-counter companies might well follow voluntarily.

Conflicts of Interest

The exchanges are reluctant to admit securities for listing if there are material transactions between the management or major shareholders of a company, and the company itself. The exchanges generally seek concessions that the company will eliminate such relationships in the future, to the extent practicable.

Voting Rights

The major exchanges will not list a common stock without voting rights or with unduly restricted voting rights. With respect to preferred stocks, the two major exchanges require that stockholders must be entitled to vote on specified defaults in the payment of fixed dividends (a maximum of two years on the American and six quarters on the New York Stock Exchange). Both exchanges prefer a quorum which is sufficiently high to insure adequate representation (one-third in the case of the American and one-half in the case of the New York Stock Exchange).

23. The policies discussed herein are set forth fully in the New York Stock Exchange Company Manual and the American Stock Exchange Company Guide.

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Shareholder Votes Required

Both major exchanges require that companies with listed securities solicit votes of stockholders on certain types of matters, whether or not such a vote is required under state law. Specifically, votes are required on acquisitions of other businesses if directors, officers or major stockholders of the listed company have an interest in the acquired company; if the acquisition would increase the outstanding stock by approximately 20 percent or more; or where the fair value of the total consideration paid is equal to approximately 20 percent or more of the market value of the outstanding common stock of the company. Stockholder votes are also required for the adoption of any option plan for directors, officers and key employees.

Outside Directors

Both major exchanges recommend at least two outside directors.

Control on Future Stock Issuances

Both exchanges have requirements to the effect that a company with a listed class of securities may not issue or commit itself to issue through convertible securities, options, warrants or otherwise, additional securities of the listed class without filing a supplemental listing application for such additional securities. At the time of each supplemental listing application, the company is required to agree to comply with all then applicable standards of the exchange, including any standards which had been promulgated in the interval following the last application for listing. Thus, by listing a security in the first instance, the company obligates itself for the indefinite future to comply with requirements which may be adopted thereafter by the exchange, unless it is willing to abandon listed status entirely or is able to obtain a waiver from certain requirements.

Timely Disclosure of Information

The exchanges have requirements obligating listed companies to make timely public disclosures of material corporate developments. These provisions are discussed below.

CERTAIN CONSEQUENCES OF GOING PUBLIC

Consequences under the Securities Exchange Act of 1934

There are certain continuing consequences arising under the '34 Act once a company goes public. If any company has total assets of

more than $1,000,000 and a class of equity securities held by more than 500 persons at the end of any fiscal year, such class of equity securities must be registered under section 12(g)[24] within 120 days after the first fiscal year ends, and on which the company meets these tests. Likewise, any company which has a class of securities registered on a stock exchange must register those securities under section 12(b).[25] These registrations under section 12 of the '34 Act are one-time registrations which apply to that entire class of securities and should be distinguished from registrations under the '33 Act which relate only to specific securities involved in a particular offering.

Registration under the '34 Act involves four separate sets of legal obligations:

A. Periodic Reporting.

The company must file certain periodic reports with the Commission. Companies with exchange listed securities also file copies with the exchange. The required reports include a Form 10-K report which is filed with the SEC on an annual basis. It generally updates the company's registration statement filed under section 12(b) or (g) and contains the complete financial statements for the year end. In addition to the Form 10-K annual report, the company must file interim reports with unaudited financial information as well as information on certain significant developments. At the present time, there are outstanding proposals which would substantially expand the scope and content of the periodic reports.[26]

Companies which have filed a registration statement under the '33 Act are required under section 15(d) of the '34 Act[27] to file periodic reports for the balance of the year in which the registration statement becomes effective, and for each subsequent year if they have 300 or more holders of the registered security at the start of the fiscal year. This requirement is applicable even if the company does not meet the section 12(g) registration requirements.

B. Proxy Solicitation.

If any person, including the company itself or its management, solicits proxies from the holders of a class of securities registered

24. 15 U.S.C. § 78*l*(g) (1964).
25. 15 U.S.C. § 78*l*(b) (1964).
26. The entire subject of periodic reports received extensive review in Chapter X of the Wheat Report, note 14 *supra*. There are currently pending extensive proposals by the SEC, based on the Wheat Report recommendations, for up-grading and expanding the periodic reports. SEC Securities Exchange Act Release Nos. 8680–84 (Sept. 15, 1969).
27. 15 U.S.C. § 78o(d) (1964).

under section 12(b) or (g) of the '34 Act, such person must comply with the Commission's proxy rules promulgated under section 14(a)[28] of the '34 Act. These rules require a proxy statement describing the matters being submitted to a vote of the security holders together with a form of proxy on which they can vote for or against each matter being submitted. The extent of the disclosure required on any matter being submitted to a vote is substantially equivalent to the disclosure required on the same such matter in a '33 Act registration statement. The proxy material is reviewed by the Commission in a manner generally similar to the procedure used for '33 Act registration statements but in a shorter period of time. If a matter is being submitted to a vote of security holders of a registered class and the company does not solicit proxies, it is required to supply an information statement[29] which contains substantially the same information as would appear in a proxy statement.

C. Insider trading under section 16.

Section 16(a)[30] of the '34 Act requires certain reports to be filed by directors and officers of any company with a class of equity securities registered under the '34 Act, and also beneficial holders of more than 10 percent of any class of such securities. Such "reporting persons" must report their beneficial holdings of all equity securities of the company, including classes of securities not registered under the '34 Act, to the SEC and, for companies with exchange listed securities, to the stock exchange on which the securities are listed. There are detailed rules as to what constitutes beneficial holdings which can include indirect holdings through entities such as partnerships, trusts and estates, and may also include, by administrative interpretation, securities owned by certain close relatives of the reporting person.

An initial report on Form 3 is filed at the time the reporting requirements become applicable. Thereafter, any changes in beneficial holdings, as a result of a purchase, sale, gift, option exercise or otherwise, occurring during any calendar month, must be reported on Form 4 by the tenth day of the next succeeding calendar month.

The reporting persons are also subject to the "short-swing profit recapture" provisions of section 16(b)[31] of the '34 Act. If any reporting person realizes any profit on a purchase and subsequent sale, or sale and subsequent purchase of any class of equity security within a six month period, he may be required to pay such profit over to the

28. 15 U.S.C. § 78n(a) (1964).
29. Securities Exchange Act of 1934 § 14(c), 15 U.S.C. § 78n(c) (1964).
30. 15 U.S.C. § 78p(a) (1964).
31. 15 U.S.C. § 78p(b) (1964).

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company. These provisions are applied mechanically so that the spread between the lowest purchase price and highest sales price within any six month period is recoverable. Losses cannot be off-set against profits. It is irrelevant that the reporting person had no undisclosed inside information. If a recoverable profit exists, suit for recovery may be brought by the company or by any security holder of the company for the company's benefit.

There are a multitude of difficult questions concerning the applicability of section 16(b) to recapitalizations, reorganizations, mergers and other types of transactions which are not generally thought to involve purchases or sales of securities but which may be so characterized for section 16(b) purposes. There have been many hard cases involving parties who were required to pay over short-swing profits under this section where they had no awareness in advance of the consequences of the transactions involved. Because of the complexity of this area, and the seriousness of the consequences, any reporting person should use extreme care in planning his transaction to avoid any section 16(b) liability.

Under section 16(c),[32] reporting persons are prohibited from selling securities "short" or selling securities which they own but do not plan to deliver currently, so-called "short sales against the box."

D. Tender rules and related matters.

The '34 Act includes several provisions relating generally to tender offers for securities registered under the '34 Act.[33] If, after registration of a class of equity securities, any person becomes the owner of more than 10 percent of the securities of any such class or makes a cash tender offer which would result in his becoming an owner of more than 10 percent of such class, he must make certain disclosures to the SEC and the company, and in some instances the company's shareholders. There are also substantive requirements relating to the mechanics of tender offers, including limitations on activities by the company in resisting the tender offer and purchasing its own shares while the tender offer is pending.

Other Consequences of Going Public

Apart from the specific requirements under the '34 Act which become applicable once a publicly owned company is required to register

32. Securities Exchange Act of 1934 § 16(c), 15 U.S.C. § 78p(c) (1964).
33. The applicable provisions are contained in sections 13(d), (e), 15 U.S.C. §§ 78m(d), (e) (Supp. 1968), and sections 14(d), (e), (f), 15 U.S.C. §§ 78n(d), (e), (f) (Supp. 1968), as well as the rules promulgated under these sections.

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under that Act, there are other requirements generally applicable to all publicly owned companies and their insiders.

A. Timely disclosure of material developments.

Good corporate practice requires publicly held companies to make timely disclosure to the public at large of any developments in its affairs which would be material to public investors, whether favorable or unfavorable. Such disclosures are normally through press releases, which may be supplemented by communications directly to shareholders. The extent to which these requirements are legally binding is a matter of growing concern. Companies with securities listed on a stock exchange are subject to the exchange's requirements to make timely disclosures.[34] Companies whose securities are traded in the over-the-counter market and quoted in newspapers must conform to NASD policies on timely disclosures.[35] There is no doubt that the trend of the law is toward increasingly more serious consequences, including the possibility of civil liability, criminal penalties, suspension of trading and various injunctive remedies, if a company does not adhere to these disclosure standards.

B. Restrictions on trading on undisclosed inside information.

Until such time as information concerning material developments has been disclosed adequately to the public, it is unlawful for any person deriving such information from the company to trade on the basis of such information. While it is customary to speak of these restrictions as dealing with "insiders" and "inside information," they clearly apply to anyone deriving the information from the company. Thus, the restricted group may include not only directors and top executives, but also lower level employees and even persons not affiliated with the company, so-called "tipees," who may receive the information from an informed source within the company. The principles involved were recently reasserted most dramtically in the *Texas Gulf Sulphur* case.[36] Every publicly owned company should establish internal procedures to assure that confidential information is kept confidential; that all persons who may become privy to such information are made aware of their obligation to refrain from trading on such information or dis-

34. *See generally* the policies of the New York Stock Exchange in the Company Manual Section A2; the policies of the American Stock Exchange in its Company Guide §§ 401–24, and ¶ 3 of the current American Stock Exchange form of Agreement to Conform with Rules and Regulations, Listing Form L (revised March 21, 1968).

35. *See generally* the policy adopted by the NASD Board of Governors in CCH NASD MANUAL ¶ 2155.

36. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied, sub nom.* Coates v. SEC, 394 U.S. 976 (1969).

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closing it improperly; and that the disclosure of information to the public at large is made under controlled procedures by knowledgeable officials with clearly defined authority and responsibilities.

C. Sale of control stock.

Even though a company becomes publicly owned, the controlling stockholders are not completely free to sell their own shares in the public securities markets without registration. There are, however, certain specific leakage provisions which permit limited sales under defined circumstances. Very generally, and without exploring the many nuances, a controlling person may sell, in any six month period, an amount of securities equal to 1 percent of the total amount of that class outstanding (not limited to the public float) or, if the class is listed on a stock exchange, the lesser of 1 percent or the highest reported weekly trading volume on security exchanges in any one of the four preceding calendar weeks.[37] Thus, the trading volume limitation can change from week to week. The sales must be handled in all respects as routine unsolicited brokerage transactions and brokers may not receive more than a standard minimum commission. Under the leakage provision, two or more closely related persons may be required to combine their sales in applying the formula. A great deal of complex law has developed concerning these provisions, and any restricted person should be cautioned to consult with counsel well in advance, before making any public sales in reliance on them.

CONCLUSION

The process of going public is a major development in the business life of any company. It is a step which should be taken only after a thorough analysis of the advantages, disadvantages, consequences and alternative means of financing. Going public is a relatively time consuming and expensive means of raising capital, although the commensurate benefits may more than outweigh these disadvantages in the appropriate situation.

Any company considering the possibility of a public offering should begin its planning long in advance. Many of the decisions which must be made in connection with a public offering require a long period of time to implement. Therefore, a well planned public offering is a project for which the preliminary steps and long range study should begin years before the securities can be sold.

37. The leakage provision is presently embodied in Securities Act Rule 154, 17 C.F.R. § 230.154 (1969). Substantial revisions in the pattern of permissible leakage, which would preserve in essence the "1 percent" of trading volume test indicated above, are contained in SEC Securities Act Release No. 4997 (Sept. 15, 1969).

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