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GOING PUBLIC: PRACTICE, PROCEDURE, AND CONSEQUENCES *

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INTRODUCTION

WHEN A COMPANY WISHES TO "GO PUBLIC" it faces a complex and challenging process. It is the purpose of this article to focus on the sections of the Securities Act of 1933 [1] (the '33 Act) dealing with registration as it applies to companies selling securities to the public for the first time—"going public." The authors' 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

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1. 15 U.S.C. §§ 77a-77bbbb (1976).

TABLE OF CONTENTS

existing security holders, who may or may not be those persons who control the company—"secondary offerings" or, more opprobriously, "bailouts."

During the decade of the 1970's there were relatively few initial public offerings compared to earlier periods. However, data available at mid-1981 suggests a resurgence in the market for initial public offerings commencing in 1980.[2]

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. A public offering of stock will 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 aftermarket, 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.

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. The use of stock and stock options may make it possible for employees to realize capital gains for tax purposes, in lieu of ordinary income which would be taxable at higher rates.

5. Through public ownership of its securities, the company may gain prestige, become better known, and thereby improve its business operations. In addition, the company's customers and

2. *See* APPENDIX, *infra.*

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.

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 one hundred shares, or even less, which may represent a fraction of one 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 of other corporations which they do not control. There are some very important limitations to the sale of control stock and considerable advance 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, although the significant adverse consequences which were envisioned rarely occur in the authors' experience.

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 available personally to the former owners may have to be turned over to the company they control. Ability to act quickly may be lost, especially when approval is required of shareholders or outside directors.

3. 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 then 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 in which a legitimate concern for stock market impact properly limits the practical alternatives of a public company.

4. There are many additional expenses, typically ranging from $30,000 to $100,000 annually, and administrative problems for a publicly-owned company. Routine legal and accounting fees can increase materially. Recurring expenses include 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 [3] (the '34 Act), and the expenditure of fees for a transfer agent, a registrar and, sometimes, a public relations consultant. There is also a cost in terms of executive time devoted to shareholder relations and public disclosures.

5. 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. 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.

6. 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, or to hold a special stock which bears no dividends, for certain periods.

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 disadvan-

3. 15 U.S.C. §§ 78a-78*lll* (1976).

tageous from an estate tax point of view. When 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 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. In terms of what underwriters will require, 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 company they perceive, the more historic earnings the underwriters will require.

During periods when investor interest in new issues is high, fads often emerge. Investors tend to gobble up new offerings in "hot" industries, and thereafter sometimes ascribe values to stocks which seem totally unrelated to their apparent intrinsic merits measured by more conventional 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 spawn many ill-conceived public ventures. There is an inevitable shakedown 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 specialize in them. 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 the 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 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 five percent to ten 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 on 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 analysts and 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 some cases, they will recommend or furnish experienced persons to become members of the company's board of directors or serve as officers or key employees.

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 price of $20 or more is likely to impart a prestige image. During some periods of interest in new issues, however, many high risk issues have been marketed at or below $1 per share.

For an offering of $3 million, 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 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 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[4] 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.

Form S-1 traditionally has been the most common registration form used. In April 1979, however, the SEC adopted a simplified Form S-18 for the registration of up to $5 million of securities by certain smaller companies. Form S-18 has been used more frequently than Form S-1 by companies which satisfy the conditions to its use.

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4. The Commission recently announced a proposed new series of forms to streamline corporate reporting through a "single comprehensive disclosure system" integrating the disclosure requirements of the '33 and '34 Acts. *See* SEC Securities Act Release Nos. 6331-38 (Aug. 6, 1981). *See generally* [1981] FED. SEC. L. REP. (CCH) ¶ 83,016. Although abbreviated registration forms were proposed for various types of issuers, even under the integrated disclosure system a full disclosure document such as the text describes will be required for an initial public offering.

Form S-18 is available for the sale of up to $5 million of securities ($1.5 million of which may be for the account of other than the company) within a one year period. Form S-18 may not be used by companies which are reporting companies under the '34 Act, offering limited partnership interests, investment companies, companies engaged in significant oil and gas operations, or insurance companies. Filings on S-18 may be made at either the SEC's principal office in Washington D.C., as is the case for Form S-1, or in the SEC Regional Office for the region in which the company conducts or intends to conduct its principal business operations.

The principal advantages of Form S-18 over Form S-1 are its somewhat less demanding requirements with respect to financial statements. Form S-18 requires a balance sheet as of the end of the company's last fiscal year (as compared to the last two fiscal years in the case of Form S-1) and statements of income, changes in financial condition, and stockholders' equity for the last two fiscal years (as compared to three years in the case of the Form S-1). Form S-18 does not require financial statements to be prepared in accordance with Regulation S-X (the SEC's accounting rules), but in accordance with generally accepted accounting standards. In addition, Form S-18 does not require the five year Selected Financial Data, Management's Discussion and Analysis of Financial Condition and Results of Operations, or the supporting schedules which are required by Form S-1. Form S-18 also requires a somewhat less detailed description of business, properties, legal proceedings, directors, officers, and management remuneration.

In the typical first public offering, the items to which it is most difficult to respond, and which require the most creative effort in preparation, deal with the description of the company's business, properties, material transactions with insiders, and use of proceeds. 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, competition, 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 business segments.

In Part II of the registration statement 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 may be that the company's financial statements must reflect a very large contingent liability under the '33 Act. In some cases, past violations may be remedied by a rescission offer. 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. Although the information in Part II normally is not seen by individual investors, sophisticated analysts and financial services may make extensive use of it, particularly the supplemental financial schedules.

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 the information that the form expressly requires, the company must add any information necessary to make the statements made not misleading.[5] Thus, the prospectus may not contain a half-truth—a statement which may be literally true but is misleading in context.

The Commission's views on many matters change from time to time. SEC practitioners, both lawyers and accountants, 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 "guides" relating to the preparation and filing of registration statements.[6] 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. It cannot prohibit an offering from being made if disclosure is adequate, but its policies on disclosure can make the offering look highly unattractive. In

5. SEC Securities Act Rule 408, 17 C.F.R. § 230.408 (1980).

6. *See* SEC Securities Act Release No. 4936 (Dec. 9, 1968). These guides, which have been amended and supplemented from time to time, reflect the policies and practices of the Commission's Division of Corporation Finance, which processes registration statements. The guides do not have the status of formal SEC rules, and the SEC is considering eliminating various guides and transferring their substance, to the extent still current, to other forms and rules.

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." [7] However, many new issues of going businesses do not require this treatment and counsel must make a judgement 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.

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, some state securities or "blue sky" laws, which are applicable in the jurisdictions where the distribution takes place, do regulate the merits of the securities.[8] Typically their

7. *See id.*, Guide No. 6.

8. *See generally* Long, *State Securities Regulation — An Overview*, 32 OKLA. L. REV. 541, 548 (1979). The Illinois Secretary of State, for example, is authorized to deny registration of a security where there are "conditions affecting the soundness of the security so that the sale of such securities would be inequitable, or would work or tend to work a fraud or deceit." *See* ILL. ANN. STAT. ch. 121½, § 137.11B (Smith-Hurd Supp. 1981-82).

standards are very indefinite, often expressed in terms of offerings which are "fair, just and equitable." In practice, state administrators exercise broad discretion in determining which offerings may be sold in their states.

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, avoiding glowing adjectives and predictions. 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 the client's satisfaction.

Until relatively recently, it was traditional to confine prospectuses principally to objectively verifiable statements of historic fact. It is now considered proper, and in some instances essential, to include some information in a prospectus, either favorable or adverse to the company, which is predictive or based upon opinions or subjective evaluations. However, no such "soft information" should be included in the prospectus unless it has a reasonable basis in fact and represents management's good faith judgment.[9]

PREPARING THE REGISTRATION STATEMENT

The "quarterback" in preparing the registration statement is normally the attorney for the company.[10] Company counsel is

9. *See* SEC Securities Act Rule 175, 17 C.F.R. § 230.175 (1980); SEC Securities Act Release No. 4936, Guide 62 (Dec. 9, 1968). *See generally* Schneider, *Nits, Grits, and Soft Information in SEC Filings,* 121 U. PA. L. REV. 254 (1972).

10. On the lawyers' role in assisting in the preparation of registration statements, *see* Association of the Bar of the City of New York, *Report by Special Committee on Lawyers' Role in Securities Transactions,* 32 BUS. LAW. 1879, 1891-98 (1977), which proposes, *inter alia,* the following guidelines for practitioners:

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

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Guideline Four:

The lawyer should assist the issuer, on the basis of information furnished to the lawyer, in reaching its decisions as to what information should be included in the registration statement, how it should be included, and to what extent its omission would raise questions under the 1933 Act — *i.e.,* he should assist the issuer in making judgments as to materiality and compliance with the requirements of the registration form and instructions.

Comment:

(a) Within the confines of the agreed assignment of responsibilities and of a realistic evaluation of the extent to which a lawyer's consideration of essentially nonlegal matters is useful to the client and warranted by the circumstances, the lawyer should study documents or otherwise inquire into other matters, not primarily legal in nature and not within counsel's expertise as such, in order to provide himself with a background from which better to assist the issuer in making its decisions.

(b) The determination of "materiality" of a fact or its omission, or of whether there is a material inaccuracy in a statement, involves many questions of fact and judgment. Usually any legal judgment will be based on a factual analysis peculiarly within the knowledge and capability of the management of the issuer. Although a lawyer can be helpful in bringing his experience, interrogation techniques and judgment to bear on questions of materiality, he cannot — and should not — take over from the issuer or other more qualified parties the responsibility for decisions in these gray areas. There will, of course, be matters where the subject involved is primarily a legal issue, or where the facts are so clear that a positive judgment can be made based on administrative regulations or administrative or judicial precedent.

More frequently, however, the lawyer can only give the client the benefit of an experienced judgment which he will often (as a practical matter) have to make without having knowledge of all relevant facts and which must be combined with the business judgment of the client, the underwriters, the auditors and perhaps other experts to enable the client to arrive at a final decision. This is not to say that the lawyer's advice and assistance in these matters (particularly in helping to develop the relevant considerations on which these decisions should be based) may not be extremely valuable to the client. The lawyer must not, however, claim too much for his own ability to give definitive answers to these questions nor should he insist on imposing his judgments in substitution for those of the client when he cannot, as a lawyer, say that his judgment as to materiality in the particular circumstances is clearly correct.

(c) The lawyer should not allow the impression to be created that he will normally "investigate" factual matters covered in a registration statement, personally examining into primary sources or data, or that he can verify the reliability of other persons providing this information. A lawyer does not search the files and records of the issuer to discover, for example, all material contracts or other documents. Except in the case of investigations into certain legal matters (such as due incorporation or valid issuance of securities) which the lawyer undertakes to perform personally rather than to rely on others, the lawyer rarely will go to primary records or other sources but will rely 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

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on interrogations of, and reports or compilations prepared by, others including other professionals such as auditors, engineers and other lawyers. Such reliance on others is entirely appropriate. Indeed, in most instances the lawyer will not have the skills and experience to work with and analyze the primary data. By questioning the issuer's officers and the other persons providing the information, the lawyer can secure an understanding of the material provided, the means by which it was prepared, and its relevance and importance, and he can, if appropriate, suggest that further investigation or inquiry be undertaken. He can also attempt to cross-check information which seems subject to doubt for some reason, or otherwise warrants such inquiry, by questioning persons who appear familiar with it. Where, because of suspicious or other unusual circumstances, the lawyer believes special investigation of a particular matter is required, he should take this up with the issuer, and a procedure for such investigation should be decided upon. Such a procedure may include the issuer's assigning specific qualified personnel or retaining outside experts to make a special investigation of underlying primary data.

Guideline Five:

The lawyer should assist in the drafting of the registration statement or portions thereof with the goal that, to the extent feasible, the registration statement says what the lawyer understands the issuer intends it to say, is unambiguous, and is written in a way that is designed to protect the issuer from later claims of overstatement, misleading implications, omissions or other deficiencies due to the manner in which the statements in question have been written. The lawyer should be careful, however, to dispel any impression that his assistance in drafting the registration statement can ensure that it will be free from all misleading, unclear or ambiguous statements.

Comment:

The lawyer's assistance in drafting the registration statement may entail preparation of initial drafts or portions thereof, and discussion and revision of drafts prepared by himself and by others. Such assistance should not be misunderstood as indicating that the lawyer has sufficient knowledge concerning the substantive content of the document that he can or does take responsibility for its accuracy or completeness. The lawyer's drafting services are significant since the manner in which the document is organized and written is of considerable importance; but the lawyer should not delude either himself or the client into regarding the lawyer's drafting or organizing abilities as also giving the lawyer the ability to determine the substantive content of the document.

Guideline Six:

The lawyer should avoid statements in the prospectus which could give a mistaken impression that he has passed upon matters which he has not, or that he takes responsibility for the accuracy and completeness of the prospectus.

Comment:

Normally, except for references to specific opinions given by the lawyer on particular matters which are referred to with the lawyer's consent, the only mention of the lawyer in a prospectus should be to his specific opinion as to the validity of the securities being issued. The lawyer should take care that the use of his name for express purknows exactly what the others expect, additional delay, expense, and irritation are predictable.

It is essential for the issuer and all others involved in the financing to perceive correctly the role of company counsel. Counsel normally assists the company and its management in preparing the document and in performing their "due diligence" investigation to verify all disclosure for accuracy and completeness. Counsel often serves as the principal draftsman of the registration statement. Counsel typically solicits information both orally and in writing from a great many people, and exercises his best judgment in evaluating the information received for accuracy and consistency. Experience indicates that executives often overestimate their ability to give accurate information from their recollections without verification. It shows no disrespect, but merely the professionally required degree of healthy skepticism, when the lawyer insists on backup documentation and asks for essentially the same information in different ways and from different sources.

A lawyer would be derelict in the discharge of his professional obligations if the lawyer allowed the client's registration statement to include information which the lawyer knew or believed to be inaccurate, or if the lawyer failed to pursue an investigation further in the face of factors arousing suspicions about the accuracy of the information received. On the other hand, it should be understood that a lawyer generally is not an expert in the business or financial aspects of a company's affairs. The normal scope of a professional engagement does not contemplate that the lawyer will act as the ultimate source to investigate or verify all disclosures in the registration statement or to assure that the document is accurate and complete in all respects. Indeed, in many cases the lawyer would lack

poses is not taken as authorization to rely on it for any other purposes, expressly or impliedly. In this connection, the lawyer should consider the advisability of including the following legend wherever his name appears:

> [The lawyer/law firm] has passed on the validity of the securities being issued [or other specific matters, *e.g.*, status of litigation] but purchasers of the securities offered by this Prospectus should not rely on [the lawyer/law firm] with respect to any other matters.

Such language will serve to ensure that the public does not acquire a mistaken impression as to the lawyer's responsibility for the prospectus, and inclusion of this legend may thus be a useful prophylactic measure. In no event should the lawyer permit his name to be used in connection with a registration statement if he believes the client has engaged him in order to make use of his name and reputation rather than for legal advice and assistance.

Id. at 1894-97.

the expertise to assume that responsibility. In some instances, the lawyer may lack the technical background even to frame the proper questions, and must depend upon the client for education about the nature of the business. Counsel does not routinely check information received against books of original entry or source documents, as auditors do, nor does counsel generally undertake to consult sources external to the client to obtain or verify information supplied by the client.

In the last analysis, the company and its management must assume the final responsibility to determine that the information in the registration statement is accurate and complete. Management cannot properly take a passive role and rely entirely upon counsel to identify the information to be assembled, verify the information, and prepare the registration statement properly.

Clients may have, quite appropriately, a different expectation of the lawyer's role relating to those parts of the prospectus which deal with primarily "legal" matters such as descriptions of litigation, legal proceedings, tax consequences of various transactions, interpretation of contracts, and descriptions of governmental requirements. To the extent that such matters are discussed, it is fair and reasonable that the company rely primarily on its counsel for the accuracy and completeness of the descriptive material in the registration statement, assuming proper disclosure of factual matters has been made to counsel. In addition, company counsel normally renders a formal opinion on the legality of the securities being registered, which is filed as an exhibit to the registration statement. In connection with a common stock offering, the opinion would state that the shares being offered are legally issued, fully paid, and non-assessable.

It is typical for counsel to the company, as well as counsel to the underwriters, to be named in a prospectus, usually under a caption heading such as "Legal Opinions" or "Legal Matters." Since the naming of counsel under such a broad heading may tend to lead public investors to misconceive the lawyer's role and responsibility in the offering, it may be more appropriate for the name of the counsel to be inserted under the caption heading dealing with the description of the securities offered, along with a statement of the substance of the opinion being rendered.[11] Such presentation would emphasize that the only legal opinion being rendered relates to these

11. *See* note 10 *supra*. *See generally*, Cheek, *Counsel Named in a Prospectus*, 6 REV. SEC. REG. 939 (1973). For the Commission's views on the responsibilities of counsel, *see* SEC Securities Exchange Act Release No. 17,831 (June 1, 1981); *In Re* Carter, SEC Securities Exchange Act Release No. 17,597 (Feb. 28, 1981).

formal legal matters except, to the extent that the prospectus otherwise indicates in appropriate sections, other specific matters such as litigation or tax consequences. An engagement letter with the client, setting forth the specific terms of counsel's responsibility, also may be a helpful practice. Such a letter can contribute materially to a better understanding between lawyer and client as to their respective responsibilities.

The authors consider it essential for the lawyers, accountants and executives to be in close coordination while the prospectus is being written. It frequently occurs that the lawyers and the accountants initially have different understandings as to the structure of a transaction, or the proper characterization or effect of an event. These differences may not be readily apparent, even from a careful reading of the registration statement's narrative text together with the financial statements. Lawyers sometimes miss the full financial implication of some important matter unless the accountants are readily available to amplify upon the draft statements and supply background information. The text is often written by counsel before the financial statements are available, based upon counsel's incorrect assumptions regarding the as yet unseen financial statement treatment of a transaction.

Experience indicates that the best and sometimes only way to flush out financial disclosure problems as well as inconsistencies between the narrative text and the financial statements is through the give and take of discussion as the structure of the offering is being determined and the draft registration statement is being reviewed. The accountant's participation in this process is often essential.

On the other hand, the authors are mindful of the expense involved when accounting representatives attend long and sometimes tedious meetings. An acceptable compromise is to request their attendance on a selective basis, and to focus only on the matters requiring their participation during the period of their presence. For example, it would be wasteful to have a page by page review of a draft with accountants present, and to have them sit through the discussions of management biographies or other details having no bearing on the financial presentation.

REVIEW BY THE SEC

After the registration statement is filed initially, the Commission's Division of Corporation Finance reviews it to see that it responds appropriately to the applicable form. The Division's staff almost always finds some deficiencies, which are communicated either by telephone, usually to company counsel, or through the "letter of comments" or "deficiency letter." Amendments to the registration statement are then filed in response to the comments. When the comments are reflected to the satisfaction of the SEC staff, the SEC issues an order allowing the registration statement to become effective. Only after the registration statement is effective may sales to the public take place.

There are styles and trends regarding the subjects on which staff comments tend to focus. As of mid-1981, public pronouncements by the staff indicate that subjects to receive particular attention in the review process include: the required management discussion and analysis of financial condition and results of operation, liquidity, capital resources and effects of inflation; the use of proceeds; and transactions between the issuer and related parties.

If counsel, or the accountants with respect to financial comments, believe that the staff's comments are inappropriate or should not be met for some other reason, the comments will be discussed with the examiner, usually by telephone but in person if the matter is sufficiently serious. If a point cannot be resolved to counsel's satisfaction through discussions with the examiner, it is considered appropriate to request that the matter be submitted to the Branch Chief who supervises the examiner. When a significant issue is involved, higher levels of staff review may be requested if counsel remains unsatisfied. However, review should be sought at successive levels, and counsel should not leapfrog to a senior official before the subordinates have been consulted. 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 whether the company has adequately responded to the comments, even if the comments are not legally binding in the formal sense.

There are usually separate reviewers for the financial and nonfinancial portions of a filing. Typically, although not always, the accounting review of the financial portion takes longer. Some branches of the SEC staff will release whichever comments are available first, without waiting for the other set, while other branches seem to prefer issuing all comments together.

There is a practice, very frustrating for those associated with an offering, for different levels of review within the staff to take place at different times. On occasion, as part of the final review immediately before the registration statement is intended to become effective, entirely new comments and questions will be raised by the final reviewers. Even more exasperating is the situation in which the final reviewer reverses a subordinate on a point which had been discussed previously and apparently resolved to the mutual satisfaction of the company and the staff. Such last minute developments can result in unanticipated and annoying delay and expense in preparing the final prospectus.

The review process can be expedited through the use of appropriate letters or memoranda to the Commission. If the company anticipates that the staff will raise particular comments or request additional information, it may be appropriate to volunteer the information with or shortly after the filing. Since transmittal letters addressed to the Commission do not always come to the attention of all reviewers through the Commission's painfully slow internal distribution procedures, the authors recommend sending supplemental information, as well as copies of all amended filings, directly to each staff member assigned to the particular filing.

Likewise, in transmitting amendments, review can be expedited by a letter or memorandum drawing specific attention to the location in the amended filing where responses to the comments may be found, and explaining why responses to other comments have been omitted. Occasionally, it is helpful to send the Commission a copy of its comment letter with various paragraphs assigned numerical references in the margin. The supplemental letter accompanying the filing, as well as the filed amendments which are marked to show changes (in accordance with the normal practice), can then use the same numerical references to relate portions of the new material to the original comment letter.

When the comment letter is received, there is a natural tendency to focus attention solely on the points raised by the Commission. However, it is most important to remember that the registration statement must be accurate as of the time it becomes effective. Accordingly, it must be reviewed carefully in its entirety just before the effective date to be sure that all statements are updated to reflect significant intervening developments, whether or not they relate to sections covered by the Commission's comments. The Commission also has specific guidelines relating to the updating of financial statements. Generally speaking, the more speculative the offering or the weaker the company's financial position, the more likely it is that the financial statements must be updated. Normally, in the case of a first offering with significant risk factors, the final prospectus will include financial information which is at least three months more current than the financials in the original filing.

PRE-EFFECTIVE OFFERS

Prior to the initial filing of the registration statement, no public offering, either orally or in writing, is permitted.[12] For this purpose, the concept of offering has been given an expansive interpretation.[13] Publicity about the company or its products may be considered an illegal offering, in the sense that it is designed to stimulate an interest in the securities, even if the securities themselves are not mentioned.[14] A violation of this prohibition is often referred to as "gun jumping." Under a specific rule, limited announcements concerning the proposal to make a public offering through a registration statement are permitted.[15]

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.[16] 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 between the filing of the registration statement and its effective date, the lead underwriter may escort company executives on a tour around the country—often called a "dog and pony show." The purpose of this tour is to attend meetings with prospective underwriters, who will be invited into the underwriting syndicate, and possibly also analysts and potential institutional investors.

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. Tombstone advertisements, so-

12. Securities Act of 1933 § 5(c), 15 U.S.C. § 77e(c) (1976).

13. For the statutory definition of an offer, *see id.* § 2(3), 15 U.S.C. § 77b(3) (1976). *See also* authorities cited in note 14 *infra.*

14. For discussion of activities permitted during the pre-filing period, *see* Chris-Craft Indus. v. Bangor Punta Corp., 426 F.2d 569 (2d Cir. 1970); Securities and Exchange Commission v. Arvida Corp., 169 F. Supp. 211 (S.D.N.Y. 1958); *In Re* Loeb, 38 S.E.C. 843 (1959). *See also* 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).

15. SEC Securities Act Rule 135, 17 C.F.R. § 230.135 (1980).

16. SEC Securities Act Rule 433, 17 C.F.R. § 230.433 (1980).

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,[17] although it is much more common for them to be published after the effective date. In addition, publicly-held companies must continue to make timely disclosure of factual information concerning themselves and their products during this waiting period so as not to interrupt the normal flow of information; of course, they may not do so to instigate publicity to facilitate the sale of stock.[18] Through the use of a red herring prospectus and 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.[19]

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 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." [20] 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.[21]

17. Securities Act of 1933 § 2(10)(b), 15 U.S.C. § 77b(10)(b) (1976). *See also* SEC Securities Act Rule 134, 17 C.F.R. § 230.134 (1980).

18. SEC Securities Act Release No. 5180 (Aug. 16, 1971).

19. Securities Act of 1933 § 5(a), 15 U.S.C. § 77e(a) (1976).

20. *See* DISCLOSURE TO INVESTORS: A REAPPRAISAL OF FEDERAL ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS 106 (1969) (internal SEC staff study group report known as the "Wheat Report").

21. *See* SEC Securities Exchange Act Rule 15c2-8, 17 C.F.R. § 240.15c2-8 (1980); SEC Securities Act Rule 460, 17 C.F.R. § 230.460 (1980).

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 fifty percent.

In either form of underwriting, the underwriters' obligations are usually subject to many conditions, various "outs" such as 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 obligations upon the receipt of certain opinions of counsel and representations, sometimes called a "cold comfort letter," from the company's auditors.

The binding firm underwriting agreement normally is not signed until within twenty-four 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. Furthermore, it is not uncommon for underwriters to suggest a reduction in the size of the offering if the market conditions are unfavorable. The company may find itself in a position of accepting a less than satisfactory final proposal, regarding size and pricing of the offering, as a preferable alternative to postponement or complete abandonment of the offering. 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.

SEC rules permit underwriters to offer and sell to the public more shares than the underwriters are obligated to purchase under the underwriting agreement—a pratice known as "over-allotment." If the underwriters over-allot, they will have a "short" position, which may help to establish a better after-market for the shares following the offering, since any shares resold by original purchasers will have been placed effectively in advance through the over-allotment sales. The underwriting agreement often gives the underwriters an option to purchase additional shares from the issuer, or possibly from selling shareholders, solely for the purpose of covering over-allotments. The shares covered by the over-allotment option are purchasable on the same price terms that apply to the shares which are part of the basic offering. This option of the underwriters, often referred to as a "Green Shoe option" (based on the offering of its initial use), typically covers up to ten percent of the number of shares included in the basic offering and can only be exercised within thirty days of the offering date. To illustrate, if the basic offering is 500,000 shares, the firm commitment will obligate the underwriters to purchase and pay for 500,000 shares; the over-allotment option will entitle them to purchase up to 50,000 additional shares solely to cover over-allotments.

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 when 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 necessary to enter into, revise, or 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.

In preparing the registration statement, there are occasionally important threshold or interpretive problems which can have a major effect on the preparation process or, indeed, on the feasibility of the offering. It is often possible to discuss such problems with the SEC staff in a pre-filing conference, although some pre-filing conference requests are denied by the staff. However, decisions to request a prefiling conference should be made with caution. Among other considerations, once a question has been asked in advance of a filing, there may be no practical alternative other than to wait for the staff's answer, which may delay a filing considerably. Frequently, the decision is made simply to proceed with the filing, resolving the threshold issue on the basis which the company considers most appropriate, in the hope that a satisfactory resolution of the problem (either the issuer's initial solution or some other) will be achieved during the review process.

TIMETABLE

Although laymen find it difficult to believe, the average first public offering normally requires two 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. Relevant factors include the level of the Commission's backlog of filings and 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.

The SEC's current policy calls for the issuance of an initial letter of comments within thirty days of the filing of a registration statement, but the delay is often longer and at times has exceeded one hundred days. The increased number of first-time registration statements and other filings since 1979, coupled with reductions in the number of the SEC's review personnel, raised the possibility of long delays in issuing comment letters. This occurred despite various initiatives by the SEC during the past several years including the adoption of various "short-form" registration statements for certain types of companies and transactions, increases in the dollar amount of securities which could be sold without registration and the processing of certain offerings in regional offices of the SEC.

As a result, the SEC in late 1980 announced a new procedure designed to reduce delays in the review and processing of registration statements and other documents filed with it.[22] Under the new procedure, the SEC will review offerings by public companies on a selective basis and certain registration statements of established public companies will no longer be reviewed at all. It is hoped that the new procedure will enable the SEC to reduce time delays by

22. *See* SEC News Digest, Nov. 17, 1980, at 1. The new system was said to replace the procedures followed by the staff for a number of years as set forth in SEC Securities Act Release No. 5231 (Feb. 3, 1972), although the prior procedures are still occasionally followed by the staff.

concentrating its resources on certain areas, including first time public offerings which will continue to receive thorough review.

The overall time lapse between the beginning of preparation of a company's first registration statement and the final effective date may well exceed six months. It rarely will be less than three months.

The SEC's requirements for unaudited financial statements for periods after the end of a company's last fiscal year represent another important ingredient in the timetable. In the case of Form S-1 for a company going public for the first time, a company filing within forty-five days after its fiscal year end must include interim financial statements at least as current as the end of the third fiscal quarter of its most recently completed fiscal year as well as the required fiscal year end audited financial statements for the prior years; a company filing after forty-five days but within 134 days of the end of the company's most recent fiscal year end must include audited financial statements for its most recently completed fiscal year; and a company filing more than 134 days subsequent to the end of its most recent fiscal year must include interim financial statements within 135 days of the date of the filing as well as the required fiscal year end audited financial statements. The financial statements for the interim periods need not be audited, however, and the statements required are not as complete as those required for the audited periods. Of course, audited financial statements must be substituted once available in lieu of unaudited financial statements.

In the case of companies utilizing the Form S-18, the interim financial statements generally must be as of a date within ninety days of the filing of the registration statement.

At the time the registration statement becomes effective, the unaudited interim financial statements must be as of a date within 135 days of the effective date in the case of Form S-1, except that such financial statements may be as of the end of the third fiscal quarter of the most recently completed fiscal year if the registration statement becomes effective within forty-five days after the end of the most recent fiscal year. Audited financial statements for the most recently completed fiscal year must be included if the registration statement becomes effective between forty-five and ninety days after the end of such fiscal year. Unaudited interim financial statements generally must be within ninety days of the effective date in the case of Form S-18.

EXPENSES

A major expense in going public is usually the underwriters' compensation. The underwriting cash discount or cash commission on a new issue generally ranges from 7% to 10% of the public offering price. The maximum amount of direct and indirect underwriting compensation is regulated by the National Association of Securities Dealers, Inc. (NASD), a self-regulatory agency which regulates broker-dealers. Normally, the three largest additional expenses are legal fees, accounting fees, and printing costs.

Legal fees for a first offering of at least $5,000,000 generally would be between $55,000 and $115,000, with $75,000 to $100,000 being typical. This amount includes not only the preparation of the registration statement itself, but also all of the corporate work, house cleaning and other detail which is occasioned by the public offering process. Fees for smaller offerings tend to be somewhat lower. In part, this may reflect the fact that offerings for start-up companies, which tend to be smaller in size, typically require less legal work in investigating business operations, since there are none. However, start-up offerings can be more difficult in other respects—for example, risk factors are more prevalent and minor matters may require disclosure on points which would be immaterial to an established company with a history of operations. Therefore, start-up offerings occasionally are even more demanding than offerings of larger seasoned companies.

Accounting fees can vary significantly depending on the complexity of the business, whether the financial statements to be included in the registration statement have been audited in the normal course, and the extent to which the independent accountants may be involved in the development of financial and other information to be included in the registration statement. Other factors which will cause accounting fees to vary from one registration statement to another are the extent to which the independent accountants are required to participate in meetings with counsel and underwriters' representatives and the nature and extent of procedures performed at the request of the underwriters for purposes of the "comfort letter." If there have been no prior audits and new accountants are engaged at the time of the offering, fees ranging up to $65,000 and even higher would not be unusual. If the company's financial statements have been audited regularly for several years in the past, the added accounting expense for a public offering, in addition to the normal audit expense, could be much less, especially if no unaudited interim statements are required. (While interim statements may be unaudited in a formal sense, the auditors are inevitably involved in some review of the interim statements, especially in connection with the comfort letter to be given to the underwriters at the closing.) Obviously, accounting expenses for start-up companies with limited past transactions can be substantially lower.

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 for projects which are not aspects of the registration process as such, such as preparation of an employee stock option plan, is often treated as a charge for current service rather than a registration expense. These latter charges are treated as current business expenses for accounting and tax purposes. The allocation, and the resulting tax and accounting treatment, should be reviewed carefully so that all parties treat the allocated expenses consistently.

Printing expenses for registration statements and various underwriting documents typically range up to $100,000, but larger charges are not unusual. Color printing, if used, can add significantly to the printing expense. If the offering involves a debt security, the printing of a trust indenture can add to the expense. Overall printing costs can be affected significantly by such factors as the length of the prospectus, the extent of updating required between the original filing and the final printing (due to staleness of financial statements, SEC comments or other intervening developments), the number of copies required, and the extent of alterations made by the parties (which are inevitably extensive, compared to other types of commercial printing, no matter how well the registration project is planned).

For each registration statement, there is a filing fee at the rate of 0.02% of the maximum aggregate offering price of the securities, with a minimum fee of $100, which fee is non-refundable.[23]

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. The company is generally required to reimburse the underwriter for the NASD filing fee, which is computed at the rate of $100 plus 0.01% of the maximum aggregate offering price of the securities, with a maximum fee of $5,100. Occasionally the company must pay an expense allowance (sometimes on an accountable basis and sometimes on a non-

23. SEC Securities Act Rule 457, 17 C.F.R. § 230.457 (1980).

accountable basis) to the underwriters. This is a negotiated figure which can range from several thousand dollars to $100,000 or more in some cases. The company frequently pays the underwriters' counsel a special fee for compliance with applicable state securities laws (so-called "blue sky" work), which can range up to many 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% of the amount of the coverage, which may be less than 100% of the total offering.

For a normal first public stock offering of several million dollars, total expenses in the $175,000 to $350,000 range would be typical, exclusive of the underwriting discount or commission but inclusive of any expense allowance (whether or not accountable) payable to the underwriter. However, it should be emphasized that there are wide variations among offerings. The estimates for aggregate as well as individual expenses given above can be too low if unusual problems or complications develop in a particular offering. Average costs have increased substantially in recent years, due to a number of factors including general inflation, the added scope and content of certain disclosure items in the forms, and ever expanding notions of due diligence obligations.[24]

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24. Howard & Co., the Philadelphia-based publisher of GOING PUBLIC: THE IPO REPORTER, is the source of the following data on out-of-pocket expenses, exclusive of the underwriters' commission or discount and also exclusive of any expense allowance payable to the underwriters:

1980	*Median*	*Mean*	*Range**
Best Efforts	$ 68,000	$ 77,552	$ 50,000-$ 95,000
Firm	175,000	228,168	100,000- 315,000
1981	*Median*	*Mean*	*Range**
Best Efforts			
Less than $2 million	$ 58,000	$ 54,274	$ 40,000-$ 66,500
$2 million and above	80,000	99,719	72,100- 101,794
Firm			
Less than $5 million	148,000	147,802	100,000- 184,000
$5 million-$10 million	250,000	265,734	185,000- 300,000
$10 million and above	313,000	366,221	270,000- 395,000

* Based on 25th to 75th percentile.

A review by the authors of approximately 100 initial public offerings during early 1981 showed approximate median and mean expenses, as itemized in Part II of registration statements (which usually includes the underwriters' expenses allowance, but not the underwriters' discount or commission) of $200,000 and $236,000 respectively, and a range (based upon 25th to 75th percentiles) of approximately $123,000

Although the amount of time, effort and printing required for an offering is not necessarily related to its dollar size, smaller offerings tend to be somewhat less expensive than the larger ones. If an offering involves either debt securities or secondary sales for selling shareholders, the expenses may tend to be somewhat higher than for a simple primary offering of common stock. Other factors being equal, offerings using Form S-18 or Regulation A may be somewhat less expensive than offerings registered on Form S-1.

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. 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 and warrants which underwriters may receive.

to $294,000. Some offerings included in the survey which are technically for first time issuers, represent one of a series of similar ventures (such as real estate syndication or oil and gas partnerships), where fees are relatively small since each successive offering represents little more than a markup of the last one. These repeat offerings are not the type to which the estimates in the text are intended to apply.

All of the data itemized in this footnote is derived from public filings and therefore excludes any portion of the overall legal or accounting fee which is allocated to routine work. Some cases where the company's reported legal fees seem unusually low may be explained by special circumstances. The counsel responsible for the work may have been compensated primarily in his capacity as a director, officer, or shareholder of the issuer. In some instances, where company counsel has limited experience in securities matters, the underwriter's counsel may take the laboring oar in preparing the registration statement (for which the underwriter would be compensated, typically through its expense allowance), an allocation of responsibility which is not recommended.

It should also be noted that the expense information in Part II and the final prospectus purports to be no more than an estimate. The estimate is usually made about the time of, but no later than, the printing of the last pre-effective amendment. The estimates are made at a very busy time when it may be difficult to ascertain the exact expenses incurred to that point. Furthermore, as of the time the estimate is made much of the work remains to be done, including the final printing, a great deal of detailed preparation for the closing, and the accountant's final review in connection with their cold comfort letter, as well as the inevitably time consuming task of cleanup after the project is completed. In the authors' experience, the estimates rarely prove to be too high compared to the actual expenses; they are frequently somewhat on the low side. Accordingly, on the average, actual expenses are probably marginally higher than the amounts disclosed in the final prospectus.

Some underwriters, typically the smaller ones, bargain for first refusal rights to handle future financing. The result may be that the company remains obligated to use the initial underwriter at the time of a second public offering, when the company has matured sufficiently to attract a larger and more prestigious lead underwriter. 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 signficant 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 fradulent 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.

In the process of preparing a registration statement, the parties will probably hear frequent references to the *BarChris* case.[25] In *BarChris,* one of the relatively few cases going to final judgment on the question of liability since the Securities Act was passed in 1933, 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.[26] The case attracted interest principally in holding that various defenses were not available to certain persons other than the company.[27]

25. Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). *See also* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (S.D.N.Y. 1971).
26. 283 F. Supp. at 654-82.
27. *Id.* at 682-707.

Under the '33 Act, the company is liable absolutely for material deficiencies in the registration statement irrespective of good faith or the exercise of due diligence.[28] 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.[29] In the *BarChris* case, it was held that some of the parties subject to personal liability had failed to establish a due diligence defense.[30] 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. There is still considerable uncertainty in this area.[31] 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 simply by 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.[32] In this section, the most common transactional exemptions will be discussed: the small public offering under Regulation A, the intrastate offering, the private offering and the relatively new exemptions provided by section 4(6) and Rules 240 and 242.

The Regulation A Offering

Pursuant to statutory authority to exempt certain small public offerings, the SEC has promulgated Regulation A,[33] which exempts

28. Securities Act of 1933 § 11(a), 15 U.S.C. § 77k(a) (1976).

29. *Id.* §§ 11(b), 15, 15 U.S.C. §§ 77k(b), 77o (1976).

30. 283 F. Supp. at 682-703.

31. The '33 Act incorporates "the standard of reasonableness . . . of a prudent man in the management of his own property." Securities Act of 1933 § 11(c), 15 U.S.C. § 77k(*l*) (1976).

32. *See id.* §§ 3 & 4, 15 U.S.C. §§ 77c & 77d (1976). Transactions exempt from registration are not exempt, however, from the anti-fraud provisions of the '33 Act imposing liability for material misstatements or omissions in the sale of securities. Even completely private sales of securities of closely-held companies are generally subject to the anti-fraud provisions. Additionally, requirements of state blue sky laws should be considered.

33. *Id.* § 3(b), 15 U.S.C. § 77c(b) (1976) contains the statutory authority. Regulation A consists of SEC Securities Act Rules 251-64, 17 C.F.R. §§ 230.251-64 (1980).

from registration public offerings for the account of a company which do not exceed $1,500,000 in the aggregate in any one year.[34] Although Regulation A is technically an exemption from the registration requirements, considerable documentation is necessary to establish the exemption, and Regulation A 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 $100,000.

The principal advantages of Regulation A offerings, as opposed to full registrations, are that the required financial statements are simpler and need not be audited, 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 on Form S-1. In some cases, Regulation A offerings have the advantage of being processed more quickly than full registrations on Form S-1 depending on the regional office and the time of year. There is, however, some prejudice in the financial community against Regulation A offerings. Some underwriters who participate in small interstate issues will refuse to take part in Regulation A offerings and prefer full S-1 or S-18 registrations, even for offerings whch would qualify under Regulation A. In addition, a number of states allow registration by coordination (usually the easiest means of complying with state blue sky laws) if Form S-1 or S-18 is used, but not if Regulation A is used.

The Intrastate Offering

There is an exemption from the registration requirements for offerings within a single state, without any fixed limit on the size of the offering or the number of offerees. The offering within the state may be to the public at large or to a more limited group. 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 a significant portion of its business in the state, and all of the offerees must be residents of the state.[35] The intrastate offering

34. SEC Securities Act Rule 254(a), 17 C.F.R. § 230.254(a) (1980) limits Regulation A offerings by persons other than the issuer to $100,000 per security holder, with certain aggregate limits for all existing security holders.

35. Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(11) (1976). Section 3(a)(11) exempts from the registration requirements of the '33 Act:

> Any 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

exemption is intended to make possible the local financing of local business entities. It is a difficult exemption upon which to rely when a wide distribution of securities is contemplated because the company has, in practical effect, an absolute liability to 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." [36] Even if all of the stock is sold at the outset, the actual distribution period may not end until a year or more after the securities have been sold, 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 police properly an intrastate offering unless it is limited to people the company knows do not expect to be trading the stock for some time. When 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 if the group of purchasers is either too large or not adequately qualified so that the offering could satisfy the private offering exemption requirements.

The Commission has adopted Rule 147, which provides that any transaction in conformity with the rule will be exempt as an intrastate offering.[37] The Rule is in the nature of a so-called "safe harbor." Safe harbor rules do not purport to be the exclusive definition of the statutory provision to which they relate, and transactions which fail to meet the requirements of the Rule may qualify nonetheless for exemption under the statute itself.

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corporation, incorporated by and doing business within, such State or Territory.

Id. See also SEC Securities Act Release No. 4434 (Dec. 6, 1961); Schneider, *The Intrastate Offering Exemption,* in PRACTICING LAW INSTITUTE, SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 22-29 (A. Fleischer & R. Mundheim, eds. 1971).

36. SEC Securities Act Release No. 4434 (Dec. 6, 1961).

37. SEC Securities Act Rule 147, 17 C.F.R. § 230.147 (1980).

Under the Rule, the company must be incorporated under the laws of the state in question; the company must maintain its principal executive offices in, derive 80% of its revenues from, maintain 80% of its assets within, and use 80% of the offering proceeds in such state; each individual purchaser of the company's securities must maintain his principal residence within such state; and the purchaser must not resell the securities to non-residents for at least nine months after the completion of the offering.

The Private Offering

A variety of statutory provisions and rules exempt from the '33 Act registration requirements, but not the antifraud prohibitions, transactions which are essentially private offerings. The exemptions are contained in sections 4(2) and 4(6), and Rules 146, 240, and 242, each of which is summarized below in general and non-technical terms.

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." [38] There has been much uncertainty as to the precise limits of a private offering.[39] The Commission has recently proposed a complete revision of the various exemptive rules discussed below, which would result in a rationalized pattern modeled generally upon Rule 242 described below.[40]

In very general terms, the exemption requires that the offerees receive or have access to important information about the issuer, that the offering be made through direct communication without general advertising or mass media circulation, that the number of offerees and purchasers be appropriately limited, and that the securities issued are not redistributed by the initial purchasers.

Rule 146 [41] has been adopted by the Commission as a non-exclusive safe harbor rule, implementing this exemption by providing that offers and sales of securities made in accordance with all the terms and conditions of the Rule will be deemed to be transactions

38. 15 U.S.C. § 77d(2) (1976).

39. *See* Schneider, *The Statutory Law of Private Placements,* 14 REV. SEC. REG. 869 (1981).

40. SEC Securities Act Release No. 6339 (Aug. 10, 1981). In general, the proposals are to rescind Rules 146, 240, and 242 and replace them with a new Regulation D. The new Regulation would have a rule which is generally similar to each of the three rules to be rescinded. However, the new rules would be generally more permissive, flexible, and objective than the rules to be replaced.

41. 17 C.F.R. § 230.146 (1980).

by an issuer not involving any public offering within the meaning of section 4(2). However, many lawyers feel that the Rule is unduly restrictive and prefer to rely directly upon the statutory exemption.[42]

In order to satisfy the terms and conditions of Rule 146, the following terms and conditions must be satisfied: offers may be made only to persons the company reasonably believes either have such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks of the prospective investment (*i.e.* they are smart) or can bear the economic risk of the investment (*i.e.* they are rich); sales may be made only to persons the company reasonably believes, after reasonable inquiry, either are smart or, alternatively, are rich and have someone acting on their behalf (specifically designated by them as their "offeree representative") who together with such persons are smart; each potential investor must be provided with the same type information which would be contained in a registration statement filed with the SEC or have access to that information by virtue of certain relationships with the company; there may be no more than thirty-five purchasers of the securities subject to certain limitations; there may be no general advertising or solicitation in connection with the offering; reasonable care must be taken to ensure that purchasers do not resell the securities in a manner that they would be involved in a public distribution; and a form must be filed with the Regional Office of the SEC for the region where the company conducts its principal business operations.

Rule 242[43] provides an exemption for the offer and sale by certain companies of up to an aggregate of $2,000,000 in securities in any six month period to an unlimited number of "accredited investors" (basically banks, insurance companies and other institutional investors, persons who purchase $100,000 or more of securities,

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42. For interpretations of the exemption outside the Rule, *see* American Bar Association Section of Corporation, Banking, and Business Law, Committee on Developments in Business Financing, *Resale by Institutional Investors of Debt Securities Acquired in Private Placements,* 34 BUS. LAW. 1927 (1979); American Bar Association Section of Corporation, Banking, and Business Law, Committee on Developments in Business Financing, *Institutional Private Placements Under the Section 4(2) Exemption of the Securities Act of 1933,* 31 BUS. LAW. 515 (1975); American Bar Association Section of Corporation, Banking, and Business Law, Federal Regulation of Securities Committee, *Section 4(2) and Statutory Law,* 31 BUS. LAW. 485 (1975). *See also* Schneider, *supra* note 39.

43. 17 C.F.R. § 230.242 (1980). In SEC Securities Act Release No. 6339 (Aug. 7, 1981), the Commission proposed to rescind this rule and replace it by a comprehensive Regulation D. The effect of Regulation D would be to expand the basic approach of Rule 242 and make it available to somewhat larger transactions.

and directors and executive officers of the company) and to thirty-five non-accredited persons. In order for the exemption to be available, certain specified written information must be furnished to any non-accredited purchasers; no general advertising or solicitations may be used in connection with the offering; reasonable care must be taken to assure that purchasers do not resell the securities in a manner that they would be involved in a public distribution; and a simple notice on Form 242 must be filed with the SEC. Rule 242 is available only for domestic or Canadian companies which are not investment companies or involved in any significant oil or gas operations. For transactions to which it applies, Rule 242 offers, in effect, a simplified version of Rule 146, with the particular virtue of eliminating Rule 146's offeree and purchaser qualification requirements. Rule 242 is very similar in structure and philosophy to the statutory exemption which was recently added by section 4(6), discussed below.

Section 4(6)[44] provides an exemption from the registration provisions for offers and sales by a company of its securities solely to "accredited investors" provided that the aggregate offering price of such securities does not exceed the amount allowed under section 3(b) of the Act (currently $5,000,000),[45] there is no advertising or public solicitation, and the company files a notice with the SEC. Accredited investors include banks, insurance companies, registered investment companies, business development companies as defined in the Investment Company Act of 1940, SBICs, employee benefit plans subject to ERISA (as long as the investment decisions for the plan are made by a bank, insurance company or registered investment adviser) and such classes of persons as may be specified as accredited investors by the SEC based upon financial sophistication, net worth, knowledge and experience in financial matters or amount of assets under management.

Rule 240[46] adopted under section 3(b) of the '33 Act, provides an exemption from the registration requirements for the offer and sale of a limited amount of securities by certain closely-held companies. In order for the exemption to be available, not more than

44. Small Business Issuers' Simplification Act of 1980, Pub. L. No. 96-477, § 602, 94 Stat. 2294.

45. Small Business Incentive Act of 1980, Pub. L. No. 96-477, § 301, 94 Stat. 2294.

46. 17 C.F.R. § 230.240 (1980). In SEC Securities Act Release No. 6339 (Aug. 7, 1981), the Commission proposed to rescind this rule and replace it by a comprehensive Regulation D. The effect of Regulation D would be to expand the basic approach of Rule 240 and make it available to somewhat larger transactions.

$100,000 of securities of the company may be sold in reliance on the Rule or otherwise without registration during the twelve month period immediately preceding the last sale; the securities of the company must be owned benefically by not more than one hundred persons both before and after the sale under Rule 240; the securities may not be offered or sold by means of general advertising or general solicitations including the use of newspapers, magazine, radio or television advertising; no commissions or similar remuneration may be paid for soliciting purchasers; reasonable care must be taken to assure that purchasers do not resell the securities in a manner that they would be involved in a public distribution; and a simple notice of sale on Form 240 must be filed with the Regional Office of the SEC for the region in which the company conducts its principal business within ten days after the close of the first month in which a sale in reliance on the Rule is made.

The $100,000 limitation applies not only to securities sold under Rule 240, but to all unregistered securities of the company and any affiliates of the company sold during the immediately preceding twelve month period. The twelve month period is not an annual calendar period, but is a revolving or shifting period so that a transaction which occurred eight months previously would not count for purposes of the $100,000 limitation after another four months. The $100,000 amount may not be exceeded by the value of the cash, services, property, notes or other consideration received for the securities. Certain sales are excluded from the $100,000 limitation so long as another exemption (typically section 4(2)) is available. First, there are excluded nonconvertible notes or similar evidences of indebtedness either representing a purchase money mortgage or issued to specified institutional investors if not sold with warrants or other rights enabling the purchaser to acquire an equity interest in the company. Second, there are excluded securities sold to "any promoter, director, executive officer or full time employee." Thus, Rule 240 allows a company to obtain $100,000 from outsiders while at the same time not precluding unlimited investment by "insiders."

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 an exempt private offering to investors in several states and then, more or less concurrently, make an exempt 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-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 listing 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.[47] 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 a single public offering. If the company can meet the somewhat lower listing requirements of the American Stock Exchange, it is often considered 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 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; [48]

47. SEC Securities Act Release No. 4936, Guide No. 52 (Dec. 9, 1968).

48. *See, e.g.*, DEL. CODE ANN. tit. 8, § 262(k) (Supp. 1980) (no appraisal rights in merger or consolidation if security listed on "national stock exchange," including New York Stock Exchange, American Stock Exchange, and most

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; less price volatility than in the over-the-counter market; and typically closer spreads than normally prevail in the over-the-counter market between the bid and offered quotations.

There is some feeling that listing on the American and regional exchanges may be disadvantageous in terms of the quality of the market. Many companies with stock eligible for listing on the American Stock Exchange prefer to have the stock traded over-the-counter. However, others feel that the advantages of listing may 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. Smaller firms which are not members of the major exchanges may lose interest in a security after it is listed.

The two major stock exchanges have certain policies which should be taken into consideration in connection with a decision to list.[49] 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. As a condition of listing, the exchanges generally seek concessions that the company will eliminate such relationships either pre-listing or in the near term 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 shareholders

regional exchanges); PA. STAT. ANN. tit. 15, § 1515L (Purdon Supp. 1981-82) (no appraisal rights to shareholders of securities listed on New York Stock Exchange or American Stock Exchange).

49. These policies are set forth in 2 NEW YORK STOCK EXCHANGE MANUAL (CCH) ¶¶ 2495A-2495E and the *American Stock Exchange Company Guide.*

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; the New York Stock Exchange has not objected to requirements which are "reasonably" less than a majority).

Shareholder Votes Required

Both major exchanges require that companies with listed securities solicit votes of shareholders 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 shareholders of the listed company have an interest in the acquired company; if the acquisition would increase the outstanding stock by approximately 20% or more; or where the fair value of the total consideration paid is equal to approximately 20% or more of the market value of the outstanding common stock of the company. Shareholder votes are also required for the adoption of any option plan for directors, officers and key employees.

Outside Directors—Audit Committees

Both major exchanges have policies favoring substantial representation on the board of directors by outside directors who are not members of management. The New York Stock Exchange requires domestic companies with listed common stock to have an audit committee comprised solely of directors independent of management. The American Stock Exchange strongly recommends such committees but does not require them.

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, directly or indirectly through convertible securities, options, warrants or otherwise, additional securitities 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 on an exchange, a company effectively commits itself for the indefinite future to comply, each time it issues or agrees to issue additional securities of the listed class, with all then effective exchange requirements. Unless a waiver can be obtained, the company's only alternative to accepting the new requirements is to abandon listed status, which is rarely a practical choice.

Timely Disclosure of Information

The exchanges have requirements obligating listed companies to make timely public disclosures of material corporate developments.

CONSEQUENCES OF GOING PUBLIC UNDER THE '34 ACT

There are certain continuing consequences arising under the Securities Exchange Act of 1934 once a company goes public.[50] 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 any fiscal year end, such class of equity securities must be registered under section 12(g)[51] within 120 days after the first fiscal year end on which the company meets these tests. Likewise, any company which has a class of securities listed on a stock exchange must register those securities under section 12(b).[52] 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 five separate sets of legal obligations relating to periodic reporting, proxy solicitation, insider trading, tender offers and related matters, and the Foreign Corrupt Practices Act.

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. The Form 10-K report requires a description of the company's business, property and financial condition. The wording of the disclosure items is substantially similar to the corresponding disclosure items in Form S-1. The general philosophy of the current Form 10-K is to keep the full range of '33 Act registration statement disclosures current on an

50. For a more extensive and technical summary of the consequences of a company becoming publicly owned, *see* Schneider & Shargel, *Now That You Are Publicly Owned . . .* , 36 BUS. LAW. 1631 (1981).

51. 15 U.S.C. § 78*l*(g) (1976).

52. *Id.* § 78*l*(b).

annual basis. However, many companies have a more condensed disclosure in their Form 10-K than in their '33 Act prospectuses.

In addition, the company must file interim quarterly reports on Form 10-Q. The principal content of Form 10-Q is unaudited quarterly financial information, but there are also other items which call for disclosures only if specific reportable events have occurred during the period covered by the report. Furthermore, for certain significant events, a report must be filed on Form 8-K, which is normally due within fifteen days after the reportable event.

Companies which have filed a registration statement under the '33 Act are required under section 15(d) of the '34 Act[53] 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. Additionally, companies having their first public offering are required by the '33 Act to file reports with the Commission on Form S-R. These reports, which are filed following the offering on a semi-annual basis until the offering has terminated and the proceeds have been applied, cover the status of the offering (in the case of a best efforts underwriting) and the application of the proceeds. The periodic reporting requirements discussed above are applicable even if the company does not meet the section 12(g) registration requirements.

Proxy Solicitation

If any person, including the company itself or its management, solicits proxies from the holders of a class of securities registered 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)[54] of the '34 Act.[55] 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.

53. *Id.* § 78o(d).

54. *Id.* § 78n(a).

55. For the text of the Commission's proxy rules, *see* SEC Securities Exchange Act Rules 14a-1 to -12, 17 C.F.R. §§ 240.14a-1 to -12 (1980).

The proxy rules also require that an annual report to shareholders must be distributed with or before the solicitation of proxies for the annual election of directors. The proxy rules prescribe certain disclosure requirements for the company's annual report to shareholders. 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 [56] which contains substantially the same information as would appear in a proxy statement.

Insider Trading under Section 16

Section 16(a) [57] 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 by beneficial holders of more than ten 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 within ten days after 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 grant or receipt of a put or call or an option to purchase or sell equity securities must also be reported, even before the right to purchase or sell has been exercised.

The reporting persons are also subject to the "short-swing profit recapture" provisions of section 16(b) [58] 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 company. These provisions are applied fairly mechanically so that the spread between the lowest purchase price and

56. Securities Exchange Act of 1934 § 14(c), 15 U.S.C. § 78n(c) (1976). *See also* SEC Exchange Act Rules 14c-1 to -7, 17 C.F.R. §§ 240.14c-1 to -7 (1980).

57. 15 U.S.C. § 78p(a).

58. *Id.* § 78p(b).

highest sales price within any six month period is recoverable. Losses cannot be offset 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, if it fails to do so, 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 when 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),[59] 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."

Tender Rules and Related Matters

The '34 Act includes several provisions relating generally to tender offers for securities registered under the '34 Act.[60] Related provisions apply to persons owning beneficially more than five percent of such securities, even if no tender offer has been involved. If, after '34 Act registration of a class of equity securities, any person or group acting in concert becomes the owner of more than five percent of the securities of any such class or makes a tender offer which would result in his becoming an owner of more than five percent of such class, he must make certain disclosures to the SEC, 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.

Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act amended the '34 Act to require a company to make and keep books, records and accounts

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59. *Id.* § 78p(c).
60. *See* Securities Exchange Act of 1934, §§ 13(d), 13(e), 14(d)-(f), 15 U.S.C. §§ 78m(d), 78m(e), 78n(d)-(f) (1976).

which, in reasonable detail, accurately and fairly reflect a company's transactions and dispositions of assets and to devise and maintain a system of internal accounting control.[61] These are very significant substantive provisions which are not related in any way to either foreign activities or corrupt practices, as suggested by the title of the Act. There are other provisions of this Act which relate, in fact, to irregular payments abroad and matters which would be considered to be corrupt foreign practices.[62]

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

Timely Disclosure of Material Developments

Good corporate practice and, to a significant degree, the antifraud provisions under the '33 and '34 Acts, require 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, where favorable or unfavorable. Such disclosures are normally through press releases, which may be supplemented by communications directly to shareholders. The SEC requires prompt and accurate public disclosure of material corporate developments.[63] Companies with securities listed on a stock exchange are subject to the exchange's requirements to make timely disclosures.[64] Companies whose securities are traded in the NASDAQ system must conform to NASD policies on timely disclosures.[65] While the scope of these various disclosure requirements is difficult to define with precision, the general trend has been toward requiring higher standards of disclosure. The possible consequences of failing to comply with these disclosure standards include civil liability, criminal penalties, suspension of trading, various injunctive remedies and

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61. *See id.* §§ 13(b)(2)(A), 13(b)(2)(B), 15 U.S.C. §§ 78m(b)(2)(A), 78m (b)(2)(B) (1976).

62. *See id.* § 30A, 15 U.S.C. § 78dd (Supp. III 1979).

63. *See* SEC Securities Act Release No. 5092 (Oct. 15, 1970); SEC Securities Exchange Act Release No. 8995 (Oct. 15, 1970).

64. *See generally, New York Stock Exchange Co. Manual* § A2; *American Stock Exchange Co. Guide* §§ 401-06; *American Stock Exchange Form of Agreement to Conform with Rules and Regulations,* Listing Form L § 3.

65. *See* NASD BY-LAWS, *Schedule D,* Part II(B)(3)(b), *reprinted in* NASD MANUAL (CCH) § 1653A.

disgorgement of any profits realized from improper trading on inside information.

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.

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 disclosing 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.

Sale of Restricted and Control Stock

Even though a company becomes publicly-owned, persons holding restricted stock (generally shares acquired in private placements) and controlling shareholders holding any kind of stock are not completely free to sell their own shares in the public securities markets without registration. There are, however, certain specific "leakage" provisions under Rule 144 [66] which permit limited sales under defined circumstances for securities of companies which meet specified tests regarding the public availability of current information. Very generally, and without exploring the many nuances, any person holding restricted stock (after a two year holding period) and a controlling person holding non-restricted stock may sell, in any three month period, an amount of securities equal to one 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 or quoted in NASDAQ, the greater of one percent or the average reported weekly trading volume on security exchanges or NASDAQ during

66. 17 C.F.R. § 230.144 (1980).

the four calendar weeks preceding the filing of Form 144. Thus, the trading volume limitation can change from week to week. After a three year holding period, non-control holders of privately placed shares become free of most of the restrictions on sale which the Rule imposes.

The sales must be handled in all respects as routine open market trading transactions and brokers may not receive more than a normal commission. Sales involving more than 500 shares or $10,000 in sales price in the aggregate in any three month period require the filing with the Commission and principal national exchange on which the securities are traded, if any, of a Form 144 at the time a sell order is placed. The sale must take place within ninety days after the Form 144 is filed. Under the leakage provision, two or more closely related persons may be required to combine their sales in applying the formula, and there are technical attribution rules covering special relationships such as donor-donee or pledgor-pledgee. Rule 144 contains very highly technical provisions, and is subject to continued SEC interpretations; therefore, any restricted person should be cautioned to consult with counsel well in advance, before making any public sales or commitments to sell in reliance on the Rule.

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 well before the securities can be sold.

APPENDIX

The approximate number of initial public offerings since 1969 has been estimated as follows by Howard & Company, publishers of GOING PUBLIC: THE IPO REPORTER:

Year	Number of Public Offerings	Amount Raised (in Millions of Dollars)
1969	950	2,600
1970	360	780
1971	385	1,700
1972	568	2,700
1973	100	350
1974	15	51
1975	80	270
1976	35	260
1977	40	180
1978	50	240
1979	80	520
1980	237	1,400
1981 (through 6/30)	291	1,900

The SEC reports that there were 291 common stock offerings by new issuers in the first six months of 1981, involving $1.9 billion. The dollar amount was approximately twice as great as the amounts for the comparable 1980 period. In the 12 months ended September 1980, 22% of the registration statements filed with the Commission were by new issuers. In the nine months ended June 30, 1981, the proportion had increased to 35%. SEC News Digest, June 30, 1981, at 2.