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Determining the Responsibilities of Underwriters Distributing Securities within an Integrated Disclosure System

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I. Investment Bankers

Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System

*Edward F. Greene**

TABLE OF CONTENTS

I. Introduction 756
II. The Role of Underwriters in the Securities Distribution Process .. 761
III. The Effects of the Securities Act Upon Underwriters' Activities .. 764
A. *Legislative History of Section 11* 767
B. *Underwriters' Responsibility in the Courts* 770
1. *In re The Richmond Corp.:* Reasonable Investigation as a Duty 770
2. *Escott v. BarChris Construction Corp.:* Determining Reasonableness in Light of the Surrounding Circumstances 772
3. *Feit v. Leasco Data Processing Equipment Corp.:* Varying the Degree of Investigation Based Upon the Accessibility of Information 775
4. *Sanders v. John Nuveen & Co.:* The Relationship Between Underwriters' Responsibilities Under Section 12(2) and Section 11 778
IV. Integration of Disclosure Requirements of the Federal Securities Laws and Evolution of the Disclosure Environment 781
V. The Stock Offering Process Under the Integrated Disclosure System 787
A. *The Effects of Integration on the Offering Process* 787
B. *The Effects of Increased Competitiveness in the Underwriting of Securities Offerings* 791
VI. Should There Be More Definite Guidance for Underwriters? 794
A. *Arguments Against Enunciation of a More Definite Standard of Underwriters' Responsibilities* 794
B. *Arguments Favoring Formulation of More Definite Guidance for Underwriters* 796
C. *The Commission's Proposals to Eliminate Extraneous Considerations*

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Relating to Material Incorporated by Reference into Registration Statements 798
VII. Alternative Approaches to Delineating Underwriters' Responsibilities Within an Integrated Disclosure System 800
A. *The SIA's Safe Harbor Definition of Due Diligence* 800
B. *Developing Standards of Professional Responsibility for Underwriters by Self-Regulatory Organizations* 802
C. *Identifying Circumstances Affecting the Reasonableness of Underwriters' Conduct* 807
VIII. Conclusion 809

I. Introduction

By including a discussion of the federal securities laws in this Symposium on The Role of Professionals in Corporate Governance, the editors of *The Notre Dame Lawyer* have recognized the importance of the interaction between investor protection and corporate governance. The broad objective of the Securities Act of 1933 (Securities Act)[1] and the Securities Exchange Act of 1934 (Exchange Act)[2] is to protect investors by preserving honesty and fair dealing in our capital markets. To achieve this end, the Acts require corporations relying on external financing or exceeding a specified size to disclose the material aspects of their financial affairs[3]—a basic requirement that Congress fully expected would improve corporate conduct[4] and business practices.[5]

Professionals bear heavy responsibilities which help assure full and fair disclosure of material corporate financial information. Commentators have discussed the role accountants[6] and lawyers[7] perform in protecting investors. Not as much scholarly attention has been devoted to another professional group—investment bankers[8]—although their effective performance as underwriters also is

1 15 U.S.C. §§ 77a-77aa (1976).

2 15 U.S.C. §§ 78a-78kk (1976).

3 *See* 15 U.S.C. § 78*l* (1976).

4 *See* S. REP. NO. 47, 73d Cong., 1st Sess. 5 (1933): "This phase of the law will have a direct tendency to preclude persons from acting as nominal directors while shirking their duty to know and guide the affairs of the corporation."

5 *See* Frankfurter, *The Federal Securities Act* (pt. 2), FORTUNE, Aug. 1933, at 55:

> By compelling full publicity . . . so that the public may have an opportunity to understand what it buys, the [Securities] Act seeks to promote standards of competence and candor in dealing with the public. It deliberately aims against dormant high-pressure techniques which have in the past so tragically submerged the investment banker's traditional responsibility for disinterested financial advice.

6 *See, e.g.*, Committee on Corporate Law and Accounting, *Corporate Responsibility in the Financial Accounting and Disclosure Areas: Who Makes and Who Implements the Rules?*, 34 BUS. LAW. 1979 (1979); Earle, *The Fairness Myth*, 28 VAND. L. REV. 147 (1975); Gruenbaum & Steinberg, *Accountants' Liability and Responsibility: Securities, Criminal and Common Law*, 13 LOY. L.A.L. REV. 247 (1980); Margolis, *Sanctions Against Accountants For Violations of the Securities Laws: A Reappraisal*, 4 DEL. J. CORP. L. 399 (1979).

7 *See, e.g.*, *In re William R. Carter and Charles J. Johnson, Jr.*, Securities Exchange Act of 1934 Release No. 17,597 (Feb. 28, 1981) [1981 Current Binder] FED. SEC. L. REP. (CCH) ¶ 82,847; Association of the Bar of the City of New York, *Report by Special Committee on Lawyers' Role in Securities Transactions*, 33 BUS. LAW. 1343 (Mar. 1978); Ferrara & Steinberg, *The Role of Inside Counsel in the Corporate Accountability Process*, 4 CORP. L. REV. 3 (1981); Gruenbaum, *Clients' Frauds and Their Lawyers' Obligations: A Response to Professor Kramer*, 68 GEO. L. J. 191 (1979); Lorne, *The Corporate and Securities Adviser, the Public Interest, and Professional Ethics*, 76 MICH. L. REV. 423 (1978); Patterson, *The Limits of the Lawyer's Discretion and the Law of Legal Ethics*: National Student Marketing *Revisited*, 1979 DUKE L. J. 1251; Williams, *Corporate Accountability and the Lawyer's Role*, 34 BUS. LAW. 7 (1978).

8 For purposes of this article, the term investment banker means an entity engaged in business as an

critical to achieving the purposes of the federal securities laws. While it is true that the untoward conduct of some investment bankers during the rampant speculation of the 1920's brought discredit upon the entire banking industry, it is also true that the care and competence displayed by investment bankers since enactment of the federal securities laws have contributed uniquely to the aura of confidence surrounding public securities offerings of the 1980's.[9]

The work of investment bankers and other securities professionals has been all the more challenging because of the multilayered regulatory framework within which they function. The Securities Act and the Exchange Act have spawned two different sets of disclosure requirements applicable to many of the same companies.[10] Because of the lack of optional coordination between the two statutes' disclosure provisions and the extent to which the securities markets and business practices have evolved since 1933, the Commission has initiated a comprehensive program to integrate, streamline and make uniform the Acts' disclosure requirements. However, even if the information required is the same under both Acts so that disclosure under one satisfies the requirements of the other, there will remain important differences in liability treatment which may only be resolved by legislation. As a result, the integration of periodic reports filed under the Exchange Act into the more stringent liability provisions of section 11 of the Securities Act has created some tension in the process of harmonizing the two Acts by rulemaking.

The Securities Act and the Exchange Act utilize different standards for determining civil liabilities for misstatements and omissions in the information furnished to investors or made available to the markets. With respect to disclosures under the Securities Act, those who distribute[11] or sell[12] the security are held to a negligence standard under section 11. Thus underwriters, for example, are liable for any misstatement or omission in a registration statement unless they can show that after reasonable investigation they had reasonable ground to believe and did

underwriter or dealer, as those terms are defined in the Acts. *See* § 2(11) of the Securities Act, 15 U.S.C. § 77b(11) (1976).

9 Indeed, it has been observed that "[t]he 1933 act and the 1934 act, and the concepts embodied therein, have become a basic part of the mores of business, and to a large extent the financial community is self-policing." Halleran & Calderwood, *Effect of Federal Regulation on Distribution of and Trading in Securities*, 28 GEO. WASH. L. REV. 86, 118 (1959).

10 With respect to issues of securities registered for public sale under the Securities Act, § 7 requires disclosure in a registration statement filed with the Commission of 32 items of information set out in Schedule A of the Act, as well as other information specified by the Commission. In addition, a prospectus containing many of the items set forth in the registration statement must be delivered to each purchaser together with any confirmation of sale. 15 U.S.C. § 77g (1976). The Securities Act requires this disclosure whenever an issuer, whatever its size, offers securities to the public, unless there is available an exemption from the Act's registration provisions.

Section 12 of the Exchange Act requires any subject company registering a class of equity securities to disclose information in 12 categories, as well as any other information the Commission deems to be necessary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78*l* (1976). Any company with $1,000,000 or more of assets and at least 500 holders of record of a class of equity securities must register that class under § 12. 15 U.S.C. § 78*l*(g)(1) (1976). Companies subject to the Exchange Act also must periodically file additional information and documents that the Commission designates as necessary to keep reasonably current the material filed pursuant to § 12. Exchange Act, § 13, 15 U.S.C. § 78m (1976). Generally issuers of securities registered under § 12 of the Exchange Act are required, by §§ 13 and 15(d) of that Act, to file annual reports on Form 10-Q and reports of special developments on Form 8-K.

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

12 *Id.*, § 12, 15 U.S.C. § 77*l* (1976).

believe the statement was true.[13] For all practical purposes, however, those who prepare and file periodic reports pursuant to the Exchange Act are probably subject to liability only if the plaintiff sustains his burden of proving that the defendant either knew the statement was false or misleading or acted with a reckless disregard for its truth or falsity.

Section 18 of the Exchange Act applies a negligence standard with respect to all reports required to be filed. It provides that any person making a false or misleading statement in a filing is liable to

> any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading.[14]

In the forty-seven years since the enactment of section 18, there has been no reported case sustaining liability under the section, primarily because of the burdens of proof placed on the plaintiff—burdens substantially different from those imposed under section 11 of the Securities Act.[15] Because of the limitations of section 18, most plaintiffs suing with respect to false statements in periodic filings now seek recovery under section 10(b) of the Exchange Act and rule 10b-5 adopted thereunder.[16] For a time it appeared that negligence might also be the standard under rule 10b-5, but *Ernst & Ernst v. Hochfelder*[17] and its progeny[18] have established that in every case the plaintiff must prove scienter.[19] Thus, today it is assumed that the standard with respect to periodic reports is that set forth in section 10(b) and rule 10b-5, if section 10(b) applies at all.[20]

Although it may not be possible completely to reconcile the differences in the liability standards of the Securities Act and the Exchange Act, the integrated disclosure system which is now taking shape[21] should substantially reduce the

13 This reasonable investigation and belief standard is discussed in the text accompanying notes 69-72 and in section III. A. *infra*.

14 Exchange Act, § 18(a), 15 U.S.C. § 78r(a) (1976).

15 Under § 11, the plaintiff need not show reliance on the statement or that the price at which he purchased the security was affected by the statement. Moreover, the defendant under § 18 need not show that he conducted a reasonable investigation. Professor Loss has described § 18 as a "very much attenuated § 11," 3 L. LOSS, SECURITIES REGULATION 1751 (2d ed. 1961).

16 17 C.F.R. § 240.10b-5 (1980).

17 425 U.S. 185 (1976).

18 *See, e.g.*, Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38 (2d Cir.), *cert. denied*, 439 U.S. 1039 (1978); Sundstrand Corp. v. Sun Chem. Corp., 553 F.2d 1033 (7th Cir.), *cert. denied*, 434 U.S. 875 (1977); Holdsworth v. Strong, 545 F.2d 687 (10th Cir. 1976), *cert. denied*, 430 U.S. 955 (1977).

19 Proof of scienter is also required in suits brought by the Securities and Exchange Commission (SEC). Aaron v. SEC, 446 U.S. 680 (1980).

20 Some defendants have argued that § 18 should be the exclusive remedy for misstatements or omissions in periodic reports, on the grounds that to hold otherwise undermines the congressional intent and could make defendants liable for massive damages to those who traded but did not rely. The courts have generally rejected this contention. *See* Ross v. A. H. Robins Co., 607 F.2d 545 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980).

21 *See* Securities Act Release No. 6231 (Sept. 2, 1980), [1981] 6 FED. SEC. L. REP. (CCH) ¶ 72,301, announcing the adoption of amendments to annual report Form 10-K and related forms, rules, regulations and guides; Securities Act Release No. 6232 (Sept. 2, 1980), 45 Fed. Reg. 63,647 (1980), announcing the adoption of Form S-15 for the registration of securities issued in certain business combination transactions and the adoption of related amendments to the proxy rules, the exhibits item of Regulation S-K, the Commission's Rules of Practice, and the rule regarding incorporation by reference under the Securities Act; Securities Act Release No. 6233 (Sept. 2, 1980), [1981] 6 FED. SEC. L. REP. (CCH) ¶ 72,302, announcing the adoption of a general revision of arts. 3 and 5 and related sections of art. 12 of Regulation S-X;

regulatory burdens on publicly-held companies, particularly with respect to the registration of new issues of securities. Under this system, certain publicly-held companies selling securities under the Securities Act will be able to rely to a considerable extent upon information previously filed pursuant to the Exchange Act by incorporating that information by reference in the registration statement.[22] This procedure of incorporation by reference should eliminate a substantial amount of duplicate disclosure. It is anticipated that eventually all companies will be classified based upon the extent to which, in the judgment of the Commission, the securities markets have already absorbed previously furnished company-specific information. Some companies widely followed by financial analysts and actively traded by professional investors would be allowed to satisfy the requirements of the Securities Act merely by incorporating by reference into their registration statement pertinent information from previously filed periodic reports, updated in the prospectus[23] to reflect any changes. Lesser known companies would be required to deliver the information so incorporated to new purchasers but would have the option of furnishing the information in its previously prepared form, updated in the prospectus, if necessary.

The effect of incorporation by reference is to subject the portions incorporated to the more stringent civil liability standards applicable to Securities Act registration statements. Such a result may be of some concern to certain participants in the distribution process. While possible effects upon the professional responsibilities of accountants and lawyers are expected to be minimal,[24] the im-

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Securities Act Release No. 6234 (Sept. 2, 1980), *id.*, ¶ 72,303, announcing the establishment of uniform instructions governing the periods to be covered by financial statements included in most registration and reporting forms and in annual reports to shareholders furnished pursuant to the proxy rules; Securities Act Release No. 6235 (Sept. 2, 1980), 45 Fed. Reg. 63,693 (1980), publishing for comment three proposed new forms for the registration of offerings of securities; Securities Act Release No. 6276 (Dec. 23, 1980), 46 Fed. Reg. 78 (1981), proposing for comment amendments to Regulation S-K; and Securities Act Release No. 6288 (Feb. 9, 1981), [1981 Current Binder] FED. SEC. L. REP. (CCH) ¶ 72,308, adopting amendments to Form 10-Q.

22 The registration statement is the form issuers must file with the Commission in order to register the securities to be offered to the public. A number of different forms of registration statements are currently available to issuers. The major forms are Form S-1, the basic form for first time and general purpose securities offerings; Form S-7, a short form of registration available to seasoned issuers meeting certain financial and reporting conditions; Form S-8, used to register securities offered to employees pursuant to certain types of employee benefit plans; Forms S-14 and S-15, used to register securities to be issued for certain business combinations, reclassifications, and consolidations; Form S-16, a short form of registration for qualified issuers in specified types of transactions; and Form S-18, an optional form of registration available to small business issuers.

23 The prospectus is the portion of the registration statement which must be delivered to investors. The Securities Act clearly contemplated that all information would be set out in the prospectus. However, if a company's shares are actively traded and the market is efficient, any new offering will generally be at no higher than the existing market price. That market price is not likely to be changed by the offering (apart from market trends) unless new information about the company is disclosed. Of course, factors extraneous to the issuer such as interest rates may affect price. The Commission, however, requires disclosure of only company-specific information. Repetitive disclosure of old information is wasteful. *See* discussion in section IV *infra*. Recognizing this, the Commission borrowed the concept of incorporation from contract law so that the prospectus may satisfy the technical requirements of the Securities Act. Thus, the missing disclosure is "incorporated" in the prospectus by reference to the necessary disclosure in Exchange Act reports and is treated as if it were set out *verbatim*.

24 Lawyers are not one of the groups of persons expressly made subject to the civil liability provisions of § 11 of the Securities Act. If a lawyer is named in the registration statement as having rendered an opinion concerning the validity of the securities when issued, there is a difference of opinion in the legal community as to whether he would be an expert within the meaning of § 11. In the author's judgment, the better view is that he should be.

Although accountants, as experts, are covered by § 11, the sequencing of their work is dictated by the issuer's fiscal year and its need for other accounting services, and integration does not reduce the time

pact of integration upon investment bankers who underwrite equity or debt securities offerings will be, in the view of many, profound.[25] Until now underwriters have, to a large extent, controlled the process of preparing the registration statement for a planned securities offering and determined the most favorable time to offer the securities publicly. Before and during the process of preparation, underwriters have conducted the investigation contemplated by section 11. Moreover, the process of preparation itself has provided an opportunity for verification, as the meaning of particular sections of the prospectus is discussed and the implications of particular sentences are pondered. Officials of the issuer also have worked with the underwriters to assemble the finished product and to supply supplemental data verifying statements made.

Under an integrated system, however, information required by the registration statement may be furnished from different documents prepared at different times by persons not associated with the underwriters. This can create several problems for the underwriters. To the extent the existence of these documents reduces the time needed to prepare the registration statement, the underwriters may be less able to influence the timing of the offering. If the underwriters are not comfortable with the disclosures in incorporated documents and wish to revise or amplify the incorporated information, the issuer is likely to resist because of the implication that the prior disclosures were inadequate. To the extent that the Exchange Act's liability provisions are less stringent than those under the Securities Act,[26] the underwriters might understandably fear that not as much care was given to preparing the incorporated documents as is given to preparing a registration statement, especially since directors are not liable for mere negligent omissions or misrepresentations in periodic reports.[27]

In addition, if preparation time is reduced, much more of the underwriters' investigation must occur not during preparation of the registration statement but at some other time before it is filed, even though the document is in final form. However, if the document is in final form the issuer will likely be impatient with any filing delay resulting from the underwriters' desire to verify information. Thus, while issuers may favor incorporating information by reference because of

available to accountants to review financial statements and render their opinion. There are detailed professional standards governing the accountant's responsibilities in examining the issuer's fiscal year financial statements and in reviewing interim financial results. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS (AICPA), *Statement on Auditing Standards No. 1*, in CODIFICATION OF AUDITING STANDARDS AND PROCEDURES (1973); AICPA, *Statement on Auditing Standards No. 24*, in REVIEW OF INTERIM FINANCIAL INFORMATION (1979).

25 *See, e.g.*, Rulemaking Petition of the Securities Industry Association (SIA) to the Commission (May 1, 1978); letter of Joseph McLaughlin, Chairman of SIA Federal Regulation Committee, to Edward F. Greene, Director of SEC Division of Corporation Finance (Aug. 19, 1980).

26 Section 19(a) of the Securities Act gives the Commission broad authority to adopt "such rules and regulations as may be necessary to carry out the provisions of this subchapter, including . . . defining accounting, technical, and trade terms used in this subchapter." 15 U.S.C. § 77s (1976). The Commission has identical general rulemaking authority under § 23(a) of the Exchange Act, 15 U.S.C. § 78w(a) (1976). The Eighth Circuit has stated that a "properly adopted" rule should be accorded "general judicial acceptance . . . unless it undebatedly is unrelated to, non-facilitative of, or in conflict with, the policy of the Act, or unless it otherwise is so arbitrary or burdensome as to be legally unreasonable." Dyer v. SEC, 226 F.2d 33, 38 (8th Cir.), *cert. denied*, 361 U.S. 835 (1959). The courts also defer to an agency's interpretation of its rules. *See generally* 2 K. DAVIS, ADMINISTRATIVE LAW TREATISE 105-08 (2d ed. 1978). For a reference by the Commission to its specific authority to set standards in the area of underwriters' duty to investigate, see text accompanying note 102 *infra*.

27 *See* text accompanying notes 11-20 *supra*.

reduced costs and preparation time, underwriters may be inclined to oppose such incorporation, for they will remain liable under section 11 for any omission or misstatement of material fact in the registration statement at the time it becomes effective or in any incorporated document unless the Commission or the courts decide otherwise.[28]

A fundamental question which the Commission staff is reviewing, then, is whether an integrated disclosure system will operate to deprive underwriters of an opportunity to conduct the reasonable investigation contemplated by section 11. If so, why? Logically, of course, the time needed to prepare issuer documents (registration statements) is entirely separate from the time needed to verify information in the documents.[29] Yet complaints are heard that reducing the size of prospectuses means reducing the extent of verification. Is the Commission responsible? Or is it the increasingly competitive climate of the underwriting business that is inducing some underwriters to abbreviate their investigation when vying to win corporate issuers unwilling to delay filing quickly prepared documents pending completion of an investigation? Is a contributing factor the fact that the securities markets, especially the bond markets, are becoming so volatile that an investigation as thorough as would be desired is not possible if the offering is to be made in the "window" suddenly opening in the market? Is that a factor which should properly be taken into account in assessing whether an underwriter has fulfilled his due diligence obligation? And finally, have the Commission's efforts to shorten both preparation time and staff processing time fueled these competitive pressures and altered the bargaining positions of companies and underwriters? If the answer to this last question is yes, then should the Commission respond by relaxing, qualifying or defining the existing investigative responsibilities imposed upon underwriters under the statute? Or should the question of what is reasonable under the circumstances of an integrated disclosure system be left to a case-by-case determination by the courts?

This article will describe the role of underwriters in the securities distribution process and the possible effects of an integrated disclosure system upon their work. The article will then present several alternative approaches to delineating underwriters' liability under the Securities Act for parts of the registration statement incorporated by reference from corporate periodic reports prepared and filed with the Commission pursuant to the Exchange Act.

II. The Role of Underwriters in the Securities Distribution Process

Investment bankers provide a broad range of financial services to issuers,[30] but none is more crucial to efficient capital formation than their underwriting of external corporate financing.[31] The underwriter's basic function is directly or

28 *See* text accompanying notes 15-20 *supra*.

29 Of course, to the extent that in the past the timing of these tasks overlapped, it could be argued that shortening the former time hampers the underwriter's ability to induce an issuer to defer commencing the offering until the investigation is completed.

30 For a general description of the capital raising, counseling and support services provided by investment bankers, see P. DAVEY, INVESTMENT BANKING ARRANGEMENTS 11-17 (Conference Board Report No. 681, 1976).

31 *See generally* J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 575-84 (5th ed. 1980).

indirectly to market securities on behalf of the issuer, and thus to serve as an intermediary between the issuer and investors.

Underwriters assume the responsibility, and usually some of the risks, of distributing securities for an issuer in exchange for receiving a portion of the price at which the securities are sold to the public.[32] With a "firm commitment" arrangement, the underwriters agree to purchase all or most of the offering from the issuer for a fixed price. With appropriate staff coordination, the underwriting agreement is signed, the pricing amendment to the registration statement is filed with the Commission, and the registration statement becomes effective promptly after the filing of the pricing amendment.[33] Settlement with the issuer occurs approximately five business days later. Securities are distributed to institutional and retail purchasers, and the underwriters bear the market risk until the distribution is completed.[34] When securities are marketed on a "best efforts" basis, the issuer bears the risks because the underwriters making the offering to the public only promise to be diligent in their efforts to distribute the securities as agents for the issuer.[35] The issuer receives the proceeds only to the extent the securities are sold.[36] Most offerings of securities are made pursuant to firm commitment underwritings. For primary issues registered under the Securities Act during the first eleven months of 1980, approximately $47.8 billion worth of securities were underwritten, as opposed to $4.6 billion in securities offered on a best efforts basis and $6.5 billion in securities sold directly by issuers.[37]

There are two primary types of distribution arrangements—the negotiated approach and the "competitive bidding" approach. Under the negotiated approach, the process begins with discussion of the proposed offering between the issuer and an investment banker. Once there is general agreement on the nature and terms of the issue to be floated, the investment banker decides on the extent to which the risks of distribution should be shared with other underwriters.[38] An underwriting syndicate, or purchase group, is then formed, comprised of a number of underwriters who agree to share the risks and liabilities associated with the distribution. The contractual obligations among the underwriters par-

32 The underwriter's share is called the "spread" and constitutes the difference between the price paid by the underwriter for the security and the retail price paid by investors. The size of the spread depends upon the nature of the security, the quality of the issuer, the volatility of the markets at the time of offering, and whether it is the issuer's initial public offering. The size of the spread is subject to fair practice rules of the National Association of Securities Dealers (NASD) if the security is subject to filing requirements of the Review of Corporate Financing adopted under art. III, § 1 of the Rules of Fair Practice (NASD Manual (CCH) ¶ 2151). For example, straight debt issues rated "B" or better by a recognized rating service need not be filed and are not subject to review.

33 Under § 8 of the Securities Act, the registration statement becomes effective 20 days after filing unless accelerated by the Commission staff. 15 U.S.C. § 77h (1976). Each amendment causes the 20 day period to begin again. Underwriters realistically cannot price a firm commitment offering 20 days in advance of the offering, so the staff must accelerate the registration statement's effective date to allow pricing and offering when the syndicate believes market conditions are optimal.

34 Perhaps the greatest risk is that the offering will be completed not at the initial offering price but at a lower retail price which can result in a loss to the underwriter.

35 Although a person distributing securities on a best efforts basis technically is not underwriting the issue, he is subsumed within the definition of "underwriter" set forth in § 2(11) of the Securities Act, because such person "offers or sells for an issuer" in connection with the distribution. 15 U.S.C. § 77b(11) (1976).

36 SEC, COST OF FLOTATION OF REGISTERED EQUITY ISSUES 1963-1965, 33-34 (1970).

37 SEC, 40 SEC MONTHLY STATISTICAL REVIEW 28 (Feb. 1981).

38 *See generally* Stewart, *Underwriting Syndicates*, in FUNDAMENTALS OF INVESTMENT BANKING 517-31 (1949).

ticipating in the distribution are set forth in the "agreement among underwriters."[39] Almost invariably, the investment banker that originally negotiated with the issuer to distribute its securities is designated as the managing underwriter for the purchase group. The managing underwriter generally receives a special fee from the other underwriters for managing the underwriting and distribution.[40]

After the purchase group has been formed, generally, a separate underwriting agreement is executed between the issuer and the managing underwriter on the group's behalf. This agreement specifies (1) the agreement of the underwriters to purchase and resell the issuer's securities, (2) the extent of each underwriter's participation, (3) the purchase price to be paid to the issuer, (4) the time and place of closing, (5) the conditions precedent to the underwriters discharging their obligations, and (6) other matters, including indemnification with respect to misrepresentations in the registration statement and rights of contribution if liability is imposed.[41] The purchase group may contract with an additional number of dealers, known as the selling group, to assist with the retail distribution of the security.[42] Some purchase group members traditionally confined their sales activities to large block sales to institutional investors. Increasingly, however, the largest underwriters have engaged in extensive retail sales to individual investors.[43] The selling group supplements these selling efforts, and its members are compensated based solely on the amount of securities sold.

The second type of distribution arrangement in which underwriters participate is "competitive bidding." Under this arrangement the issuer invites bids from two or more purchase groups. Underwriters form competing syndicates, which submit bids to the issuer. After the group making the best bid has been announced, its members decide on the public offering price and the method of distribution and sale. Virtually all competitively bid offerings are underwritten on a firm commitment basis. Competitive bidding is ultilized almost exclusively by issuers compelled to do so in regulated industries.[44]

39 The agreement covers, among other things, (1) payment and security delivery terms, (2) designation of the managing underwriters and the scope of the managers' authority to act on behalf of the purchase group, including price stabilizing activities, (3) indemnification arrangements among the underwriters, (4) trading restrictions on the various underwriters with respect to and during the distribution of the issuer's shares, and (5) the termination date of the offering. Prime, *Private Negotiation in The Origination of Securities*, in FUNDAMENTALS OF INVESTMENT BANKING 477, 484-86 (1949).

40 For a form of underwriting agreement see Weiss, *The Underwriting Agreement—Form and Commentary*, 26 BUS. LAW. 647 (1971). The form of agreement must be filed as an exhibit to the registration statement, which is available to the public.

41 Mere "sellers" are subject to civil liability only under § 12 of the Securities Act. They are not deemed underwriters for purposes of § 11 because the statutory definition of underwriter does "not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission." Securities Act, § 2(11), 15 U.S.C. § 77b(11). Section 12 imposes liability upon the sellers of a security for any material misstatement or omission in a prospectus or oral communication. A seller may escape liability by proving that he "did not know, and in the exercise of reasonable care could not have known, of such untruth or omission." 15 U.S.C. § 77*l*(2) (1976).

42 Wolfson, *Investment Banking*, in ABUSE ON WALL STREET: CONFLICTS OF INTEREST IN THE SECURITIES MARKETS 412 (1980).

43 The fee is paid not by the issuer but by the other underwriters, because § 11(e) of the Securities Act limits an underwriter's liability with respect to a misstatement or omission in the prospectus to the "total price at which the securities underwritten *by him* and distributed to the public were offered to the public" unless the underwriter "shall have knowingly received *from the issuer* for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting." 15 U.S.C. § 77k(e) (1976) (emphasis added).

44 The Interstate Commerce Commission, the Federal Power Commission and the SEC have imposed such requirements on certain classes of issuers. *See generally* Henkel, *The Auction Block for Securities*, 36 VA. L.

Regardless of which type of underwriting arrangement is utilized, the investment bankers selected by the issuer to distribute the planned offer are expected to conduct a detailed investigation of the issuer.[45] The purpose of this investigation, historically, was to help the investment banker determine whether the underwriting would be appropriate in view of the issuer's financial condition and prospects. The investigation associated with negotiated underwritings in the past generally involved

> a more or less prolonged period during which the skilled technicians of the investment banker [were] working with the executive and financial advisers of the issuer, studying the business from every angle, becoming familiar with the industry in which it functions, its future prospects, the character and efficiency of its operating policies and similar matters.[46]

With negotiated underwriting arrangements, the issuer, the managing underwriter and their counsel work together to prepare the registration statement and prospectus.[47] With competitively bid offerings, however, the issuer usually designates independent counsel to represent the bidders prior to bidding and to work with the issuer and its counsel in preparing the registration statement. The issuer may communicate with the syndicates planning to bid to assure that the proposed counsel is acceptable to all the syndicates.[48] Although the independent counsel's client is the underwriter, its work with the issuer to prepare the registration statement occurs without participation by any underwriter because none will have been selected yet.[49]

III. The Effects of the Securities Act Upon Underwriters' Activities

The Securities Act reflects the central role played by underwriters in the securities distribution process. Section 11 of the Act imposes civil liability upon underwriters for even the negligent omission or misstatement of material information in the registration statement. After initially resisting the standards embodied in section 11,[50] the investment banking industry learned how to survive and even flourish despite its strictures and despite the fact that courts consistently interpreted the statute to hold underwriters to a relatively high standard of conduct.[51]

REV. 701 (1950). For discussion of the SEC's competitive bidding requirements see text accompanying notes 226-30 *infra*. Some commentators assert that competitive bidding tends to narrow the spread and to increase the issuer's proceeds from the offering. *See, e.g.*, Kessel, *A Study of the Effects of Competition in the Tax Exempt Bond Market*, 79 J. POLITICAL ECON. 706 (1971); Ederington, *Negotiated Versus Competitive Underwritings of Corporate Bonds*, 31 J. FINANCE 17 (1976). However, several studies have disputed this contention. *See* Logue & Jarrow, *Negotiation vs. Competitive Bidding in the Sale of Securities by Public Utilities*, 7 FINANCIAL MANAGEMENT 31 (Autumn 1978).

45 See discussion of underwriters' "due diligence" obligation, text accompanying notes 208-21 *infra*.

46 United States v. Morgan, 118 F. Supp. 621, 653 (S.D.N.Y. 1953).

47 Under § 5 of the Securities Act, each confirmation of sale must be accompanied or preceded by a prospectus containing the information specified in § 10(a), and of course that information must be true and correct in all material respects. A prospectus may also be any "notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale." Securities Act, § 2(10), 15 U.S.C. § 77b(10) (1976).

48 Holding Company Act Release No. 3118 (Nov. 7, 1941), [1941-1944 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 75,219; *see also* Henkel, *supra* note 44.

49 The process is described in Henkel, *supra* note 44, at 714-21. For discussion of the effects of such procedures on the underwriters' responsibility to investigate, see text accompanying notes 227-37 *infra*.

50 *See* text accompanying notes 82-84 *infra*.

51 This attitude of the courts may help explain why there has been a recent revival, in the context of

To appreciate the present concerns of underwriters about the extent of their obligations in an integrated disclosure system, it is necessary to understand the responsibilities imposed on them by the Securities Act. Generally, section 11 of the Securities Act, as amended, imposes civil liability where "any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading . . . ."[52] The persons liable for such omissions or misstatements are:

(1) the signers of the registration statement;
(2) the directors or partners of the issuer;
(3) incoming directors or partners named in the registration statement;
(4) the accountants, engineers, appraisers or "any other person whose profession gives authority to a statement made by him" who consents to being named as having prepared or certified any part of the registration statement or any report or valuation cited in the registration statement; and
(5) every underwriter of the security.[53]

By including underwriters, Congress recognized that underwriters customarily are active in preparing the document used to sell the issue, and should thus be responsible for it.[54] Noting the types of persons associated with a public offering who are excluded from liability under section 11,[55] Professor Ernest Folk has observed: "In most instances the existence or absence of liability seems approximately correlated with the person's probable power to influence the content of the registration statement and the extent to which a purchaser would likely rely upon that person's authority."[56]

Any purchaser of a security offered pursuant to an effective registration statement[57] can sue any or all of the statutorily specified persons, who are made jointly and severally liable for damages.[58] Although the measure of damages is the depreciation in the value of the security, in no case can the amount of dam-

proposals to integrate disclosure requirements, of efforts to clarify underwriters' statutory responsibilities with respect to information contained in periodic reports which they did not help prepare and which are subsequently incorporated by reference into the prospectus. *See* SIA Rulemaking Petition, *supra* note 25, and discussion of the petition in the text accompanying notes 275-82 *infra*.

52 15 U.S.C. § 77k(a) (1976).

53 *Id*. It should be noted that the definition of underwriter excludes sellers of the securities "whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission." Securities Act, § 2(11), 15 U.S.C. § 77b(11) (1976).

54 The English custom is for the underwriters to have primary responsibility for drafting the documents since they sell the security; that custom has not developed here. Issuers and their counsel assume the primary role, with active assistance by the managing underwriter and its counsel.

55 Persons excluded from § 11 liability include the attorney for the issuer or underwriter, dealers and brokers selling the security, transfer agents, and other officers or employees of the issuer or underwriter.

56 Folk, *Civil Liabilities Under the Federal Securities Acts: The* BarChris *Case*, 55 VA. L. REV. 1, 12 (1969). This view is somewhat inconsistent with the fact that participating underwriters are just as liable as the managing underwriter, "even though they are in no position to duplicate the investigatory function of the originator or to participate in his activities." Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171, 200 (1933).

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

58 *Id*. § 11(f), 15 U.S.C. § 77k(f) (1976). The maximum liability of an underwriter is limited to the public offering price of the portion of the issue it agreed to underwrite, provided it received no special inducement from the issuer. *See* text accompanying note 41 *supra* and the discussion of § 11(e)'s legislative history, text accompanying note 88 *infra*.

ages exceed the public offering price of the securities.[59] In order to recover, the plaintiff must prove that he purchased a security issued under an effective registration statement,[60] that the registration statement contained a material omission or misstatement when it became effective,[61] and that he has complied with the relatively brief statute of limitations.[62] Plaintiff must also establish the extent of the security's depreciation in value[63] and, if he purchased the security after issuance of a financial statement covering at least the twelve months following the registration statement's effective date, he must prove reliance upon the registration statement.[64] Otherwise, the plaintiff need not show that he relied upon the material omission or misstatement, or indeed that he ever read the prospectus.

Beyond contesting the matters which plaintiff must prove, the issuer's only defense against liability is to prove that the plaintiff purchased the security with knowledge of the material omission or misstatement.[65] The underwriter and other defendants, however, have several additional defenses available.[66] Any of these other defendants can, prior to the effective date of the registration statement, disassociate himself from the offering and notify the Commission of this fact.[67] He can similarly notify the Commission and the public that part of the registration statement became effective without his knowledge.[68]

Finally, and most significant for our purposes, a nonissuer defendant may prove that he made a reasonable investigation and had reasonable grounds to believe in the accuracy of the nonexpertised parts of the registration statement or, with respect to the expertised portions (audited financial statements, for example), that he had no reasonable grounds to believe and did not believe that they contained a material misstatement or omission.[69] This reasonable investiga-

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59 Securities Act, § 11(g), 15 U.S.C. § 77k(g) (1976).

60 *Id.*, § 11(a), 15 U.S.C. § 77k(a) (1976). *See* Barnes v. Osofsky, 373 F.2d 269 (2d Cir. 1967); Lorber v. Beebe, 407 F. Supp. 279 (S.D.N.Y. 1975). He may have purchased the security in the after market, not the initial distribution, but he may recover nevertheless if he can trace the shares back to the registration statement. Such result is possible because reliance need not be proved by the plaintiff under § 11 unless the purchase occurred after publication of 12 month financial statements.

61 Securities Act, § 11(a), 15 U.S.C. § 77k(a) (1976). *See* Montague v. Electronic Corp. of America, 76 F. Supp. 933, 935 (S.D.N.Y. 1948).

62 Securities Act, § 13, 15 U.S.C. § 77m (1976). Actions must be brought within one year after the omission or misstatement was discovered or should have been discovered by the exercise of reasonable diligence. In no event may an action be brought more than three years after the security was offered to the public. *See* Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949).

63 Securities Act, § 11(g), 15 U.S.C. § 77k(g) (1976).

64 *Id.*, § 11(a), 15 U.S.C. § 77k(a) (1976).

65 *Id.*

66. § 11(b) provides defenses available only to nonissuers.

67 The exact language requires:

> (1) that before the effective date of the part of the registration statement with respect to which his liability is asserted (A) he had resigned from or had taken such steps as are permitted by law to resign from, or ceased or refused to act in, every office, capacity, or relationship in which he was described in the registration statement as acting or agreeing to act, and (B) he had advised the Commission and the issuer in writing that he had taken such action and that he would not be responsible for such part of the registration statement . . . .

Id., § 11(b)(1), 15 U.S.C. § 77k(b)(1) (1976).

68 Liability is avoided if a defendant can show

> that if such part of the registration statement became effective without his knowledge, upon becoming aware of such fact he forthwith acted and advised the Commission, in accordance with paragraph (1) of this subsection, and, in addition, gave reasonable public notice that such part of the registration statement had become effective without his knowledge . . . .

Id., § 11(b)(2), 15 U.S.C. § 77k(b)(2) (1976).

69 *Id.*, § 11(b)(3), 15 U.S.C. § 77k(b)(3) (1976).

tion and belief standard was a focal point of legislative attention at the time the Securities Act was adopted.[70] It also has been a major subject of consideration by the courts in the few reported cases addressing section 11[71] and by the Commission's staff in connection with its effort to streamline the securities registration process.[72]

A. *Legislative History of Section 11*

The capital markets were in complete disarray when President Roosevelt called on Congress to enact legislation that "puts the burden of telling the whole truth on the seller" of securities in order to "bring back investor confidence."[73] Economic conditions clearly warranted a strong federal response. Half of the $50 billion of new securities offered during the 1920's proved to be worthless.[74] When investor confidence eventually collapsed, capital formation all but ceased.[75] The House Report on the Securities Act blamed investment bankers for much of the problem: "The flotation of such a mass of essentially fraudulent securities was made possible because of the complete abandonment by many underwriters and dealers of those standards of fair, honest and prudent dealing that should be basic to the encouragement of investment in any enterprise."[76] Of course, congressional criticism was not confined to investment bankers. According to James Landis, one of the drafters of the Securities Act, the Senate Committee on Banking and Currency's lengthy hearings on corporate financing "indicted a system as a whole that had failed miserably in imposing those essential fiduciary standards that should govern persons whose function it was to handle other people's money."[77]

Rather than proscribing certain practices, the drafters of the Securities Act proposed to solve the problems associated with past corporate financings indirectly, by requiring that there be "full and fair disclosure of the character of securities" sold to the public.[78] Nevertheless, it is clear that Congress intended to alter conduct at least to the extent necessary to produce adequate disclosure. The House Committee on Interstate and Foreign Commerce stated that the "essential characteristic" of the bill's civil liabilities

> consists of a requirement that all those responsible for statements upon the face of

70 *See* text accompanying notes 80-81 *infra*.

71 *See* section III.B. *infra*.

72 *See* text accompanying notes 309-17 *infra*.

73 *Quoted in* H.R. REP. NO. 85, 73d Cong., 1st Sess. 2 (1933).

74 *Id*. at 2.

75 1 *Stock Exchange Practices: Hearings Before the Sen. Comm. on Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong., 2d Sess. 5 (1933) (testimony of J.P. Morgan).

76 H.R. REP. NO. 85 at 2. As early as 1920, a committee of the Investment Bankers Association had criticized the spread of irresponsible underwriting practices: "[A]t the present time, when large syndicates are the rule and offerings are made at once on receipt of a syndicated letter or telegram, it is little exaggeration to say that in some cases the distributing banker knows no more about the issue than does his customer." *Quoted in* V. CAROSSO, INVESTMENT BANKING IN AMERICA 265 (1970). Apparently, the basic problem was that "investment bankers had to rely almost exclusively on their own values and judgment in setting individual standards of firm conduct. The result was a range of behavior running from high norms of most established firms to the excesses, even fraud, of some old and many new houses." *Id*. at 255.

77 Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29, 30 (1959).

78 H.R. REP. NO. 152, 73d Cong., 1st Sess. 24 (1933). Representative Sam Rayburn, a sponsor of the Securities Act, declared that its purpose was to "place the owners of securities on a parity, so far as possible, with the management of corporations." 77 CONG. REC. 2918 (1933).

> which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. Honesty, care, and competence are the demands of trusteeship. These demands are made by the bill on the directors of the issuer, its experts, and the underwriters who sponsor the issue.[79]

The defense of reasonable investigation and belief was included in section 11 to protect persons, other than the issuer, from liability for material misstatements or omissions which might occur despite their careful investigation of the issue.[80] To assist in interpretation of the adequacy of conduct, section 11(c) specified that in determining "what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a person occupying a fiduciary relationship."[81]

Although there was general agreement as to the need for federal securities legislation, enactment of the Securities Act in 1933 produced a cacophonous response from the investment community, in part because there was no limitation of damages to the offering price of the securities actually underwritten by each underwriter. The result was that each underwriter could be held liable for the entire offering. The President of the Investment Bankers Association declared: "[A]n intensive study has been made of it from every angle by potential issuers of securities, underwriters and their counsel. It is the consensus of those who have made this study that modifications must be made if sound securities are to be issued and sold to the public."[82] The new law's detractors insisted that its provisions, particularly those relating to civil liability, created such an unmanageable level of risk that securities offerings were simply not feasible.[83] One law professor predicted that under the new Securities Act "fundamental changes are apt to develop in securities marketing" including the demise of firm commitment underwritings, and speculated that "much of the underwriting may be done either by the less desirable bankers of borderline integrity, impecunious or whose wives will be rich women."[84]

In an effort to dispel apprehensions about the civil liability standards, the Securities Exchange Act of 1934 amended sections 11 and 13 of the Securities Act to reduce nonissuers' exposure to civil liability. First, section 11(a) was amended to require the plaintiff to prove reliance upon the registration statement where the issuer had published an earnings statement covering at least a period of twelve months after the effective date of the registration statement. The rationale for the change was that subsequent purchasers in these circumstances would

79 H.R. REP. NO. 85 at 5.

80 *Id.* at 23.

81 Securities Act, § 11, 15 U.S.C. § 77k(c) (1976).

82 Gordon, *Benefits of Security Regulation*, in 4 INVESTMENT BANKING 4, 8 (Oct. 7, 1933).

83 *See, e.g.*, the statement of J. Augustus Barnard, Director, American Investment Bankers Associations: "[I]f it were not for fear engendered by the Securities Act, there would be many new issues put out and . . . there would be an excellent market for high-grade bonds." Winthrop W. Aldrich, President of Chase National Bank, testified that

> leading security houses, and many of our largest corporations, are actually afraid to undertake public offerings under the act. . . .
>
> . . . What excites anxiety are some of the civil liabilities imposed upon issuers and underwriters of securities, as well as upon directors and officers of corporations, uncertainty of its liabilities, and in some respects the unequal incidence of the liabilities in relationship to the damage that may be done or in proportion to the risks involved.

8 *Stock Exchange Practices: Hearings Before the Sen. Comm. on Banking and Currency on S. Res. 84 and S. Res. 56*, 73d Cong., 2d Sess. 4122 (1933).

84 James, *The Securities Act of 1933*, 32 MICH. L. REV. 624, 661 (1934).

likely be relying on information in the earnings statement rather than on the registration statement containing the misstatement or omission.[85] Second, the diligence standard of section 11(b)(3)(C) and (D), applicable to the expertised parts of the registration statement, was transformed from an affirmative to a negative standard.[86] Third, the standard of reasonableness set forth in section 11(c) was restated from "that required of a person occupying a fiduciary relationship" to "that required of a prudent man in the management of his own property."[87] Fourth, section 11(e), pertaining to recoverable damages, was extensively revised. Each participating underwriter's liability (which under the original Securities Act potentially extended to the aggregate price of the entire offering) was now limited to the public offering price of the portion of the offering which he underwrote. The amended section 11(e) also permitted the defendant to reduce the amount of damages by proving that some or all of the depreciation in the security's value resulted from matters unrelated to the material omission or misstatement.[88] Finally, the statute of limitations set forth in section 13 was changed in two ways. The period during which suit could be brought under section 11 was shortened from two years to one year from the date the omission or misstatement was discovered or should have been discovered. The maximum period during which suit could be brought also was reduced from ten to three years after the security was offered.

Commenting upon the Securities Act shortly after its adoption, Professor Harry Shulman observed:

> [T]he provisions for civil liability are calculated to be largely preventive rather than redressive. Both in the extent of liability imposed—the variety of persons to whom the liability attached, the basis of the liability and the persons in whose favor it runs—and in the limitation of amounts recoverable, the *in terrorem* function of the Act is evidenced. The Act seeks not only to secure accuracy in the information that is volunteered to investors but also, and perhaps more especially, to compel the disclosure of significant matters which were heretofore rarely, if ever, disclosed. Civil liability is imposed largely as one appropriate means of accomplishing these ends, not as an end in itself . . . .[89]

Despite the considerable relaxation of civil liabilities in the Securities Act attributable to the Exchange Act amendments, the provisions of section 11 appear to have functioned reasonably well to prevent inadequate disclosure—a fact evi-

85 H.R. REP. NO. 1838, 73d Cong., 2d Sess. 41 (1934). Notwithstanding the change, plaintiffs still do not have to show actual reliance on the registration statement before publication of an earnings statement; reliance is presumed.

86 The language "he had reasonable ground to believe" was replaced with "he had no reasonable ground to believe and did not believe that . . . the statements therein were untrue . . . ."

87 A memorandum explaining the proposed change stated that "the term 'fiduciary relationship' has been terrifyingly portrayed. The amendment substitutes for that language the accepted common-law definition of the duty of a fiduciary." 78 CONG. REC. 8669 (1934).

88 Thus, in Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971), the court found that part of the depreciation in value of the security was due to a "very drastic general decline in the stock market," and that to the extent of that drop "plaintiff's damages were not 'caused' by" defendant's actions. *Id.* at 586. The damage figure was reduced by multiplying the amount paid by the reciprocal of the decline in the Standard and Poor's index during the period in question. *Id.*

89 Shulman, *Civil Liability and the Securities Act*, 43 YALE L. J. 227 (1933). William O. Douglas and George B. Bates judged that civil liabilities "have been set high to guarantee that the risk of their invocation will be effective in assuring that the 'truth about securities' will be told." Douglas & Bates, *The Federal Securities Act of 1933*, 43 YALE L. J. 171, 173 (1933).

denced by the very infrequent reported litigation involving section 11 claims.[90] Moreover, the fact that the amendments did not go further suggests that Congress believed underwriters played a critical role in assuring that companies tell the whole truth when issuing securities.

B. *Underwriters' Responsibility in the Courts*

In 1969, Professor Louis Loss computed that only twenty-three cases, reported and unreported, raising section 11 claims had gone to final judgment since enactment of the federal securities acts.[91] Of this total, in only two cases did plaintiffs recover under section 11[92] while six others were judicially approved settlements of class action suits.[93] Nearly all of the few reported cases deal, at least to some extent, with the reasonable investigation (or "due diligence") defense. Two of the reported cases and one settlement of an administrative proceeding help chart the course of the evolving professional responsibilities of underwriters and hence warrant consideration. In addition, a reported case involving liability under section 12(2) of the Securities Act may shed further light on the obligations of underwriters.

1. *In re The Richmond Corp.:* Reasonable Investigation as a Duty

The earliest relevant case, *In re The Richmond Corp.*,[94] was a stop order proceeding instituted by the Division of Corporation Finance against The Richmond Corporation to suspend the effectiveness of a registration statement filed in 1961 covering 142,858 shares of the issuer's common stock, 36,500 warrants and an identical number of additional shares to be issued upon exercise of the warrants. The underwriting was to be on a best efforts basis. The Commission found the registration statement false and misleading in that it failed to include a summary statement describing the speculative aspects of the offering,[95] and failed to disclose (1) the intended use of over half of the net proceeds as well as the proposed order of priority of use,[96] (2) the existence and nature of potential conflicts of interest relating to competitive real estate practices of its officers and

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90 "[T]he liability provisions have had the *in terrorem* effect of creating an extraordinarily high sense of care and responsibility in the preparation of registration statements." Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1355 (1966). *See* 3 L. LOSS, SECURITIES REGULATION 1721 (2d ed. 1961). In addition to § 11's preventive effect, there may be other explanations for the dearth of cases. For example, § 11(e) provides that in any proceeding under the Securities Act the court may require an undertaking for the payment of litigation costs, including attorney's fees, and, if judgment is rendered against a party, may assess costs if it believes the suit or the defense to have been without merit. 15 U.S.C. § 77k(e) (1976). Comparable provisions were not included in the Exchange Act and are therefore not applicable to suits alleging violations of § 10 and rule 10b-5 thereunder. But Professor Loss believes that "probably the greatest single deterrent to § 11 actions has been the Commission's careful examination of registration statements." *Id.* at 1690. It has also been noted that "most of the registration statements that are filed have errors or omissions of one kind or another that aren't caught, that might or might not be material, for which there is fortunately not an opportunity to test or challenge simply because the price of the stock goes up." Panel Discussion, *Advice to My Client*, 24 BUS. LAW. 573, 621 (1969) (remarks of Kenneth J. Bialkin).

91 Since 1969 there have been additional recoveries and settlements. L. LOSS, *supra* note 90, at 3821.

92 Martin v. Hull, 92 F.2d 208 (D.C. Cir.), *cert. denied*, 302 U.S. 726 (1937); and Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968).

93 *See* L. LOSS, *supra* note 90, at 1688, 3823.

94 41 S.E.C. 398 (1963).

95 *Id.* at 404.

96 *Id.* at 401.

directors,[97] and (3) the underwriter's inexperience and failure to form a selling group in connection with the best efforts offering which could affect the success of the offering.[98]

Although the underwriter was not a party to the proceeding, the Commission's opinion included a lengthy discussion of the deficient nature of the underwriter's performance, with emphasis on its failure to fulfill its investigatory responsibilities.[99] The stipulation of facts entered into by the Division of Corporation Finance and the issuer indicated that the underwriter's investigation had consisted solely of visiting the issuer's principal properties, examining its stock list, and obtaining a credit report on the company. The underwriter apparently had relied upon management's representations on all other matters bearing on the registration statement. The Commission found that "such a limited investigation by an underwriter does not measure up to the degree of care, reasonable under the circumstances, necessary for and required of an underwriter to satisfy himself as to the accuracy and adequacy of the representations in the prospectus."[100] Satisfactory performance on this responsibility was especially important in the Commission's view:

> By associating himself with a proposed offering, an underwriter impliedly represents that he has made such an investigation in accordance with professional standards. Investors properly rely on this added protection which has a direct bearing on their appraisal of the reliability of the representations in the prospectus.
>
> The underwriter who does not make a reasonable investigation is derelict in his responsibilities to deal fairly with the investing public. Such dereliction, moreover, does not serve the statutory objective of achieving a prospectus for the sale of securities which, in all material respects, contains the information necessary for an informed evaluation of the securities offered.[101]

The Commission's proceeding in *Richmond* suggests strongly that an underwriter has a duty to conduct a reasonable investigation within the meaning of section 11 in connection with any public offering with which it is associated. Some members of the bar strenuously dispute the Commission's position that such a duty exists. In their view, the reasonable investigation referred to in section 11 is simply a defense to avoid the imposition of liability. Thus, no sanctions are appropriate if an underwriter performs no investigation whatsoever provided there is no false statement in the registration or, even if there is one, provided no lawsuit is commenced. The Commission staff believes that by associating his name with an offering as an underwriter, the underwriter "sponsors" the offering and therefore, consistent with notions of fair and equitable practices, makes an implied representation that he has investigated the affairs of the issuer. The staff's belief is buttressed by the customary practice of prominently displaying the name of the managing underwriter on the cover of the prospectus. The Commission has concluded that "[t]he public looks to the underwriter for protection and expects him to verify the accuracy of the statements in the registration statement."[102] If no such investigation had been undertaken, appropriate disclosure

97 *Id.* at 402.
98 *Id.* at 403.
99 *Id.* at 404-06.
100 *Id.* at 405. *See also In re* Charles E. Bailey & Co., 35 S.E.C. 33 (1953).
101 41 S.E.C. at 406 (footnote omitted).
102 Securities Act Release No. 5275 (July 27, 1972), 37 Fed. Reg. 16,011, 16,013 (1972).

would be necessary to avoid the imposition of sanctions. However, if such disclosure were made, it is extremely unlikely that the Commission or its staff could make the findings necessary to accelerate the registration statement. Section 8(a) allows the Commission to accelerate "having due regard to the adequacy of the information respecting the issuer theretofore available to the public . . . and to the public interest and the protection of investors."[103] It also is evident from the House Report on the bill, as reiterated by James Landis, who helped draft the Securities Act and the House Report, that Congress intended to impose a duty of "care and competence" upon those subject to section 11, including underwriters.[104] The House Report explained that

> the provisions throwing upon the defendant in suits under sections 11 and 12 the burden of proof to exempt himself are indispensable to making the buyer's remedies under those sections practically effective. Every lawyer knows that with all the facts in the control of the defendant it is practically impossible for a buyer to prove a state of knowledge or a failure to exercise due care on the part of defendant. Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements for the public's reliance. The responsibility imposed is no more nor less than that of a trust.[105]

2. *Escott v. BarChris Construction Corp.:* Determining Reasonableness in Light of the Surrounding Circumstances

While *Richmond* stands for the proposition view that independent investigation of the issuer is a duty underwriters cannot readily avoid, it was not until 1968, thirty-five years after adoption of the Securities Act, that a court first attempted to define what constitutes a reasonable investigation "under the circumstances" with respect to the different classes of persons named in section 11(a). In *Escott v. BarChris Construction Corp.*,[106] the United States District Court for the Southern District of New York set forth parameters to the investigatory responsibilities of signers of the registration statement, inside and outside directors, accountants, managing underwriters and participating underwriters. BarChris was in the business of constructing and equipping bowling alleys. Because its method of operations required it to expend significant funds before receiving sizable payments from customers or from the factor it utilized,[107] adequate cash flow was a recurrent problem. Part of the proceeds from the debenture offering giving rise to the suit would, according to the prospectus for the offering, be used to help meet its working capital needs. The registration statement covering the $3.5 million issue of subordinated convertible debentures became effective on May 16, 1961. The following year BarChris filed a petition in bankruptcy and defaulted

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103 15 U.S.C. § 77h(a) (1976).

104 H.R. REP. NO. 85, 73d Cong., 1st Sess. 5 (1933). *See also* Landis, *The Legislative History of the Securities Act*, 28 GEO. WASH. L. REV. 29, 48 (1959).

105 H.R. REP. NO. 85 at 10.

106 283 F. Supp. 643 (S.D.N.Y. 1968).

107 BarChris either (1) sold its bowling alleys to customers who made a small down payment and contracted to pay the balance in installments over a number of years, or (2) utilized a sale-leaseback approach, whereby it sold an "interior package" for a bowling alley to its factor who, in turn, leased the interiors directly to a third party or to a BarChris subsidiary which then leased them to others. *Id.* at 653-54.

on interest payable on the debentures.[108] Thereafter a class action suit was brought against the defendants seeking recovery under section 11.

The court found that the prospectus issued in connection with the offering was false and misleading in several respects. The use of proceeds section of the prospectus failed to disclose that funds earmarked for "additional" working capital to be used in the "expansion" of construction were in fact to be used primarily to pay off prior debts.[109] Nor did the section disclose that the deteriorating credit record of BarChris's customers might, pursuant to its agreement with the factor, necessitate the repurchase of over $1.3 million of customers' notes held by the factor.[110] The description of business section failed to disclose that in addition to its construction, manufacturing, and sales activities, BarChris, due in part to customer defaults, was operating bowling alleys. The court found that the operation of bowling alleys amounted to "a different business" involving "different problems and different risks."[111] The prospectus overstated BarChris's net operating income, earnings per share, net sales, and backlog of unfilled orders, while understating BarChris's contingent liabilities.[112] The court's painstakingly detailed discussion of the various defendants' conduct in relation to their asserted due diligence defenses provides considerable insight into the manner in which the district court judge believed section 11 responsibilities were to be discharged in connection with offerings made in the 1960's. For the purpose of this article, however, only the court's analysis of the underwriters' conduct need be discussed.

Eight investment banking firms participated in distributing BarChris's debentures, with Drexel & Co. acting as the managing underwriter. Drexel's attorney served as attorney for the syndicate.[113] In order to decide whether Drexel should underwrite a financing, a Drexel partner undertook a preliminary investigation of BarChris's financial condition in the fall of 1960. Drexel and BarChris signed a letter of intent[114] in February 1961.

In March 1961, representatives from Drexel and BarChris met three times to discuss the prospectus drafted by BarChris's counsel. These due diligence meetings offered Drexel and its counsel an opportunity to explore with BarChris's management the adequacy of disclosure contained in the drafts of the registration statement. The underwriter posed questions regarding a number of important issues, including the reserve for bad debts, the accuracy of backlog figures, the description of the use of proceeds, BarChris's past experience in repurchasing customers' notes, whether BarChris operated any bowling alleys, and loans made to the company by its officers.[115]

Drexel also made some effort to obtain documentation relating to the representations made in the registration statement. Drexel instructed its counsel to review pertinent corporate records, and counsel determined to examine Bar-

108 *Id.* at 654.
109 *Id.* at 675-76.
110 *Id.* at 676-78. A factor purchases trade receivables with or without recourse. The factor receives a commission on advances against receivables.
111 *Id.* at 678.
112 *Id.* at 668-71.
113 *Id.* at 692.
114 A letter of intent is a nonbinding written statement of the terms of underwriting prepared by the originating underwriter and addressed to the issuer.
115 *Id.* at 693-94.

Chris's minutes for the past five years and its major contracts.[116] The minutes of board meetings and of several executive committee meetings were examined by a very junior associate at the law firm, but written summaries of other executive committee meetings were missing and were not sought out because counsel accepted at face value a company official's statement that the meetings dealt only with "routine" matters.[117] As it turned out, examination of the missing minutes or the minutes of the company's subsidiaries would have revealed some of the matters inadequately disclosed in the registration statement. Counsel examined an insurance policy but apparently did not examine the agreement with BarChris's factor or any customer contracts or accounting records. No effort was made to review BarChris's schedule of delinquencies, the factor's notices of delinquencies, or BarChris's correspondence with the factor.

The court refused to find this inquiry reasonable, concluding that "[t]o effectuate the statute's purpose, the phrase 'reasonable investigation' must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of 'data presented' to them by the company."[118] Noting that the positions of underwriter and issuer are somewhat adverse,[119] the court declared:

> In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them.[120]

Drexel was held bound by its counsel's failure to make a reasonable investigation, as were the participating underwriters who relied upon Drexel and its attorneys.[121] The court believed underwriters were obliged to verify that all material facts had been addressed and accurately presented in the registration statement. This verification required independent inquiry, investigation and analysis by the underwriters.[122]

The *BarChris* opinion engendered lively discussion among professionals.[123] While there was some disagreement over where the court had drawn the line, there was general agreement that more attention should be paid to reviewing documentation. In commenting on the opinion, one attorney did not find this prospect particularly troubling:

116 *Id.* at 694.

117 *Id.* at 695.

118 *Id.* at 697.

119 The court explained: "It is not unlikely that statements made by company officers to an underwriter to induce him to underwrite may be self-serving. They may be unduly enthusiastic. As in this case, they may, on occasion, be deliberately false." *Id.* at 696.

120 *Id.* at 697. The court added its belief that "[i]t is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case." *Id.*

121 *Id.*

122 Presumably BarChris's periodic reports, which also described its business, were also false and misleading and if they had been incorporated by reference the prospectus would have been deficient. Since the prospectus was a stand alone document, however, the underwriters concentrated on it.

123 *See especially* Folk, *supra* note 56. *See also* Heller, Weiss, Israels & Schwartz, BarChris: *A Dialogue on a Bad Case Making Hard Law*, 57 GEO. L. J. 221 (1968); Panel Discussion, *Advice to My Client*, 24 BUS. LAW. 573 (1969); Comment, BarChris: *Due Diligence Refined*, 68 COLUM. L. REV. 1411 (1968); Comment, BarChris: *Easing the Burden of "Due Diligence" Under Section 11*, 117 U. PA. L. REV. 735 (1969); 21 STAN. L. REV. 171 (1968).

> All that is required, I think, is the obvious good sense of reading all corporate documents including minutes, having them read by a responsible attorney, of course and the same thing with the company's contracts. The lesson of the *BarChris* case is that if such procedures are not followed, the result may be disastrous.[124]

Another commentator concluded that

> the real significance of the case . . . must be assessed by the effect it has on the quality of information which is disseminated to the investing public. Basically, the other issues dealing with the very real and practical problem of how to comply with its edict, are subservient to this consideration.[125]

3. *Feit v. Leasco Data Processing Equipment Corp.*: Varying the Degree of Investigation Based Upon the Accessibility of Information

Three years later, in 1971, another district court handed down a decision regarding underwriters' liability which proved somewhat more favorable to underwriters. *Feit v. Leasco Data Processing Equipment Corp*.[126] was a class action suit brought by former shareholders of Reliance Insurance Company (Reliance) against Leasco, its directors and underwriters. During an exchange offer, plaintiffs had exchanged their Reliance shares for Leasco shares registered pursuant to an effective S-1 registration statement.[127] They alleged that Leasco's registration statement failed to provide an estimate of the amount of "surplus surplus"[128] held by Reliance and failed to indicate Leasco's plans for rechannelling surplus surplus for its own benefit. As was customary, the registration statement was prepared primarily by Leasco's attorneys and reviewed by the dealer-managers,[129] White, Weld & Co. and Lehman Brothers, and their counsel.

The evidence indicated that Leasco was interested in acquiring Reliance primarily because the insurance company had a large amount of excess capital (or "surplus surplus") which Leasco could tap if Reliance were reorganized. Approximately six months before the exchange offer, Leasco's Vice President for Corporate Planning had prepared a report which recommended the takeover of Reliance and estimated the amount of Reliance's surplus surplus to be $125 million as of June 30, 1967 and $100 million at the end of 1967.[130]

Despite Leasco's intense interest in Reliance's surplus surplus, the prospectus for the exchange offer made only a vague reference to it. The prospectus stated that Leasco favored operating the insurance company within the framework of a holding company because such a framework would provide "more flexible operations, freedom of diversification and opportunities for more profitable utilization

124 Panel Discussion, *supra* note 123, at 620 (remarks of Graham L. Sterling). Mr. Sterling's statement makes sense in the context of a small offering for a small issuer. However, the extent to which such documentation must or should be reviewed when the issuer is a large multinational corporation is not clear.

125 Statement of Professor Donald Schwartz, in Heller, *supra* note 123, at 239.

126 332 F. Supp. 544 (E.D.N.Y. 1971).

127 The S-1 registration statement is described in note 22 *supra*.

128 The term refers to "the highly liquid assets of an insurance company which can be utilized in non-regulated enterprises." 332 F. Supp. at 551.

129 A dealer-manager solicits acceptance of exchange offers. A dealer-manager is deemed to be an underwriter as defined in § 2(11) of the Securities Act, because it assists an issuer in connection with distribution of a security. 15 U.S.C. § 77b(11) (1976).

130 332 F. Supp. at 551.

of financial resources."[131] The court found the prospectus to be false and misleading because of its failure to describe Leasco's plans for the insurance company in greater detail or to provide an estimate of the amount of surplus surplus.[132] The court rejected Leasco's argument that it could not be more specific or accurately estimate the surplus surplus due to Reliance's hostility to the tender offer and refusal to make the pertinent information available.[133] In this regard, the court placed special emphasis on the fact that only a few months after the tender period ended, Leasco filed another Form S-1 registration statement for a different offering which estimated Reliance's surplus surplus at $125 million.[134]

While finding Leasco and its officer-directors civilly liable for failing to meet their section 11 duty to investigate the adequacy and completeness of the registration statement, the court exculpated the dealer-manager/underwriters. With respect to the treatment of surplus surplus, the court noted that White Weld's representative was "fully aware of the complexity of the computation problem."[135] The representative had discussed the matter at several due diligence meetings and had examined pertinent documents, including the Leasco vice president's memorandum containing the estimate of surplus surplus.[136] Leasco had informed the underwriters and their counsel, however, that Reliance's management would neither provide information nor verify the accuracy of Leasco's estimates. The underwriters were aware of an agreement between Leasco and Reliance dated August 1, 1968 which terminated Reliance's hostility to the takeover. But Leasco substantiated its position by presenting the underwriters with copies of a July 1968 telegram from a Reliance official and an August 13, 1968 letter from Leasco's counsel to the Commission indicating that Reliance was unwilling to furnish pertinent information.[137] The court stated that "[t]hough the finding might have gone the other way, on balance" the dealer-managers reasonably investigated and reasonably verified Leasco's representations that access to Reliance's management was not possible.[138]

Undoubtedly the most significant message of *Leasco* for underwriters functioning in an integrated disclosure system is the general principle set out by the court during its discussion of the officer-directors' liability. The court declared: "What constitutes 'reasonable investigation' and a 'reasonable ground to believe' will vary with the degree of involvement of the individual, his expertise, and his access to the pertinent information and data."[139] Although the implications of

131 *Id.* at 552.

132 *Id.* at 574-75.

133 The two companies resolved their differences in an agreement dated August 1, 1968. The registration statement became effective on August 19, 1968. *Id.* at 556.

134 *Id.* at 560.

135 *Id.* at 582.

136 *Id.*

137 *Id.* at 583.

138 *Id.*

139 *Id.* at 577. The case suggests that a court should consider the likelihood of an underwriter being able to verify information (and have access to appropriate backup material with respect to it) incorporated by reference from documents prepared earlier. Although this may well be the case, the outcome of *Leasco* must be viewed in its factual context—that of a hostile exchange offer in which the omission complained of was informaton about the target which the underwriter reasonably believed to be uncooperative. Lack of cooperation by an issuer in a negotiated offering is a totally different matter. See in this regard the discussion of § 1704(a) of the proposed Federal Securities Code of the American Law Institute, text accompanying notes 311-17 *infra*.

this statement vis-a-vis underwriters' responsibilities within an integrated disclosure system will be analyzed later in this article,[140] it is worth emphasizing now that the court's analysis of the variability of investigatory duties owed by different persons associated with the issuer would seem equally applicable with respect to underwriters' liability. The court appeared to say that what is "reasonable" depends in part upon the nature of the person involved and of the information to which he has access. After observing that more would be expected of inside directors intimately familiar with corporate affairs and the particular transactions at issue than of outside directors, the court added: "Similarly, accountants and underwriters are expected to investigate to *various* degrees."[141] In evaluating the reasonableness of the underwriters' conduct in *Leasco*, the court considered the nature of the transaction, the underwriters' relationship to the issuer and their access to the underlying data.

In *Leasco*, the apparent basis for the underwriters' reasonable reliance upon the *issuer*, Leasco, was the unavailability of the information from the *target*, Reliance, needed to verify the estimates of surplus surplus.[142] Documents reviewed by the underwriters indicated that Reliance was hostile to the tender offer and implied that it would not produce the information even after its resistance to the tender offer ended. In this situation, the court concluded that it was reasonable for the underwriters to rely upon Leasco's officers, who asserted that without confirmation by Reliance the estimate by Leasco should not be included in the prospectus.[143]

More generally, the case *implies* that a variety of other circumstances may deprive the underwriter of access to information essential to establishing that he conducted a reasonable investigation under section 11. The relevance of the type of underwriting arrangement is intimated by the court's observation that the "[d]ealer-managers cannot . . . be expected to possess the intimate knowledge of corporate affairs of inside directors, and their duty to investigate should be considered in light of their more limited access."[144]

The court's extension of a variable standard applicable to underwriters, while criticized by some,[145] appears consistent with the intentions of Congress. The House Committee recognized that "the duty of care to discover varies in its demands upon participants in security distribution with the importance of their place in the scheme of distribution and with the degree of protection that the public has a right to expect."[146] The Conference Committee Report on the Securities Act authorized "delegation of the performance of acts which it is unreasonable to require" the person to perform personally.[147] The test in such cases

140. *See* section VI *infra*.

141 332 F. Supp. at 578 (emphasis added).

142 Even though Leasco was making a hostile exchange offer, Form S-1 required the inclusion by Leasco of information about Reliance to the extent available. The underwriters would understandably be reluctant to include in the registration statement an estimate of excess cash which was not the subject of an audit, was substantial in amount, and was subject to the provisions of § 11, unless they were reasonably certain of its accuracy.

143 332 F. Supp. at 550, 561-62, 582.

144 *Id.* at 582.

145 *See, e.g.*, R. JENNINGS & H. MARSH, SECURITIES REGULATION 830-31 (4th ed. 1977).

146 H.R. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933).

147 H.R. REP. NO. 152, 73d Cong., 1st Sess. 26 (1933).

would be whether "reliance is reasonable in light of all the circumstances."[148] When a syndicate is involved, this means that there can be variation among the underwriters in the investigation performed. Participating underwriters may delegate to the managing underwriter the responsibility to conduct the investigation, but the Commission has stated that it will not consider the delegation reasonable unless the participating underwriter "satisf[ies] himself that the managing underwriter makes the kind of investigation the participant would have performed if he were the manager."[149] Thus, the participating underwriter usually limits its investigation to ascertaining that reliance upon the managing underwriter is reasonable. This makes sense if redundant investigations are to be avoided[150] and is consistent with the view of James Landis, who declared shortly after the Securities Act was adopted that "reasonability . . . will differ widely according to the person involved."[151] With regard to underwriters, Landis observed:

> [T]he type of investigation which can reasonably be demanded of the sponsoring or principal underwriters is one thing; that which the Act requires of the small participating underwriter in order that he satisfy its requirements is another thing, while an even *less* standard of investigation would be demanded of the dealer selling on commission who, because of his relationship to the issuer, is considered *as* an underwriter by the Act.[152]

The importance of this principle to underwriters in the future will become more apparent after a description of the changes occurring in the disclosure environment and the impact of these changes upon underwriters' opportunity to investigate.

4. *Sanders v. John Nuveen & Co.:* The Relationship Between Underwriters' Responsibilities Under Section 12(2) and Section 11

Sanders v. John Nuveen & Co.[153] was a class action suit brought by purchasers of commercial paper of Winter & Hirsh, Inc. (WH) following its default on the notes. Founding their suit on section 10(b) of the Exchange Act and section 12(2) of the Securities Act, the plaintiffs claimed that Nuveen and its control persons had failed to conduct the reasonable investigation required of an underwriter prior to selling underwritten securities to the public.[154] Between September 1968 and February 1970, Nuveen purchased virtually all of WH's commercial paper

148 *Id.*

149 Securities Act Release No. 5275 (July 26, 1972), [Special Edition No. 434] FED. SEC. L. REP. (CCH) ¶ 4506B.

150 As one district court recently observed, "[a]lthough supplementary, independent inquiries by the participating underwriters might occasionally dredge up an additional misstatement, the margin of improvement probably would not warrant the expense and confusion of proliferating inquiries." *In re* the Gap Stores Sec. Litigation 79 F.R.D. 283, 300 (N.D. Cal. 1978).

151 Landis, *Liability Sections of the Securities Act Authoritatively Discussed*, 18 AM. ACCOUNTANT 330 (1933).

152 *Id.* at 332.

153 619 F.2d 1222 (7th Cir. 1980), *cert. denied*, 49 U.S.L.W. 3706 (U.S. Mar. 23, 1981) (*Sanders IV*). The other three decisions in the *Sanders* case appear at 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972) (*Sanders I*); 524 F.2d 1064 (7th Cir. 1975), *vacated and remanded*, 425 U.S. 929 (1976) (*Sanders II*); and 554 F.2d 790 (7th Cir. 1977) (*Sanders III*).

154 Commercial paper is exempt from registration under the Securities Act by reason of § 3(a), 15 U.S.C. § 77c(a) (1976). Nevertheless, sales are still subject to § 12(2) of the Securities Act, 15 U.S.C. § 77*l*(2) (1976), and the antifraud provisions of the Exchange Act, including rule 10b-5 thereunder, 17 C.F.R. § 240.10b-5 (1980).

for resale to Nuveen's customers, and in the ensuing legal action Nuveen and the other defendants accepted plaintiffs' terming Nuveen an underwriter.[155] Nuveen made no investigation into the business or financial condition of WH prior to marketing its commercial paper initially to institutional and individual investors. Nuveen did regularly review WH's semiannual financial statements prepared by its independent certified public accountant, and in 1969 a credit analyst with Nuveen examined WH's accounts receivable and its collection procedures.[156] Nuveen did not, however, review the minutes, material contracts, accounting work papers or tax returns of WH. In January 1970, Nuveen inquired about WH's credit worthiness with its ten bank creditors. All the responses were either neutral or favorable. Also in January, two of WH's lenders insisted that WH replace its current auditor. The new auditor quickly discovered that the company's accounts receivable were overstated by $14 million, and that there was unreported indebtedness of $1.75 million. Soon it was also clear that the company's swelling financial imbalance had been concealed by the prior accountants for at least ten years. Section 11 of the Securities Act was not applicable because commercial paper is exempt from registration and therefore not sold pursuant to an effective registration statement. However, after establishing in *Sanders I* that commercial paper is a security under the Exchange Act,[157] the Seventh Circuit in *Sanders II* concluded that the standards of rule 10b-5 require underwriters to make a reasonable investigation of the issuer similar to that required to establish a defense under section 11, and that "Nuveen's investigation of WH was deficient and . . . an appropriate investigation would have revealed the fraud."[158] As the court in *Sanders II* explained, "a greater quantity of information is 'reasonably ascertainable' by an underwriter than by a mere broker, and something more than published data must be analyzed if an underwriter is to discharge his duty of investigation."[159] The defendant's appeal to the Supreme Court led to dismissal of the section 10(b) claims in *Sanders III* because the scienter required by the Court's intervening decision in *Ernst & Ernst v. Hochfelder*[160] could not be shown.[161]

The case then was remanded to the district court for consideration of plaintiffs' section 12(2) claims. Section 12(2) imposes liability on any person who "offers or sells a security . . . by means of a prospectus or oral communication" that misstates or omits material information.[162] Nuveen's distribution of commercial paper reports describing WH's paper to some purchasers was held in *Sanders IV* to satisfy the prospectus requirement, because the dissemination of the reports could have affected the price that all purchasers paid for the notes.[163]

Section 12(2) provides a defense for sellers who "in the exercise of reasonable care could not have known" of the inaccuracy.[164] The Seventh Circuit panel in

155 *Sanders II* at 1067.
156 *Id.*
157 *Sanders I* at 1080.
158 *Sanders II* at 1071.
159 *Id.*
160 425 U.S. 185 (1976). *See* text accompanying notes 18-20 *supra*.
161 *Sanders III* at 792.
162 Securities Act, § 12(2), 15 U.S.C. § 77*l*(2) (1976).
163 *Sanders IV* at 1227.
164 15 U.S.C. § 77*l*(2) (1976).

Sanders IV, citing with approval the reasoning in *Sanders II*, found that this defense was unavailable to a seller who was also an underwriter and who had failed to make a reasonable investigation that would have uncovered the issuer's fraud.[165] The court added that "[s]ince what constitutes reasonable care under § 12(2) depends upon the circumstances, we, of course, do not intimate that the duty of a seller under § 12(2) is always the same as that of an underwriter in a registration offering under § 11."[166] The court thus implicitly distinguished the duties of an underwriter and those of a mere seller under section 12(2). But although the court appeared to equate the duties of an underwriter under section 11 with those under section 12(2), it came close to requiring more investigation by an underwriter of a nonregistered offering than by an underwriter of a registered offering. For example, the opinion in *Sanders II*, cited with approval in *Sanders IV*, criticized the underwriter's failure to verify the contents of WH's audited financial statements or to review the work papers of the accountants[167]—a level of investigation not required by section 11, which permits the underwriter to rely on the audited financial statements so long as he "had no reasonable ground to believe, and did not believe" that the statements were untrue or omitted material information.[168]

Although the Supreme Court refused to review the decision in *Sanders IV*, Justice Powell wrote an opinion dissenting from the denial of certiorari, in which Justice Rehnquist joined.[169] Justice Powell expressed concern that the decision would "be read as recognizing no distinction between the standards of care applicable under §§ 11 and 12(2), and particularly as casting doubt upon the reasonableness of relying upon the expertise of certified public accountants."[170] Justice Powell took the position that "almost by definition, it is reasonable [for an underwriter] to rely on financial statements certified by public accountants."[171] On the other hand, the court of appeals in *Sanders II* found that WH's disclosure deficiencies also would have been detected if the underwriter had reviewed the corporate minutes,[172] and it is customary for underwriters to review the minutes as part of their section 11 investigation.

In his dissent, Justice Powell did not refer to the views expressed in the amicus curiae brief submitted on behalf of the United States. In urging the court to deny the petition for a writ of certiorari, the Solicitor General contended that

> [e]ven if, as a general matter, Sections 11 and 12(2) impose distinct standards of care, a standard of care that is the same or similar to that imposed by Section 11 may be appropriate in this unusual factual situation—involving an unregistered offering having many of the characteristics normally associated with an offering required to be registered. In these circumstances, the standard of "reasonable care" under Section 12(2) may converge with the standard of "reasonable investigation" prescribed under Section 11.[173]

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165 *Sanders IV* at 1227-28.
166 *Id.* at 1228.
167 *Sanders II* at 1067-68, *cited in Sanders IV* at 1227.
168 15 U.S.C. § 77k(b)(3)(C) (1976).
169 John Nuveen & Co. v. Sanders, 49 U.S.L.W. 3706 (U.S. Mar. 23, 1981).
170 *Id.* at 3707.
171 *Id.*
172 *Sanders II* at 1069.
173 Brief for the United States as Amicus Curiae at 7-8 (Sanders IV) (footnote omitted).

Sanders involved an unusual fact situation, but conveys the clear message that underwriters of offerings exempt from the registration provisions of the Securities Act should still make a reasonable investigation of the accuracy of information contained in the prospectus. To the extent that such underwriters proceed to sell the exempt securities pursuant to an inaccurate prospectus, they may be held to a standard of investigation similar to that set forth in section 11. Moreover, the steps the underwriters failed to take (for example, reading tax returns) may be steps a court will now require to sustain a section 11 defense, although as noted above there are significant doubts as to whether these steps are or should be required by section 11.

The four principal cases discussed above make two things clear. First, underwriters may not simply rely upon management's assurances or content themselves with reading documents prepared by the issuer. Second, their investigation must be thorough, but judges are prepared to take into account some or all of the circumstances surrounding the offering.

IV. Integration of Disclosure Requirements of the Federal Securities Laws and Evolution of the Disclosure Environment

The Division of Corporation Finance of the Securities and Exchange Commission has devoted substantial resources to the task of formulating, through rulemaking, a single disclosure system compatible with both the transaction-based disclosures called for by the Securities Act and the continuous corporate reporting requirements of the Exchange Act. The creation of this system of integrated disclosure is the culminating phase of a reorientation process initiated by the Commission's Disclosure Policy Study (the Wheat Report) over a decade ago[174] and first given concrete form by the Commission's Advisory Committee on Corporate Disclosure.[175] From these initiatives and an ongoing dialogue among professionals,[176] a consensus has developed supporting the concept of an integrated disclosure system.

Prior to these developments, the disclosure systems of the Securities Act and the Exchange Act operated independently of each other, despite the fact that each contained similar disclosure requirements. Issuers, underwriters, accountants and other professionals spent several weeks preparing the lengthy registration statement, including the prospectus required to be provided to investors in connection with new offerings registered under the Securities Act, even though some of the information contained therein might have been disclosed earlier in one of the issuer's periodic reports filed pursuant to the Exchange Act and thus already available to the securities markets. The issuer, its accountants and perhaps its outside counsel prepared the periodic reports filed under the Exchange Act; representatives of the issuer's traditional underwriters were of course not involved. In 1966, Milton Cohen observed that the legislative history of the securities acts helped explain this lack of cohesion. The disclosure scheme would

174 The Commission's staff, after an extensive reexamination of the disclosure policy under the Securities Act and the Exchange Act, called for "closer coordination of the disclosures required by" the two Acts. 1 SECURITIES AND EXCHANGE COMMISSION, DISCLOSURE TO INVESTORS 13 (1969) (Wheat Report).

175 1 REPORT OF THE ADVISORY COMM. ON CORPORATE DISCLOSURE TO THE S.E.C., 95th Cong., 1st Sess. 420-69 (Comm. Print 1977) [hereinafter ADVISORY COMM. REP.].

176 *See* Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340 (1966).

have been better, he wrote, if the two statutes "had been enacted in opposite order, or had been enacted as a single, integrated scheme of continuous disclosures covering issues of actively traded securities and the question of special disclosure in connection with public offerings had then been faced in this setting."[177]

The Commission has taken several steps to reduce the overlap and duplication under the two statutes. The adoption of registration Form S-7 in 1967[178] was the first recognition by the Commission that information reported under the Exchange Act could substitute for some of the information previously required to be separately disclosed in a registration statement. Use of this somewhat shortened form of registration was limited to issuers with a substantial history of reporting under the Exchange Act and hence to companies for which considerable information was already available to potential investors.[179] In addition, pursuant to a recommendation of the Commission's Disclosure Policy Study, the Commission adopted an even shorter form of registration, Form S-16.[180] When an issuer qualified for use of Form S-7, it could utilize Form S-16 to register securities to be sold in certain secondary distributions by the issuer's shareholders.[181] In 1978, in a major step, use of Form S-16 was expanded to apply to certain primary offerings that are underwritten on a firm commitment basis.[182] Form S-16 incorporates into the registration statement corporate reports previously filed pursuant to the requirements of the Exchange Act. As a result, the prospectus is substantially shorter and can be prepared in far less time. For example, the Form S-16 prospectus dated March 20, 1981 of Security Pacific Corporation relating to a sale of $100,000,000 of convertible subordinated debentures is fourteen pages long. If the offering had been on the traditional Form S-1, it would have been at least six times as long.

While the adoption of Forms S-7 and S-16 was an important step toward coordinating disclosure requirements,[183] the use of these forms has been limited to a small portion of all reporting companies. The Commission's present integra-

177 *Id.* at 1241.

178 Securities Act Release No. 4886 (Nov. 29, 1967), [1966-1967 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,500.

179 Securities Act Release No. 4849 (Nov. 16, 1966), [1966-1967 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 77,415.

180 17 C.F.R. § 239.27 (1980).

181 Only issuers may register securities under the Securities Act. Thus, if affiliates need to have their shares registered for resale the issuer must cooperate and file the registration statement, for which it has absolute liability but under which it receives none of the proceeds. The short form was adopted to reduce the burdens on companies and to make it less likely that they would resist registering the shares where necessary.

182 The form can be used for offerings to the public of debt or equity securities by (1) issuers with a specified market capitalization, or (2) issuers whose parents meet this requirement and who offer debt securities which are guaranteed as to principal and interest by the parent, provided the offering is made pursuant to firm commitment underwriting. Any debt securities must be issued pursuant to a trust indenture qualified under the Trust Indenture Act of 1939. The form can also be used for offerings to existing security holders pursuant to rights offerings or to dividend or interest reinvestment plans, or for offerings to holders of convertible securities or transferable warrants under certain circumstances. Securities Act Release No. 5923 (Apr. 10, 1978), 43 Fed. Reg. 16,672 (1978).

183 The Commission has taken other preliminary steps to coordinate disclosure requirements. *See* Securities Act Release No. 5276 (July 26, 1972) (announcing changes in registration Forms S-1 and S-2 modeled on Forms 10 and 10-K); Securities Act Release No. 5395 (June 1, 1973), [1973 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,383; Securities Act Release No. 5758 (Nov. 2, 1976), [1976-1977 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,783.

tion project is comprehensive in scope and is designed to benefit all companies which have been reporting for at least three years. The integration project is based on two important premises.

First, there is little justification for requiring redundant disclosure by companies that are closely followed by securities analysts and institutional and other professional investors.[184] For this group of companies, the market appears to assimilate available company-specific information in a timely manner and market prices quickly reflect such information.[185] The Commission staff has been unable to detect any appreciable incremental benefit from requiring such companies to prepare registration statements which reproduce much of the same information that has already appeared in periodic reports filed with the Commission pursuant to the Exchange Act.[186]

Second, redundant disclosure requirements burden business and conceivably could slow down the process of capital formation because of the time necessary to prepare lengthy registration statements containing the repetitive disclosures.[187] The Advisory Committee on Corporate Disclosure found that

> [a] continuous, coordinated and integrated disclosure system for industrial issuers required to file information under the 1933 and 1934 Acts will curtail registration costs and administrative obstacles incurred by industrial issuers in raising capital, facilitate timely access to the capital markets, and simplify the exchange offer and business combination processes.[188]

Under both the Securities Act and the Exchange Act, the Commission has broad discretion to prescribe the information that companies must set forth in registration statements[189] and in periodic corporate reports.[190] The Commission's initiatives in 1980 approached the goal of integrating the two Acts' disclosure requirements by identifying a basic information package, primarily financial, which is material both to investors trading the securities of issuers regis-

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184 Research by the Advisory Committee on Disclosure Policy revealed that less than 1,000 issuers out of the more than 10,000 which file periodic reports pursuant to the Exchange Act are followed by one or more analysts at any given time. ADVISORY COMM. REP., *supra* note 175, at XVIII-XIX.

185 *See, e.g.*, Beaver, *The Information Content of Annual Earnings Announcements*, EMPIRICAL RESEARCH IN ACCOUNTING: SELECTED STUD. 67, 90 (1968); Fama, Fisher, Jensen & Roll, *The Adjustment of Stock Prices to New Information*, 10 INT'L ECON. REV. 1, 17-18 (1969); Scholes, *The Market For Securities: Substitution Versus Price Pressure and the Effects of Information on Share Prices*, 11 J. BUS. 179, 203 (1972). Summarizing the findings of a number of studies, Tinic and West report that "the results thus far are generally consistent with the hypothesis that publicly available information tends to be impounded very quickly and, on the average, in an unbiased fashion." S. TINIC & R. WEST, INVESTING IN SECURITIES: AN EFFICIENT MARKET APPROACH 508 (1979).

Naturally, companies have the option of including more disclosure than is required in the Form S-16 prospectus. This often happens with equity offerings. Although the market may have assimilated the information, the new purchaser may still have to be sold on the deal.

186 This does not presume that the previously furnished information is necessarily accurate. In this regard see discussion in text accompanying notes 250 & 266-70 *infra*.

187 There has been some criticism of the Commission's reporting requirements in this regard. *See, e.g.*, J. GREENE, REGULATORY PROBLEMS AND REGULATORY REFORM: THE PERCEPTIONS OF BUSINESS 12 (1980).

188 ADVISORY COMM. REP., *supra* note 175, at 425.

189 Securities Act, § 7, 15 U.S.C. § 77(g) (1976) authorizes the Commission to waive statutorily imposed disclosure requirements if there still will be "disclosure fully adequate for the protection of investors" and to require additional disclosures in the registration statement which are "necessary or appropriate in the public interest or for the protection of investors."

190 Exchange Act, § 13, 15 U.S.C. § 78(m) (1976) grants the Commission similar authority, and under that section the Commission requires issuers to file annual reports on Form 10-K and interim reports on Form 10-Q or Form 8-K.

tered under the Exchange Act and to persons considering whether to invest in securities offered pursuant to the Securities Act. It was determined that such a basic information package should consist of (1) audited financial statements (comprised of balance sheets issued at the end of the two most recent fiscal years, and income and source and application of funds statements for the three most recent fiscal years, all prepared on a consolidated basis), (2) a five year summary of financial data appropriate for trend analysis, and (3) management's discussion and analysis of the company's financial condition, including liquidity, capital resources and the impact of inflation.

The disclosure requirements relating to this basic package of financial information are set forth in Regulation S-K[191] and Regulation S-X.[192] The basic financial information package will be disclosed, in the Exchange Act context, in Part II of the issuer's annual report on Form 10-K or in its annual report to security holders which can, in turn, be incorporated by reference into the Form 10-K.[193]

Under the integrated disclosure system, it is proposed that issuers be divided into three tiers.[194] An issuer's classification will determine what information must be set forth directly in the prospectus or otherwise delivered to investors and the extent to which previously disseminated information can be incorporated by reference, in lieu of actual presentation in the prospectus or delivery to investors.

New proposed registration Forms A, B, and C are designed to respond to the disclosure needs of investors with respect to these three categories of issuers.[195] Each of the proposed forms would, by cross reference to items in Regulation S-K, generate the same basic package of information described above, supplemented by such other information as may be necessary or appropriate for the protection of investors.

Proposed Form A would be available for use by the top tier of issuers. As proposed, it employs the same qualifications and would be used for the same primary and secondary offerings as existing Form S-16.[196] Much of the basic

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191 *See generally* Securities Act Release No. 6276 (Dec. 23, 1980), 46 Fed. Reg. 78 (1981). Regulation S-K eventually also will be the repository of all general disclosure requirements under the Securities Act. Securities Act Release No. 5949 (July 28, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,649.

192 Securities Act Release No. 6178 (Jan. 15, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,424.

193 Securities Act Release No. 6231 (Sept. 2, 1980), [1981] 6 FED. SEC. L. REP. (CCH) ¶ 72,301.

194 *Id.*

195 Securities Act Release No. 6235 (Sept. 2, 1980), 45 Fed. Reg. 63,693 (1980).

196 As proposed, use of the form would be subject to the following conditions among others:

(1) It could be used only by an issuer with a class of securities registered pursuant to § 12(b) of the Exchange Act or by a domestic issuer with a class of equity securities registered under § 12(g);

(2) The issuer must have been subject to and in compliance with the periodic reporting requirements of the Exchange Act for at least the 36 months preceding the filing of the registration statement, including timely filing of all reports during the preceding 12 months. If the issuer is subject only to § 15(d) of the Exchange Act, it must have distributed an annual report within the previous 12 months to all security holders of each class to which the registration statement related;

(3) During the previous 36 months, the issuer must not have failed to pay any required dividend or sinking fund installment on preferred stock or have defaulted on material indebtedness or rental on a material long-term lease;

(4) The issuer and its subsidiaries must have consolidated net income of at least $250,000 for three of the previous four years, including the most recent fiscal year; and

package of financial information would be incorporated by reference from the issuer's Form 10-K or other corporate reports filed pursuant to sections 13(a) or 15(d) of the Exchange Act. The prospectus would notify potential investors how to obtain without charge the documents incorporated by reference. Form A as proposed would be available for use only in primary offerings that are underwritten on either a firm commitment or best efforts basis.[197]

Proposed Form B would be available for the registration of securities offered by the middle tier of issuers lacking the market characteristics of those companies eligible to use Form A. The conditions for use of the form are modeled after those for existing Form S-7. In most respects the conditions are identical to those for Form A[198] except that instead of Form A's net income requirement, issuers would be eligible to use the form if they did not possess any of certain specified financial characteristics.[199] Much of the information required by Form B is the

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(5) With respect to primary offerings,
  (a) the aggregate market value of the voting stock held by nonaffiliates must be $50 million or more;
  (b) the aggregate market value of the voting stock of the issuer's parent held by nonaffiliates must be $50 million or more, the issuer must be a majority-owned subsidiary and its parent must have fully guaranteed the securities as to principal and interest; or
  (c) the aggregate market value of voting stock of the issuer's parent held by nonaffiliates must be $50 million or more, the issuer must be a majority owned subsidiary and
    (i) $250 million of registered securities outstanding must be held by nonaffiliates and
    (ii) the issuer must have 1,000 shareholders to whom it furnishes an annual report with the financial statements prescribed by rule 14a-3.

45 Fed. Reg. at 63,709.

197 This limitation is similar to the restriction of Form S-16 to firm commitment offerings, and is based on the Commission's belief that "the presence of an underwriter who has a degree of responsibility for an offering serves to enhance the likelihood that investor protection will not suffer because of abbreviated disclosure in the prospectus." Securities Act Release No. 6235 (Sept. 2, 1980), 45 Fed. Reg. 63,693, 63,700 (1980). That is to say, the underwriter will have reviewed and verified to the extent necessary the documents incorporated. However, the logic of such restriction is questionable. The form is predicated upon the nature of the market for a company's securities and reduces the need to reiterate prior disclosure because of its ready availability. Yet why should a company have to reiterate the disclosure when it self-underwrites or engages in a best efforts offering? Repetition does not guarantee accuracy, and since the information is incorporated by reference, it is subject to § 11 standards. The limitation to firm commitment underwritings was probably the product of an abundance of caution. However, logic dictates that if the issuer qualifies, it should be able to issue any type of security in any manner it wishes. If an underwriter is used, of course, it will have to conduct an investigation into the business of the issuer, a process separate from the preparation of the short-form registration statement. Moreover, if underwriters are correct in believing that reduced preparation time compels curtailed investigation, then perhaps the short form should *not* be available for the type of offerings that necessitate a firm commitment underwriting; the parties should be required to prepare a long-form prospectus. That would mean issuers would have to incur unnecessary expense to allow underwriters to verify information that issuers are absolutely liable for and with respect to which directors are comfortable that they can show they have conducted the reasonable investigation necessary to avoid liability. In addition, if the form is premised upon an efficient market, it is not clear whether all the criteria are logical. For example, a company like General Motors could not use the form for a debt or equity offering because it had a loss in its last fiscal year, yet certainly the company is widely followed. Thus, the staff is examining thoroughly the question of appropriate criteria.

198 The conditions for the use of Form A are set forth in note 196 *supra*.

199 The characteristics proposed were:
  (1) a decline of more than 50% in income from continuing operations over the last fiscal year;
  (2) any material financial uncertainty which has or will result in a "subject to" opinion in the accountant's report; or
  (3) a downgraded bond rating during the previous 12 months.

45 Fed. Reg. at 63,701. Commentators have been severely critical of conditioning eligibility to use a form on specified financial criteria. They argue persuasively that while the existence of such characteristics might warrant additional disclosure or greater review, it should not deprive companies of the benefits of the form. Moreover, there is little agreement as to which of a company's financial characteristics mean the

same as that required by Form A. The major difference is that most required information in Form B must be delivered to potential investors rather than simply incorporated by reference into the *prospectus*. The requirements could be met either by presenting the information in the prospectus directly or by delivering to security holders a copy of the issuer's previously prepared annual report and, where applicable, the issuer's latest Form 10-Q. Another distinction between the two forms is that offerings made pursuant to Form B need not be underwritten. Thus, although information must be delivered, previously prepared documents can be used, thereby reducing the time necessary to prepare the prospectus. To make those materials part of the *registration statement*, the relevant portions would be incorporated by reference.

Proposed Form C would be used by issuers who either do not qualify to use or choose not to use any other Securities Act registration form. It is also the only form, other than Forms S-15 and S-14, which could be used to register securities to be issued in an exchange offer for securities of another person. Form C, as the basic full form for registering securities under the Securities Act, would be a streamlined version of existing Form S-1. The core financial information would be the same as that required in Forms A and B. Additional disclosure items would derive from items required by Regulation S-K. There would be only minimal incorporation by reference.

There have been several other changes in the Commission's registration forms as part of the integration program. The Commission has adopted a new experimental short form of registration statement, Form S-15, for offerings of securities to be issued in certain business combination transactions.[200] Specifically, its use is limited to registration of securities for issuance in rule 145(a)(1) transactions,[201] short-form mergers, and exchange offers to acquire a majority of a class of securities of another person where the acquisition will have less than a ten percent consolidated pro forma effect on the issuer. Form S-15 allows issuers meeting the conditions for its use[202] to furnish shareholders of the company to be acquired with the issuer's basic package of financial information by delivering its latest annual report to security holders along with the prospectus. The prospectus contains only disclosures about the proposed business combination transaction, the company being acquired, and any additional information necessary to update information contained in the annual report to security holders.

Finally, the Commission has proposed rule 462A,[203] which would permit the "shelf" registration[204] of securities that can reasonably be expected to be offered

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company is troubled, and it would be inappropriate for the Commission to characterize a company through a form as financially troubled.

200 Adoption of Form S-15 was announced in Securities Act Release No. 6232 (Sept. 2, 1980), 45 Fed. Reg. 63,647 (1980).

201 Rule 145(a)(1) transactions are reclassifications of securities, other than stock splits, reverse stock splits, or changes in par value, which involve the substitution of one security for another security.

202 The five conditions which must be met are set forth as General Instruction A to Form S-15, 45 Fed. Reg. 63,647, 63,655 (1980) (to be codified in 17 C.F.R. § 239.29).

203 Securities Act Release No. 6276 (Dec. 23, 1980), 46 Fed. Reg. 78 (1981).

204 "Shelf" registration occurs when an issuer registers securities "for the shelf," *i.e.*, when it does not plan to offer the securities immediately upon the effectiveness of the registration statement. The last sentence of § 6(a) of the Securities Act provides: "A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." 15 U.S.C. § 77f(a) (1976). Guide 4 of The Guides for the Preparation and Filing of Registration Statements and Periodic Reports, as originally adopted in Securities Act Release No. 4936 (Dec. 9, 1968), [1967-1969 Transfer Binder] FED. SEC. L. REP.

and sold within two years provided adequate current information is made available to investors by means of post-effective amendments.[205] The proposed rule would restrict shelf registration to certain types of offerings.[206] With respect to such offerings, the Commission has stated: "Shelf registration can utilize integration effectively, thereby facilitating the development of important new capital raising techniques. Accordingly, the Commission believes that a restrictive policy on shelf registration is not appropriate or necessary for the protection of investors."[207]

The elements of the evolving streamlined, integrated disclosure system acquire practical meaning in the context of the securities offering and distribution process.

V. The Stock Offering Process Under the Integrated Disclosure System

A. *The Effects of Integration on the Offering Process*

The Commission's integration program affects the offering process in three major ways that impact upon the activities and responsibilities of underwriters. First, integration reduces the time necessary to prepare registration statements,

(CCH) ¶ 77,636, interprets that provision of § 6(a) to prohibit the registration of securities for a delayed or postponed offering. The guide does, however, cite instances in which such registration has been permitted—for example, where the registrant proposed to engage in a continuing acquisition program. In Securities Act Release No. 6276 (Dec. 23, 1980), 46 Fed. Reg. 78 (1981) (the "Shelf Release"), the Commission proposed to drop the guide and replace it with rule 462A to be added to Regulation C because the guide no longer reflects current staff policies and its interpretation of § 6(a) may be too restrictive. In the absence of any specific legislative comment, early opinions of the Commission and its staff interpreted the last sentence of § 6(a) as requiring that the registration statement be effective only as to securities to be offered in "the proximate future." The general prohibition against shelf registration was designed to effectuate the policy of the last sentence of § 6(a) that registration statements provide current information. This interpretation was in turn based on the assumption that securities offered at some remote future time gave the appearance of registered status without providing accurate and current information. Shelf Release at 87.

In practice, the Commission did not absolutely bar shelf registrations. Recognizing that the early interpretations were based in large part on concerns about the currency of information, the Commission and its staff developed, by changes in rules and practice, more effective means—particularly through post-effective amendments and undertakings—for updating and assuring the adequacy of disclosure. Because the statutory terminology "proposed to be offered" has no specific time frame, it has been considered reasonable to take into account (in the proposed rule 462A) the availability of adequate information under an integrated disclosure system in administering agency policy with respect to shelf registration.

205 Securities Act Release No. 6276 (Dec. 23, 1980), 46 Fed. Reg. 78 (1981).

206 The proposed rule provides in part:

(a) A registration statement may be declared effective for an offering of securities to be made on a continuous or delayed basis in the future, provided that

(1) The registration statement pertains to:

(i) Securities in an amount which can reasonably be expected to be offered and sold within two years from the effective date of the initial registration statement; or

(ii) Securities which are reasonably expected to be offered and sold pursuant to dividend or interest reinvestment plans or employee benefit plans of the registrant; or

(iii) Securities which (A) are the subject of exercisable options, warrants or rights which are, or within two years from the effective date of the initial registration statement will be, exercisable, or (B) are issuable upon conversion of other securities, if such other securities are also registered on the effective date, or (C) are pledged as collateral.

46 Fed. Reg. at 87-88 (1981). The remainder of the proposed rule requires that registrants undertake to keep the information in the registration statement current by several specified means. If the rule is adopted, issuers could for the first time register equity and debt securities for a continuous offering "at-the-market" or otherwise.

207 46 Fed. Reg. at 88.

thereby eliminating artificial barriers to the speed with which an offering may be accomplished if everything else has been done. Second, it places special emphasis on periodic reports often composed by persons divorced from the underwriters. Third, for unrelated reasons, it has been accompanied by more rapid processing of registration statements by the Commission staff. The integration program is designed to benefit issuers; it does not purport to change the critical role played by underwriters in the process of distributing securities. The issue, however, is: Has it had unintended effects for which the Commission should accept responsibility?

Historically, the offering process began several months before the proposed effective date of the registration statement. This preparation period was needed to allow the underwriter, the issuer and counsel sufficient time to gather the extensive information needed to write the prospectus. After filing, there was usually a significant time period during which the Commission staff reviewed and commented on the filing. Underwriters would almost always have completed their investigation before filing.[208]

Under the evolving integrated disclosure system, parties will need to prepare considerably less material in connection with the offering. Registration Forms S-16 and S-15 and proposed Form A and (to a lesser extent) Form B rely to the extent possible on previously filed periodic reports or the issuer's annual report to security holders, which would be incorporated by reference into the pertinent registration form. Only minimal additional information, primarily related to describing the proposed transactions and updating previously filed information, would need to be prepared in connection with filing the registration statement. These changes will shorten significantly the preparation period that precedes the filing of a registration statement with the Commission. This puts added pressure on underwriters to complete their investigation before filing. If that is the case, why not complete due diligence while the Commission is processing the filing? First, underwriters are reluctant to do that, because a preliminary prospectus is circulating during that process.[209] Second, processing time is being drastically reduced, in part because of a reduction of resources in the Division of Corporate Finance.

The Securities Act provides that the effective date of a registration statement shall be the twentieth day after the filing date, and that amendments to the registration statement reactivate the twenty day "waiting" period.[210] The purpose of this delay period, according to the Conference Committee on the Securities Act, is to allow time for "public scrutiny" of the proposed offering.[211] The Commis-

208 *See* note 209 *infra*.

209 Technically, under the Securities Act no prospectus need be given the purchaser before he receives his confirmation of purchase, since oral offers are permitted under § 5 before the registration statement becomes effective. The Commission, however, has encouraged prior distribution of preliminary prospectuses to prospective purchasers to enable them to assess their investment. The Commission takes into account such prior distribution when granting requests for acceleration. *See* rule 460, 17 C.F.R. § 230.460 (1980). Any material changes in disclosure resulting from any investigation would require recirculation before acceleration would be granted. The number of preliminary prospectuses distributed varies widely, from as few as 1,000 to more than 15,000, depending on the nature of the offering. One can therefore appreciate the cost savings to an issuer inherent in a Form S-16, and the reluctance of underwriters to file before due diligence is substantially complete.

210 Securities Act, § 8(a), 15 U.S.C. § 77h(a) (1976).

211 H.R. REP. NO. 152, 73d Cong., 1st Sess. 25 (1933).

sion may, at its discretion, "accelerate" the effectiveness date upon request.[212] Because traditional long-form registrations are amended, sometimes several times, in response to comments by the Commission's staff, in practice the period between filing and effectiveness has often been as long as forty-five to ninety days.

In the future, however, there may be considerable shortening of this waiting period. The volatility of the markets[213] has led issuers and counsel routinely to request acceleration of effectiveness shortly after filing. Processing time for Form S-16 registration statements has been drastically reduced to a few days, or to only forty-eight hours in some cases of debt offerings, because of the volatility of the bond markets.[214]

The staff has honored such acceleration requests because the Division of Corporate Finance is simply not able to review in detail all filings made with it and, as a result, must leave the decision as to the appropriate effective date to the issuer and underwriter. Selective review procedures are now in place in the Division. While the staff probably will continue to review thoroughly first-time registration statements, "going private" transaction statements,[215] and registration statements of financially troubled companies, other filings will be reviewed on a selective basis, and those not reviewed will become effective on the date requested by the issuer and underwriter.

The decision not to review thoroughly every registration statement was based primarily on the enormous processing and review burdens placed upon the Commission's comparatively small staff. In 1940, the size of the staff was 1,670.[216] During the intervening forty years, the Commission staff has increased

212 17 C.F.R. § 230.461 (1980).

213 The following data submitted by Morgan Stanley & Co. as part of its Comment letter on proposed Forms A, B and C illustrates the increasingly wide fluctuations in interest rates which could substantially increase the risks associated with undewriting debt offerings in particular:

20 Year Treasury Notes Weekly Percentage Yields

Year	High	Low	Range High-Low	Mean	Median	Standard Deviation
1971	6.51	5.73	0.78	6.13	6.09	0.21
1972	6.19	5.74	0.45	6.01	6.01	0.10
1973	7.79	6.42	1.37	7.12	7.07	0.26
1974	8.68	7.40	1.28	8.06	8.08	0.37
1975	8.63	7.63	1.00	8.19	8.22	0.26
1976	8.17	7.28	0.89	7.87	7.94	0.21
1977	7.92	7.23	0.69	7.66	7.68	0.12
1978	9.00	8.01	0.99	8.48	8.47	0.24
1979	10.56	8.79	1.77	9.33	9.08	0.53
1980*	12.79	9.59	3.20	11.10	10.97	0.89

* Information through third quarter only.

Morgan Stanley & Co. letter (Jan. 14, 1981) (File No. S7-763).

214 During the period from October 1979 to June 1980 there were 249 Form S-16 offerings. 22.4% became effective within one week of filing and 38.8% became effective within between one and two weeks. For a statistical profile of Form S-16 issuers and offerings, see Securities Act Release No. 6235A (Oct. 15, 1980), [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,665.

215 SEC Press Release (Nov. 17, 1980), reprinted in 2 PRACTICING LAW INSTITUTE, PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 1981, 33.

216 SEC ANNUAL REPORT 102 (1940).

by only twenty percent[217] while the number of reporting companies has tripled, and the number and complexity of filings has increased enormously.[218] Another consideration is the increasing volatility of the market, which shortens the period during which market conditions are optimal for offering an issue of securities. Any review of a selected filing must be done within a time framework sensitive to market conditions. Three months processing time is not acceptable. It can be anticipated that there will be substantial pressure to accelerate the effective dates or to shorten processing time of the new proposed registration forms for the same reasons.

In soliciting public comment on proposed Form A, the Commission specifically invited comment regarding whether there should be a minimum time period between filing and effectiveness of a registration statement on Form A.[219] With respect to the responsibilities of underwriters, the commentators indicated that underwriters usually conclude their investigation prior to the filing of the registration statement.[220] Therefore, even though registration statements become effective very soon after filing, there should be no effect upon the adequacy of the underwriter's investigation, assuming there has been adequate time for investigation prior to filing.[221]

A viable integrated disclosure system will depend, in part, upon upgrading and maintaining the quality of Exchange Act filings.[222] Toward this end, some of the saved staff time resulting from selective review of Securities Act registration statements will be shifted to more intensive review of Exchange Act filings, with examination focusing on the portions of filings that could be incorporated by reference into registration statements.[223]

217 SEC ANNUAL REPORT 65 (1979).

218 For example, in 1962 the Division received 18,000 filings under the Securities Act and the Exchange Act. There were 55,000 such filings in 1980.

219 45 Fed. Reg. 63,700 (1980).

220 *See* Comment letter of the Nat'l Ass'n of Sec. Dealers (Jan. 30, 1981) at 2 ("In our experience, an underwriter substantially completes the due diligence investigation in connection with an offering prior to the time that the registration statement is filed, and not during the period between filing and effectiveness. The brevity of the latter period should not, therefore, be a factor in determining the thoroughness with which due diligence is performed."). *See also* Comment letter of AT&T Co. (Jan. 15, 1981) at 6 (File No. S7-849) ("our experience is that most underwriters satisfy . . . their due diligence obligations prior to the initial filing of the registration statement").

221 It should be noted, however, that since § 11 liability arises from omissions or misstatements in the registration statement "when it became effective," any delay in effectiveness requires that the underwriters continue to be vigilant with respect to late-breaking material developments which should be added to the registration statement by means of an amendment. *See* Securities Act Release No. 5180 (Aug. 16, 1971), 36 Fed. Reg. 16,506 (1971).

222 *See* Securities Act Release No. 6176 (Jan. 15, 1980), [1979-1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,422 (enhanced quality of disclosure in the Form 10-K and in shareholder reports will be necessary if the integration of disclosure under the Securities Act and Exchange Act is to be achieved in a successful manner). To help maintain the quality of disclosure, the Commission now requires the Form 10-K to be signed by a majority of an issuer's directors. *Id.* at 82,766.

223 As reporting under the Securities Act and Exchange Act is integrated, careful disclosure oversight of periodic reports has to be assured. Such oversight should not necessarily be triggered solely by a Securities Act filing incorporating a periodic report by reference. In fact, most companies reporting under the Exchange Act do not necessarily finance each year, yet the market trades back and forth in great volume based in part upon the presumed accuracy of periodic information. It has been estimated that the dollar value of equity securities traded in the United States secondary markets in 1979 was about $345 billion, with the comparable figure for corporate debt securities far higher. In contrast, the dollar value of equity and debt sold in underwritten public offerings in 1979 was about $36 billion. Comment letter of Securities Industry Association (Feb. 18, 1981) at 4 (File No. S7-849). To shift to review of periodic reports creates a dilemma for the Commission staff because resources already are heavily taxed; yet there are far more periodic reports filed than registration statements. In 1980, for example, 3,299 registration statements were

B. *The Effects of Increased Competitiveness in the Underwriting of Securities Offerings*

In the past, a key characteristic of the investment banking business was the tradition of issuers maintaining long term relationships with the same principal underwriter or underwriters.[224] Indeed, the ties between issuers and particular underwriters were allegedly so strong at one point that the Department of Justice sued seventeen investment banking firms for conspiracy to monopolize the securities business. The district court's decision in *United States v. Morgan*[225] rejected these allegations. The court found that, while underwriters competed vigorously for business, there were good reasons why continuing business relationships existed:

> In every business the customer feels that there are cogent reasons why he should continue with the firm which has rendered good service in the past. But with a series of security issues, the saving in the time and labor of the officers and employees of an issuer, which would have to be spent in teaching a new investment banker the intricacies of the business, and the financial set up of the company, are a matter of real consequence; and it must not be forgotten that many of the matters to be discussed are of such a character that company officials desire to have such conversations only with those whom they trust, and in whose integrity and competence they have complete confidence.[226]

Such continuing relationships no doubt simplify underwriters' reasonable investigation of the information contained in registration statements, since the investment banker's ever increasing familiarity with particular issuers should make each successive investigation both more efficient and more fruitful.

Long term underwriting relationships were disrupted to some extent by the Commission's adoption of rule U-50 in 1941.[227] The rule requires subject public utility holding companies and their subsidiaries to publicly invite sealed, written proposals for the purchase or underwriting of securities covered by the rule. The introduction of competitive bidding has affected the underwriters' relationship with these issuers in several ways. For one thing, there no longer is assurance of a continuing relationship between issuer and underwriter, unless the underwriter happens consistently to submit the best bid. Moreover, since the bidding proposals address the terms of the offering, competitive bidding requires underwriters to make judgments about the issuer's financial condition and financing needs with-

filed, of which 601 involved initial public offerings by previously non-reporting companies, and which hence were given a full review. This represented a substantial increase from 1979, when 2,560 registration statements were filed, of which 480 were initial public offerings. Even with this increase, the number of registration statements filed in 1980 is far less than the approximately 8,000 Forms 10-K filed in that year. Therefore, it will be necessary to establish a system for selectively reviewing periodic reports as well as registration statements.

224 One indication of such ties was the common practice of putting the investment banker on the issuer's board of directors. Some investment banking firms requested and received board seats because, so the argument goes, their presence helped insure that the company was managed in a manner that protected the interests of the investors to whom the investment bankers had sold the issuer's securities. *See, e.g.*, United States v. Morgan, 118 F. Supp. 621, 639 (S.D.N.Y. 1953). This practice has been criticized because of the potential conflicts of interest associated with the investment banker serving as a director, and there has been a substantial reduction in the number of investment bankers sitting on their clients' boards. *See generally* SEC DIVISION OF CORPORATE FINANCE, 96TH CONG., 2D SESS., STAFF REPORT ON CORPORATE ACCOUNTABILITY 310-15 (Comm. Print 1980); ERNST & ERNST, SOCIAL RESPONSIBILITY DISCLOSURE: 1978 SURVEY (1978).

225 118 F. Supp. 621 (S.D.N.Y. 1953).

226 *Id.* at 817.

227 17 C.F.R. § 250.50 (1941) (current version at 17 C.F.R. § 250.50 (1981)).

out benefit of the preliminary discussions that previously occurred during the "origination" phase of planning for external financing.

The chief complaint against competitive bidding, however, concerns its effects on the civil liabilities of the Securities Act. In an illuminating discussion of the securities distribution process, two commentators stated:

> Although the successful underwriting group must still assume all the civil liabilities imposed upon underwriters by the 1933 Act, their opportunities to make the investigation, which normally precedes their assumption of such liabilities, has been greatly curtailed by the practical impossibility of conducting such investigations without any assurance of ultimately getting the business.[228]

Perhaps the most detrimental effect of competitive bidding is that the investigation by bidders' counsel, who is not liable under section 11, is not supervised by the bidding underwriters who are liable.[229] The independent counsel appointed by the issuer may not entirely substitute for the underwriter's active involvement. As a partner for Salomon Brothers, who addressed the quality of disclosure in competitively bid utility issues, testified in hearings sponsored by the Commission: "The competitive bidding process in which 'due diligence' is performed to a large extent by counsel for the bidders appointed by the issuer has in many cases unfortunately led to a certain 'hardening of the prospectuses.' "[230] It should be emphasized, however, that apart from regulated industries, competitive bidding is not a widespread practice.[231]

Another type of underwriting arrangement, the Dutch auction, was attempted three years ago by Exxon Corporation with respect to an issue of pollution control bonds and an issue of municipal revenue bonds—both exempt from registration. Under this approach the issuer invites bids which, unlike competitive bids, need not cover the entire proposed issue or be submitted by a group of underwriters. Rather, each dealer bids for the amount of securities it intends to distribute. The issuer selects the best bids in order until all the securities are purchased. The arrangements are made on a firm commitment basis, and all successful bidders receive their portion of the issue based upon the terms of the last bid accepted. In addition, unlike offerings made pursuant to a syndicate agreement, there is no fixed spread and no fixed reoffering price.

The issuer may benefit from a Dutch auction arrangement by receiving a higher aggregate price for the issue than it would receive with competitive bidding or negotiated offerings.[232] Due to highly competitive retail pricing of such

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228 Halleran & Calderwood, *supra* note 9, at 104.

229 One critic of this arrangement observed: "The underwriting groups, only one of which will get the deal, have little incentive or opportunity to do an independent investigation of the issuer's operations. They tend to rely on the issuer's bidding prospectus and registration statement, which have been prepared in advance by the issuer and its lawyers." Wolfson, *supra* note 42, at 371.

230 Quoted in Wolfson, *id.* at 372. *See generally Hearing on Temporary Suspension of the Competitive Bidding Requirements of Rule 50 with Respect to Common Stock of Holding Companies Registered Under the Public Utility Holding Company Act of 1935* (Jan. 6-9, 1975) (File No. S7-529).

231 *See* Welles, *Wall Street's Last Gold Mine*, INSTITUTIONAL INVESTOR, Feb. 1978, at 133: "Actual use of competitive bidding . . . remains rather sparse—if anything, the recent overall trend has been toward negotiated offerings. In the utility field, which accounts for a third of corporate underwritings, . . . the tradition of competitive bidding remains well entrenched . . . ." During the first three quarters of 1977, approximately 60% of all public capital financings by public utilities and 73% of long-term debt financing was competitively bid. *Id.*

232 For example, Exxon contends that it saved approximately $1.9 million by employing a Dutch auc-

securities, however, the underwriters or selling broker-dealers may lose money.[233] Under these conditions, it seems likely that the underwriter in a Dutch auction arrangement will investigate far less extensively than it would in the case of a negotiated offering or even a competitively bid offering.[234] As one commentator observed in 1978, "[f]ortunately for Wall Street, no other corporation has seen fit to emulate Exxon" by utilizing a Dutch auction.[235] Because of its potential appeal to issuers, however, other companies may eventually experiment with this approach.

Another source of competitive pressure on underwriters has been the availability of the Eurodollar market, which American companies increasingly tap for offerings of debt and convertible securities.[236] The ready alternative of an expeditious Eurodollar offering without compliance with the registration requirements of the Securities Act[237] may heighten the pressure upon underwriters to participate in equivalent debt offerings made on American securities markets within the shortest possible time so as to not lose the business abroad.

The underwriting community also may be affected if the Commission adopts proposed rule 462A, which would in all likelihood greatly expand the use of shelf registrations of securities. Under rule 462A an issuer would file a registration with respect to securities it anticipated offering during the next two years. When market conditions were favorable, it would file a post-effective amendment or a supplement under rule 424(c) describing the terms of the offering. Since the basic registration statement would have been prepared, reviewed and declared effective previously, preparation of the post-effective amendment or supplement would be a simple process allowing issuers to market securities quickly.

The proposed shelf rule raises several questions bearing on the underwriter's duty to conduct a reasonable investigation. If issuers make offerings of shelf-registered securities solely through their traditional underwriter or underwriting group, there should be no special difficulty.[238] To the extent issuers do not com-

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tion rather than a conventional underwriting arrangement for two bond offerings totalling $305 million. Robertson, *Future Shock at Morgan Stanley*, FORTUNE, Feb. 27, 1978, at 90.

233 *Id.*

234 One authority has cautioned that underwriters "will be unwilling to incur the expense of an investigation if they do not have some assurance that they will get the issue." G. ROBINSON & K. EPPLER, 1 GOING PUBLIC—SECURITIES UNDERWRITING § 24 (rev. pages 1978). The same authors opine that "trying to get firms to bid against each other may cause many good firms to lose interest in the issue." *Id.* If the quality of the underwriters declines so may the quality of investigations.

235 Welles, *supra* note 231, at 134.

236 Borrowings on the Eurodollar market totalled $88.6 billion in 1980. Nine percent of this amount was loaned to U.S. borrowers, a dramatic increase from the 1.8% of the value of all loans that were granted to U.S. borrowers during 1979. *Annual Financing Report* at 34, supp. to *Euromoney*, Mar. 1981. With respect to U.S. issuers the prospectus used in the Eurodollar market is substantially similar to the one which would be used if the offering were here. However, the prospectus need not be filed with the Commission, is not subject to § 11, and may be prepared so quickly that an offering may be done virtually overnight.

237 Securities Act Release No. 4708 (July 9, 1964). The Commission does require that certain steps be taken to prevent flow back of securities into the United States; after the interest equalization tax expired, the Commission restated its position in no action letters relating to Pacific Lighting Corp. (June 13, 1974) and Singer Co. (Sept. 3, 1974).

238 It is likely that underwriters will suggest to their clients that securities be registered for the shelf, for distribution through them in a variety of ways. In addition to sales in fixed price underwritings, securities on the shelf might also be sold (1) in "regular way" transactions in the auction market on the floor of (for example) the New York Stock Exchange, where the broker-dealer acts as selling agent; (2) in sales to various institutions by broker-dealers as agents; (3) in block transactions on an exchange in which a broker-dealer will have solicited and acted as both broker for the buyers and agent for the issuer with securities on the shelf; or (4) in fixed price offerings off the floor of an exchange, where a broker-dealer commits

mit to make offerings through any one underwriter, they may generate competition, but since they are poised to make an offering, issuers may resist allowing underwriters to take the time to verify the information either in the prospectus or incorporated by reference. Underwriters worry that competitive pressures may force them to take business risks if the shelf rule is expanded. Integration *per se* does not cause this problem, but it does take away underwriters' ability to control the preparation of the document and to verify its contents in the first instance. The underwriters no longer have the regulatory barriers posed by preparation of a complex prospectus, and must insist on time for verification in different contexts.

VI. Should There Be More Definite Guidance for Underwriters?

The changes in competitive underwriting practices, the increasing integration of disclosure requirements, and the significantly greater efficiency of today's securities markets, taken together, raise the questions of what constitutes a "reasonable" investigation in today's disclosure environment and whether the Commission should attempt to identify the factors to be taken into account in determining what is reasonable. Arguments can be marshalled both for and against taking action at this time to clarify the extent of underwriters' responsibilities under section 11.

A. *Arguments Against Enunciation of a More Definite Standard of Underwriters' Responsibilities*

It can be argued that there is no need for further elaboration by rulemaking of the standard set forth in section 11. Courts are especially adept at resolving questions about the manner in which specific factual situations affect statutory obligations. Moreover, the legislative history of the Securities Act makes clear that Congress intended section 11's reasonable investigation and belief duty to be construed in light of the surrounding circumstances.[239] The Commission has also expressed its belief that "a court, in determining the liability of an underwriter, would consider all the facts and circumstances (including incorporation by reference) surrounding the underwriter's participation in the offering."[240] Courts can, therefore, be expected to be sensitive to circumstances which defendants contend have prevented them from making a more extensive investigation. To the extent underwriters assert that such circumstances compelled them to abbreviate their investigation of the information contained in the registration statement or to narrow the basis for concluding that a prospectus's expertised portions

to purchase from the issuer a large block and forms a group of selected dealers to participate in the resale of the shares, with a selling concession being paid to such dealers. To the extent underwriters persuade clients to register securities for the shelf for offerings solely through them, there is much less time pressure with respect to completing their due diligence investigation, since it can be conducted in connection with the initial filing. Issuers may want more flexibility, however, and therefore not commit to issue securities through one investment banker. If an underwriter is named in the initial shelf, updating perhaps could be done simply through a rule 424(c) prospectus; if, however, the underwriter is not named, a post-effective amendment should perhaps be required, identifying the underwriter and the method of distribution. The underwriter might then be required to join in the request to accelerate the effective date. *See* text accompanying note 324 *infra*.

239 See text accompanying notes 79-88 *supra*.

240 Securities Act Release No. 5998 (Nov. 17, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,761. *See also* text accompanying notes 144-48 *supra*.

contain no material inaccuracies, the courts will decide whether they have acted at their own peril or whether market conditions or competitive pressures are among the circumstances contemplated by the Act.[241] Moreover, as discussed below, underwriters have themselves been unable to agree as to what constitutes a reasonable investigation—a fact which suggests that a case by case approach is more appropriate to flesh out the contours of the defense.

In addition, experience with existing short form registrations on Form S-16 may not evidence a need for further clarification. Form S-16, which has been in use for several years, is applauded by issuers, who believe it has been highly successful without reducing the quality of disclosure available to the market. As discussed above,[242] Form S-16 requires the incorporation by reference of the issuer's latest annual report on Form 10-K and all other reports subsequently filed pursuant to sections 13 or 15(d) of the Exchange Act. While use of the form is limited to firm commitment underwritings, experience reveals no increase either in section 11 suits against underwriters or in faulty disclosure because of the requirements of the form or the other circumstances surrounding S-16 offerings. And as discussed above,[243] logic suggests that the form be available for any type of offering for a qualified issuer.

Moreover, underwriters are not compelled by any Commission action to associate themselves with offerings where the issuer is unwilling to allow time for a reasonable investigation of the registration statement's contents. In commenting upon the *BarChris* decision, attorney Kenneth J. Bialkin provided advice which should be as valuable to investment bankers as it is to securities lawyers:

> This is a good time . . . to here highly resolve that as a profession we will not be pushed around by circumstances, we will not be rushed by clients. We will not short cut the standard of care both in our interests and in the interests of our clients. Perhaps we can enter into an informal restraint of trade at this time which will demand for the profession the right and the opportunity to practice the profession as it ought to be practiced, the right and the opportunity to read the documents, to sit back and think about the risks implicit in a particular business.[244]

Underwriters simply should not succumb to the temptation to participate in offerings, no matter how seemingly solvent the issuer may be,[245] in circumstances that deprive them of the opportunity to make a reasonable investigation. As the court observed in *BarChris*: "To require a check of matters easily verifiable is not unreasonable. Even honest clients can make mistakes."[246]

The competitive pressures that assertedly restrict underwriters' ability to conduct adequate investigations, while real, may be somewhat overstated. A 1976 Conference Board study of investment banking practices found that:

> Two-thirds (67) of participating companies have maintained their current invest-

241 *See, e.g.*, Shulman, *supra* note 89, at 251: "[R]easonable care is a plastic concept which has been adapted to specific cases without undue hardship to defendants. It would be strange, indeed, if, in cases under the Securities Act, human judgment of reasonableness would become warped."

242 *See* text accompanying notes 177-81 *supra*.

243 *See* text accompanying notes 183-88 *supra*.

244 Panel Discussion, *supra* note 123, at 623 (remarks of Kenneth J. Bialkin).

245 Surely the financial collapse of such companies as Penn Central, Franklin National, and W. T. Grant should make investment bankers chary of underwriting offerings of large issuers without adequate investigation.

246 Escott v. BarChris Const. Corp., 283 F. Supp. 643, 690 (S.D.N.Y. 1968).

> ment banking connections for at least the past five years (many of these associations date back a score of years or more); the remaining one-third (33) have either changed investment banking affiliations, added to the number of investment bankers used, or abstained from forming any investment banking associations during the period.[247]

However, the Conference Board study was completed before the use of Form S-16 became prevalent.

Moreover, new practices may evolve with respect to preparation of documents incorporated by reference. Underwriters and their counsel may be requested to review the documents before filing and to provide comments.[248] Alternatively, issuers may designate independent counsel (as in competitive bidding) to review the documents; such counsel would advise underwriters in any subsequent offering.

A final reason for resisting any proposal to narrow even partially the underwriter's duty of investigation is that underwriters are better situated than anyone else to verify an issuer's representations in the registration statement. If underwriters are relieved of any part of their duty, the gap thus created will simply not be filled. As Professor Ernest Folk observed in his seminal study of the *BarChris* decision:

> Underwriters are in a uniquely advantageous position to thoroughly investigate and verify the facts concerning an issuer. They are professionals who frequently have long experience in the field; indeed, they usually have more accumulated expertise than most issuers who make one shot or intermittent offerings. Besides competence in a specialized area, underwriters also have the staff and facilities that are needed to assume such responsibilities.[249]

The need for verification by underwriters does not diminish under an integrated disclosure system. The efficient market theories upon which the Commission's integration program is premised demonstrate only that the securities markets rapidly assimilate available company-specific information. These markets do not, however, necessarily discriminate between true and false information. In this regard, the Advisory Committee on Disclosure Policy reported:

> The market price of a security reflects true information and false information with equal efficiency, as long as the quality of the information is not itself a part of the information in the market place. Thus, a fraudulent income statement not known to be false, will be reflected in the market price of the security to the same extent as a true one.[250]

It may well be that adequate disclosure cannot be preserved under an integrated disclosure system absent full participation by underwriters, and that they must take the time necessary to complete their investigation before the registration statement is filed, no matter how quickly it can be prepared.

B. *Arguments Favoring Formulation of More Definite Guidance for Underwriters*

Nevertheless, there is strong feeling in the securities industry that the many

247 P. Davey, Investment Banking Arrangements 8 (Conference Board Report No. 681, 1976). But for recent evidence of intense competition among some underwriters see Feinberg, *Poaching is the New Name of the Game*, Institutional Investor, Nov. 1980, at 37.

248 Comment letter of AT&T (Jan. 15, 1981) at 5 (File No. S7-849).

249 Folk, *supra* note 56, at 54.

250 Advisory Comm. Rep., *supra* note 175, at xxxiii-xxxiv.

changes in the disclosure environment, to which Commission actions have contributed, have rendered untenable the underwriter's traditional role and responsibilities in securities distributions. Citing the increasing volatility of the markets, the trend toward incorporation of Exchange Act reports into registration statements, the altered review procedures employed by the Commission's staff, the expansion of financial disclosure requirements, and the Commission's emphasis on removing barriers to capital formation, Joseph McLaughlin, Chairman of the Securities Industry Association (SIA) Federal Regulation Committee, informed the Division of Corporation Finance in the fall of 1980 that in his judgment, these factors "have affected underwriters' opportunity to perform a 'reasonable investigation' in connection with a registration statement," at the same time that "others factors have combined to increase the likelihood that underwriters will become involved in litigation."[251] He believed, too, that the role of the underwriter has changed in several respects:

> No longer are particular underwriters identified with particular issuers to the same degree. No longer are underwriters perceived as "sponsoring" an issuer's securities or as issuing "statements for the public's reliance" in respect of securities offerings. What underwriters are perceived as offering is financial advice and services in distribution.[252]

He concluded that "[w]hat underwriters need . . . is a role that would restore their ability to assert the defense of a 'reasonable investigation' in the context of public offerings as they are conducted under modern conditions."[253]

For several years, the SIA has been attempting to persuade the Commission that underwriters need and deserve relief.[254] The gravamen of the SIA's concern, prior to the Commission's issuance of proposed Forms A, B, and C, was the perceived dilemma imposed upon underwriters by Form S-16, which has features similar to proposed Form A and to some extent Form B. The capital markets have benefitted from the availability of Form S-16. As one source recently observed:

> The S-16 has literally transformed the way U.S. corporations and their investment bankers do business. They now can raise huge sums of money almost instantaneously, filing, pricing and marketing a deal in a few short days. The S-16, in fact, was partly responsible for the record financing volume during the first half of 1980—a total of $31.4 billion, $20.4 billion of it between April and June alone—as corporations rushed to take advantage of the recovery in the market.[255]

However, the characteristics that make Form S-16 appealing as a financing mechanism may be the source of potential problems for underwriters. The SIA explained its position in a letter to the Commission in 1979:

> Of all those subject to Section 11 liability, underwriters are unique in not being able to control either the procedures or personnel for preparing these filings [incorporated by reference] or to participate directly in the review of these documents prior to filing. Indeed, underwriters usually do not know in advance which registrants will make public offerings using Form S-16 or whether they will be selected to manage the

251 Letter from Joseph McLaughlin to Edward F. Greene (Aug. 19, 1980) at 3 (File S7-849).
252 *Id.* at 5.
253 *Id.* at 6.
254 *See* text accompanying notes 275-77 *infra*.
255 *The Mixed Blessing of the S-16*, INSTITUTIONAL INVESTOR, Nov. 1980, at 40.

underwriting.[256]

The SIA is not alone in this view.[257] If in the context of short-form registration statements issuers are able totally to dictate the timing of the offering, underwriters may be put in the unfortunate position of having to either truncate their investigation or withdraw from participation in the offering.[258] Neither choice would appear to serve the interests of full and fair disclosure for the protection of investors.[259]

On the other hand, it is argued that if issuers permit underwriters to investigate fully offering materials, including material incorporated by reference, the issuers might not be able to take advantage of existing "windows" in the market and the cost of investigation might reduce the benefits otherwise provided by the integrated system, which arise to a large extent from the substantial reduction in printing and distribution costs. As a prominent law firm advised the Commission: "In our view, unless and until the legitimate concerns of underwriters . . . are addressed, the proposals to integrate 1933 Act and 1934 Act disclosure documents, with the concomitant benefits to issuers and the investing public from such integration, will not prove successful in practice."[260]

C. *The Commission's Proposals to Eliminate Extraneous Considerations Relating to Material Incorporated by Reference into Registration Statements*

The Commission has previously indicated that it was not inclined, in the short run,[261] to attempt to resolve this controversy.[262] In publishing for public comment proposed Forms A, B, and C,[263] the Commission did, however, include in the proposals several provisions[264] intended to prevent extraneous factors from impeding the ability of issuers, underwriters, and others to assure adequate dis-

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256 Letter of the SIA to George A. Fitzsimmons, SEC Secretary (Jan. 24, 1979) at 6 (File No. S7-763).

257 *See, e.g.*, Comment letter of the Committee on Securities Regulation, Association of the Bar of the City of New York (Jan. 14, 1981) at 25 (File No. S7-849).

258 There often is no formal underwriting syndicate when the securities are registered pursuant to Form S-16. Indeed, it has been observed that a dealer "often does not become involved . . . until after the registration statement is declared effective and he may have little or no opportunity to verify the information contained in or incorporated by reference, in the registration statement." Comm. on Federal Regulation of Securities, Section of Corporation, Banking and Business Law, American Bar Association, *Current Issues and Developments in the Duties and Liabilities of Underwriters and Securities Dealers*, 33 BUS. LAW. 335, 349 (1977) (Kenneth J. Bialkin, chairman) (remarks of Stephen R. Volk). In such situations, it is argued that the dealer "is going to assess risk-reward, and go ahead and do the business if it makes sense from a practical standpoint." *Id.* at 352 (remarks of Alan B. Levenson).

259 It is argued that if reputable houses withdrew from an offering they would be replaced by less reputable firms.

260 Comment letter of Gibson, Dunn & Crutcher (Jan. 15, 1981) at 8-9 (File No. S7-849).

261 The Commission has in effect proposed a long-term solution in connection with its endorsement, with some reservations, of § 1704(g) of ALI FED. SECURITIES CODE (1978), which clarifies what constitutes "reasonable" investigation and belief. For a discussion of this provision see the text accompanying notes 310-16 *infra*.

262 Although the Commission's statutory authority would permit it to adopt standards as to due diligence, the Commission has decided "to permit, in the first instance, the appropriate self-regulatory organizations to establish standards of conduct for their members." Securities Act Release No. 5275 (July 26, 1972), 37 Fed. Reg. 16,011, 16,012 (1972). For a discussion of the efforts by National Association of Securities Dealers to establish standards for underwriters see the text accompanying notes 288-305 *infra*.

263 Securities Act Release No. 6235 (Sept. 2, 1980), 45 Fed. Reg. 63,693 (1980).

264 Similar provisions originally were proposed in 1978 as amendments to Form S-16, Securities Act Release No. 5998 (Nov. 17, 1978), [1978 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 81,761, but were not adopted by the Commission.

closure of all material information in the proposed forms. Specifically, the proposed provisions would:

(1) deem, only for purposes of determining pursuant to section 11(a) when an incorporated document became effective, the effective date of documents incorporated by reference into the registration statement to be the date of the document's initial filing with the Commission;

(2) deem a statement in a document incorporated by reference into the registration statement not to be part of the registration statement if the statement has been modified or superseded in the registration statement or in subsequently filed documents which are incorporated by reference into the registration statement; and

(3) provide that the making of a modifying or superseding statement shall not be deemed an admission that the modified or superseded statement constituted a violation of the federal securities laws.[265]

The proposals were prompted by concern that, because section 11 imposes liability for omissions or misstatements in any part of the registration statement when that part became effective, liability could be asserted based on Exchange Act reports which were accurate when filed but which become outdated and subsequently are incorporated by reference into the registration statement.

The proposals also respond to the concerns of some underwriters who fear that issuers would be reluctant to accept recommendations to change or update the disclosures in incorporated Exchange Act reports for fear that the revision might be taken as an admission of a deficiency in the original filing. Such fears perhaps originated in the court's reference in *Feit v. Leasco Data Processing Equipment Corp.*[266] to the fact that barely three months after terminating the tender offer whose prospectus omitted to state the estimated amount of Reliance's surplus surplus, Leasco included an estimate of the surplus surplus in a prospectus for the sale of its own securities.[267] While it appears that the subsequent disclosure of the estimate led to the suit, the episode need not concern issuers able to demonstrate that changed circumstances or subsequent events warrant revision of the prior disclosure. The basic problem in *Leasco* was that the issuer was unable to prove that it had obtained any new information from Reliance or otherwise which triggered the subsequent disclosure.[268]

In any event, the Commission's proposed treatment of subsequent disclosure should provide issuers with additional grounds for confidence. It certainly should make clear to any inquiring court the Commission's belief that subsequently improved disclosure promotes the purposes of the federal securities acts, and that the fact of revision should be disregarded in assessing the adequacy of disclosures on the same subject matter contained in prior filings.[269] These pro-

265 45 Fed. Reg. at 63,712, 63,715 (Item 8 of proposed Form A and Item 9 of proposed Form B).
266 332 F. Supp. 544 (E.D.N.Y. 1971).
267 *Id.* at 560. *See* text accompanying notes 131-34 *supra*.
268 *Id.* at 560-61.
269 The intended effect is identical to that achieved when courts exclude evidence of remedial safety measures taken after an injury. The policy justification for this treatment was explained by the court in Ashland Supply Co. v. Webb, 206 Ky. 184, 185-86, 266 S.W. 1086, 1086 (1924):

> There are two reasons why evidence of subsequent repair should not be admitted. One is that, while it may be necessary to subsequently repair the appliance, it does not follow from that that the appliance was defective at the time of the accident. The other reason is that, if such

posals do not, however, relieve underwriters of their duty to investigate and to establish reasonable ground for belief in the adequacy of disclosures in incorporated periodic reports as of the filing date, or of their duty to determine the adequacy of disclosures in the registration statement that are necessary to update the information contained in such previously filed reports.[270]

Some commentators believe that the Commission's proposed treatment of Exchange Act documents incorporated into the registration statement is sufficiently responsive to the needs of underwriters. The National Association of Accountants, for example, has stated that "[i]t would seem the Commission has been attentive and responsible in addressing liability problems relating to incorporated documents relative to superseding comments."[271] American Telephone and Telegraph Company has opined that "the procedures outlined . . . are sufficient protections for underwriters."[272] Other commentators, however, have urged the Commission to provide even greater protection to underwriters.[273]

VII. Alternative Approaches to Delineating Underwriters' Responsibilities Within an Integrated Disclosure System

In spite of the Commission's proposals for alleviating several of the immediate concerns of underwriters about their section 11 liabilities under an integrated disclosure system, there are those who would urge the Commission to go further. Several well developed alternatives have already been put forward in recent years, each of which deserves serious consideration.

A. *The SIA's Safe Harbor Definition of Due Diligence*

It has recently been suggested that the Commission, at least with respect to offerings in which information is incorporated into the prospectus by reference, adopt a rule describing what underwriters must do in order to perform a reasonable investigation and to establish a reasonable ground to believe. Meeting the conduct standard would constitute full discharge of the underwriter's due diligence duty in such circumstances. Three proposals of this nature have been presented to the Commission in the past.

In recommending the adoption of the short registration form, the Wheat Report proposed adoption of a rule defining the scope of investigation expected of a broker acting as a statutory underwriter with respect to a secondary offering on an exchange.[274] Under this proposal, the broker would be deemed to have made a reasonable investigation and to have had reasonable grounds to believe in the adequacy of statements made in a registration statement, including information incorporated by reference, if he read the registration statement and the

evidence were admitted, it would have a tendency to cause employers to omit making needed repairs for fear that the precaution thus taken by them could be used as evidence against them.

270 The requirement to update information is set forth in Item 7(b) of proposed Form A and Item 7(a)(3) of proposed Form B.

271 Comment letter of National Association of Accountants (Jan. 14, 1981) at 4 (File No. S7-849).

272 Comment letter of AT&T (Jan. 15, 1981) at 5 (File No. S7-849). *See also* Comment letter of Edison Elec. Inst. (Jan. 15, 1981) at 4.

273 *See, e.g.*, Comment letter of Brown, Wood, Ivey, Mitchell & Petty (Jan. 15, 1981) at 5-6; Comment letter of Morgan Stanley (Jan. 14, 1981) (File No. S7-849). *See also* discussion of a safe harbor rule for underwriters, section VII.A. *infra*.

274 SECURITIES AND EXCHANGE COMMISSION, DISCLOSURE TO INVESTORS 99-101, app. III-2 (1969).

incorporated Exchange Act disclosure documents and was not aware of any omission or misstatement. The Commission did not act on this recommendation because there was no short form of registration at the time it was made.

A somewhat similar but much more broadly applicable suggestion was presented by the Securities Industry Association to the Commission in June 1978, following its earlier submission in May 1978 of a private petition for rulemaking. The SIA's proposed permanent rule provided that, in connection with an offering pursuant to a registration statement on Form S-16,

> an underwriter shall be deemed to have conducted a reasonable investigation and to have reasonable ground for belief for purposes of Section 11, and to have exercised reasonable care for purposes of Section 12(2), of the Securities Act of 1933 if the underwriter (1) has read the registration statement, including all exhibits and documents incorporated therein by reference, (2) has discussed the registration statement with responsible representatives of the registrant, and of any persons named therein as an expert, and (3) after such reading and discussion, does not know of any untrue statement of a material fact required to be stated therein or necessary to make the statements therein not misleading.[275]

The SIA explained that the proposed rule was necessary because when the short form of registration is used for offerings, "the time and opportunity afforded underwriters to perform a reasonable investigation with respect to possibly out-of-date information incorporated by reference will be reduced."[276] The Commission denied the SIA's petition, but in so doing expressed its belief that "a court, in determining the liability of an underwriter, would consider all the facts and circumstances (including incorporation by reference) surrounding the underwriter's participation in the offering."[277]

Perhaps the strongest arguments favoring a safe harbor definition of due diligence are (1) that it would minimize differences among underwriters in the nature of the investigation performed, and (2) that it would remove uncertainty about possible liability. The safe harbor standards could be made as stringent as the Commission deemed necessary for adequate protection of investors. If the conditions were perceived as unduly strict, however, underwriters would not utilize the safe harbor rule, and the objective of the safe harbor approach would be undermined.

The difficulty of striking the precise balance between too few and too extensive conduct requirements for underwriters may fatally flaw the safe harbor approach. For example, the SIA's proposed safe harbor rule clearly set the standard too low in both its comparative and its absolute terms. By holding underwriters to the same proposed standard of care as that of mere sellers of securities subject to the liability provisions of section 12, the proposal disregarded the greater responsibilities statutorily imposed on underwriters.[278] As one district court has noted, "since an underwriter's relation to the issuer is more substantial than that of a broker-dealer and it plays a more central role in the marketing process, somewhat more is required of an underwriter than a broker-dealer to

275 Letter of the SIA Corporate Finance Committee to the SEC (June 26, 1978) at 2.

276 *Id.* at 3.

277 Letter of George A. Fitzsimmons, SEC Secretary (May 25, 1978).

278 See generally the discussion of Sanders v. John Nuveen & Co., section III.B.4. *supra*.

discharge its obligation to the investing public."[279] Moreover, the SIA's proposal would have permitted underwriters to rely exclusively upon issuers' representations as to the adequacy of disclosures in the periodic reports incorporated into the registration statement and, to some extent, of disclosures required to update the information in the previously filed periodic reports. The courts have rejected the appropriateness of underwriters' relying exclusively on management,[280] whose disclosure practices characteristically may be self-serving,[281] and in all likelihood the Commission cannot reduce, by rule, the scope of the statutory term as interpreted by the courts. Exclusive reliance on management also would preclude underwriters from detecting and correcting honest but negligent treatment of material information required to be disclosed. Moreover, since developments occurring after the end of the latest fiscal year are considered to be especially important in evaluating the company's future prospects, it is particularly important that such developments be carefully reviewed and adequately disclosed.

The safe harbor approach raises several additional problems. It would be virtually impossible for the Commission to state in advance what level of verification by underwriters would meet the needs of investor protection in all cases. Moreover, the underwriter's relationship with the issuer is unique, and investors, analysts and others would likely be unable to verify disclosures in the underwriter's stead. For these reasons there probably are better ways to respond to calls for a long term solution to the concerns of underwriters.

B. *Developing Standards of Professional Responsibility for Underwriters by Self-Regulatory Organizations*

Contemporary interest in formulating standards of professional conduct for underwriters can be traced to experiences during the hot issues periods of the securities markets.[282] New issues of securities expected to rise rapidly in price very soon after their issuance are said to be "hot." Broker-dealers are usually anxious to participate as underwriters or as members of the selling groups of hot issues, and sometimes their eagerness has exceeded their ability to discharge the responsibilities associated with the distribution of new stock issues to the public. The Commission's Special Study of Securities Markets, which examined the hot issues period between 1959 and 1961, described the inconsistencies in the treatment of hot issues by different underwriters:

279 University Hill Foundation v. Goldman, Sachs & Co., 422 F. Supp. 879, 898-99 (S.D.N.Y. 1976). It should be noted that *Goldman* was decided before Form S-16 was available for primary offerings. *See* Sanders v. John Nuveen & Co., 524 F.2d 1064, 1071 (7th Cir. 1975), *vacated and remanded*, 425 U.S. 929 (1976).

280 As the *BarChris* court explained:

> The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection.

283 F. Supp. at 697.

281 *Id.* at 696.

282 One such period occurred from approximately 1959 to late 1961. Another took place during 1968 and 1969 and a third in the early 1970's. Today the securities offerings of some small high technology issuers might be deemed hot issues. For recent discussion of hot issues, see Bettner, *Penny Stocks, New Issues are Still the Rage: Risks, Fraud Charges Don't Deter Investors*, Wall St. J., Mar. 30, 1981, at 44; Sinisi, *Penny Stocks: Denver's New Gold Rush Fever*, The Denver Post, Feb. 25, 1981, at 62-63.

> In general, some investment banking houses carefully investigated issuers whose offerings they brought to the public market and registration statements reflected the meticulous standards of these underwriters and the lawyers and accountants involved in preparing them. Other underwriters, anxious to merchandise stock in public demand, were lax in performing their responsibilities to investigate issuers whose securities they intended to offer to the public. Under these circumstances carelessly prepared registration statements, if they were not corrected by the Commission's staff, might contain serious misrepresentations about the issuer and its affairs.[283]

In 1972, the Commission held public hearings on hot issues securities markets[284] and again found that some underwriters were not conducting reasonable investigations of new issues.[285] The hearings convinced the Commission that there was a need to improve professional standards relating to the obligations of underwriters. In a release discussing its conclusions from the public hearings, the Commission noted that in the absence of industry-wide guidelines, the determination of what must be verified and how such verifications should be made varies considerably among underwriters.[286] Such variations may make it difficult for responsible underwriters to determine what constitutes a reasonable investigation. The Commission stated that it had "the authority under the registration and anti-fraud provisions of the federal securities laws to adopt standards as to due diligence" but determined to permit "in the first instance, the appropriate self-regulatory organizations to establish standards of conduct for their members."[287]

Accordingly, then Commission Chairman William J. Casey wrote the President of the National Association of Securities Dealers (NASD) conveying the Commission's request that the NASD "consider formulation and establishment of standards for underwriters to follow" in investigating issuers.[288] For the next four years the NASD attempted, without success, to adopt specific standards to guide the conduct of its members.

In 1973, the NASD proposed a Rule of Fair Practice whose stated purpose was "the establishment of a system of regulation in the areas of underwriter inquiry and investigation respecting distributions of issues of securities to the public."[289] The proposed rule would have required managing underwriters to establish and maintain written procedures for investigation of an issuer. It would have further required that such procedures include sixteen specified areas of inquiry[290] and that the principal or managing underwriter certify that an adequate

283 1 SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. 554 (1963). The Study specifically found that "[s]ome of the newer underwriters that flourished during the period covered by this study performed little or no investigation of the issuers for which they acted as managers." *Id.* at 513.

284 SEC Division of Corporation Finance, *In the Matter of the Hot Issues Securities Market Hearings* (1972) (File No. 4-148).

285 *See* Securities Act Release No. 5275 (July 26, 1972), 37 Fed. Reg. 16,011 (1972).

286 *Id.*

287 *Id.* at 16,013.

288 Letter dated July 26, 1972, at 2. The letter is reproduced as an attachment to Securities Act Release No. 5275 (July 26, 1972), [Special Edition No. 434] FED. SEC. L. REP. (CCH) ¶ 4506B.

289 NASD Notice to Members 73-17 (Mar. 14, 1973) at 1.

290 The proposal provided that investigatory procedures "shall include, but not necessarily be limited to," the following:

(1) Review by underwriters' counsel of the issuer's corporate charter, by-laws, and corporate minutes;

(2) Examination of the audited and unaudited financial statements of the issuer, including

investigation had been made.[291]

The comments received by the NASD concerning the proposed rule were generally adverse. A number of the commentators especially criticized the suggestion that specific written procedures be established. Morgan Stanley & Co. opined that "the problem of inadequate performance can never be solved by a checklist."[292] In the firm's judgment, the existence of a list would nevertheless "have fundamental consequences on the established pattern of liabilities in the securities industry."[293] Smith, Barney & Co. wrote that "[e]stablishment of written procedures will open a Pandora's Box to the detriment" of underwriters.[294] No doubt some of the commentators were mindful that part of the problem in *BarChris* was not only that underwriter's counsel had failed to review all the documentation that Drexel, the underwriter, instructed it to examine, but also that Drexel had accepted counsel's written report describing its investigative procedures even though such procedures fell short of those established by the underwriter.[295] In view of the extensive negative comment, the NASD withdrew the rule proposal.

In 1975 the NASD proposed instead that its Board of Governors promulgate a "Statement of Policy Concerning Due Diligence Requirements" designed to stress the responsibilities and liabilities of underwriters and to emphasize the

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footnotes, for the preceding ten year period or for the entire period of the issuer's existence if less than ten years;

(3) Review of all changes in auditors by the issuer within the preceding ten year period if applicable and the reasons therefor;

(4) Review, with the issuer's auditors, of the financial statements which will appear in the prospectus or offering circular;

(5) Review of the issuer's budgets, budgeting procedures, and order/backlog figures;

(6) Review of internal projections of the issuer, including the intended use of the proceeds of the offering;

(7) Review of all pertinent marketing, scientific and/or engineering studies or reports concerning the issuer or its products during the previous ten year period or for the term of the issuer's existence if less than ten years;

(8) Consideration as to the necessity of third party review of appropriate portions of the inquiry if the issuer is a promotional organization or engaged in marketing high technology or previously unmarketed products;

(9) Investigation of the issuer's current and past relationships with banks, creditors, suppliers, competitors and trade associations;

(10) Communication with key company officials and appropriate marketing and operating personnel regarding the nature of the issuer's business and the role of each of the above individuals in the business operation;

(11) Inspection of the issuer's property, plant and equipment;

(12) Examination of business protection devices and related data such as trademarks, patents, copyrights and production obsolescence, among others;

(13) Review of available information with respect to the issuer's position within its industry;

(14) Review of pertinent management techniques, organization of management and the background of the management personnel of the issuer;

(15) Preparation and maintenance of memoranda pertaining to all meetings and/or conversations regarding the issuer held during the member's performance by it of its obligation of adequate inquiry;

(16) *Tax-Sheltered Program*—In addition to the above, when considered appropriate, written procedures relating to inquiry and investigation of tax-sheltered programs shall include but not necessarily be limited to . . . four specified areas of review.

Id. at 9-11.

291 *Id.* at 12.

292 Comment letter of Morgan Stanley & Co. (Apr. 24, 1973) at 1 (NASD File No. 73-17).

293 *Id.*

294 Comment letter of Smith, Barney & Co. (Apr. 24, 1973) at 2.

295 Escott v. BarChris Const. Corp., 283 F. Supp. 643, 696 (S.D.N.Y. 1968).

need for member firms "to insure that an adequate due diligence investigation has been performed prior to participating in the distribution" of publicly offered securities.[296] In place of the discredited list of procedures the proposed statement included "specific examples of generally acceptable industry practice."[297]

Some commentators found even the Proposed Statement of Policy approach unacceptable. For example, the SIA's Compliance Division wrote that "[t]he standards of underwriting liability have been and are being developed by case law and there appears to be no reason to create new liabilities for underwriters."[298] While not objecting to the concept of a Statement of Policy, the Association of the Bar of the City of New York argued that any policy statement should be expressly limited to negotiated, syndicated offerings because other types of underwritten offerings, such as competitively bid or shelf registrations, restricted underwriters' "opportunity" to investigate.[299]

After incorporating many of the commentators' suggestions,[300] the NASD on August 23, 1976 filed with the Commission, as required by section 19 of the Exchange Act,[301] the *Policy of the Board of Governors Concerning Due Diligence Requirements for Public Offerings of Securities*.[302] Since the filing was a statement of policy rather than a rule, it became effective upon filing.

The Statement of Policy remained in effect for only a few months. In an unusual turnabout, the NASD notified the Commission on February 22, 1977 that it was rescinding the statement because its Board of Governors "has recon-

296 NASD Notice to Members 75-33 (Apr. 25, 1975) at 3-4. The proposed Statement of Policy indicated that "[t]he Association believes . . . that failure to fulfill the obligation of due diligence described under the Securities Act of 1933, or in a manner inconsistent with the anti-fraud provisions, constitutes conduct inconsistent with high standards of commercial honor and just and equitable principles of trade." *Id.* at 13.

297 In this regard, the Proposed Statement of Policy reported:

> Areas which appear to be covered at minimum in most due diligence investigations performed in connection with corporate offerings, however, include a review of the issuer's corporate charter, by-laws and corporate minutes including executive committee minutes for at least the previous five (5) years (or for the entire life of the issuer if it has been in existence a shorter period; or for even a longer period than five years if circumstances dictate such) and a review of the issuer's audited and unaudited financial statements, including footnotes, for at least the same five (5) year or shorter or longer period commencing with the most recent statement as well as an investigation of any changes in auditors within that time period and the reasons therefor. Also, investigations involve a sampling and examination of the issuer's chief products, major customers and suppliers and an examination of any trademarks, patents, copyrights and similar devices where such are material and utilized to protect the issuer's business. To the extent necessary for the underwriter to verify material information furnished by the issuer and/or to arrive at an understanding of the issuer's business, investigations include a review of the issuer's current and past relationships with banks, creditors, suppliers and trade associations. Most due diligence investigations also include communication by the underwriter with key company officials and appropriate marketing and operating personnel regarding the nature of the issuer's business and the role of each of the above individuals as well as an on site inspection, at least on a random sampling basis, by the underwriter of the issuer's material property, plant and equipment. Prior to completing most due diligence investigations of promotional companies, underwriters may want to consult with experts in the scientific and technological fields if the underwriter feels it lacks sufficient capabilities to conduct a proper investigation on its own.

Id.

298 Comment letter of SIA Compliance Division (May 23, 1975) at 2 (NASD File No. 75-33).

299 Comment letter of Association of the Bar of the City of New York (June 3, 1975) at 4 (NASD File No. 75-33).

300 The Final Statement of Policy did not purport to address the type of procedures appropriate for (1) competitive bidding offerings, or (2) shelf registrations and S-16 offerings in which there is no named underwriter in the registration statement or offering circular.

301 15 U.S.C. § 78s (1976).

302 SEC File No. SR-NASD-76-9 (Form 19b-4B filed with the SEC).

sidered the issues involved and has determined that the filing of the policy statement was premature and that further deliberation was required."[303] It appears that the rescission was necessary because the NASD had underestimated the extent of the security industry's resistance to more explicit guidance for underwriters. Although the NASD plans to issue a Rule of Practice to describe underwriters' obligations in connection with direct participation programs,[304] there is no indication the NASD will make any further effort to set forth general professional standards for underwriters.

The demise of the NASD's project to adopt professional standards of reasonable investigation for underwriters left no viable alternative to rulemaking by the Commission. The idea of self-regulatory standard-setting was very appealing. It would have permitted investment bankers to set realistic standards consistent with actual underwriting practices. At the same time it offered the chance to raise the standards of care and investigation of all underwriters to a minimum level of adequacy. The existence of specific standards and the certification process required by the original NASD rule proposal could have enhanced section 11's primary, preventive function and provided assurance to participating underwriters that the managing underwriter or underwriters had discharged the reasonable investigation responsibility.

Another appealing aspect of the standards approach is that the courts might utilize such standards as the benchmark for adjudicating the adequacy of underwriters' conduct in specific circumstances. However, since underwriters are not considered "experts" as that term is used in section 11, professional standards developed by the NASD might not be received with the deference accorded to authoritative judgments by the accounting profession concerning professional responsibilities.[305]

The attempt at standard-setting by the NASD points up the principal, and perhaps insurmountable, problem with the standards approach—a lack of consensus in the industry as to what those standards are and when they should apply. Those commenting upon the NASD's proposals suggested it probably is undesirable to formulate one set of standards applicable to all situations. The Comment letter of Smith, Barney & Co. emphasized this point:

> Our experience is that each underwriting presents a comparatively unique set of cir-

303 NASD, *Amendment to the Policy of the Board of Governors Concerning Due Diligence Requirements for Public Offering of Securities*, SEC File No. SR-NASD-77-6 (Form 19b-4B filed with the SEC).

304 Draft of Proposed Appendix F to art. III, § 35 of the Rules of Fair Practice (Nov. 1978). A direct participation program is defined as "a program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution including, but not limited to, oil and gas programs, . . . agricultural programs, cattle programs, [and] condominium securities . . . ." *Id.* at 4. The proposed rules would prohibit member organizations from underwriting or participating in the public distribution of a direct participation program unless the program met detailed standards relating to a number of matters, including (1) additional assessments, (2) acquisitions of property from the sponsor or its affiliates, (3) removal of the general partner or manager, (4) impermissible conflicts of interest, and (5) disclosure of (a) organization and offering expenses, (b) sponsor's compensation, (c) quarterly reports to participants, and other matters.

305 The possibility of judicial deference springs from the *BarChris* court's decision not to hold the accountants in that case "to a standard higher than that recognized in their profession." 283 F. Supp. at 703. It will be interesting to see whether the courts take judicial notice of the proposed rule and statement of policy as evidence of what the NASD believes constitutes an adequate investigation. Although not adopted, their formulation suggests that at least some in the profession believe they reflect what constitutes due diligence.

> cumstances . . . . In our opinion the use of such a list by any underwriter would, in time, encourage reliance upon mechanical execution of written procedures rather than the vital analytical thinking addressed to the facts of the particular case which is the best guaranty that all material information concerning a company will be ascertained and understood.[306]

This also seems to be the position of the court in *BarChris*: "It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case."[307] However, to the extent the profession cannot agree on the constituents of due diligence, it lessens the strength of their importunities that whatever standard does apply be lowered because of the advent of integrated disclosure.

C. *Identifying Circumstances Affecting the Reasonableness of Underwriters' Conduct*

Rather than attempting to describe how the underwriter should conduct its investigation, several commentators have proposed that a more logical approach would be to delineate some of the factors that should affect the nature of the investigation while leaving to the courts the question of whether defendants lived up to their obligations in the particular circumstances of the case. The Advisory Committee on Corporate Disclosure proposed that the Commission adopt a rule identifying seven factors which a court should consider in determining care and reasonable ground to believe with respect to information incorporated by reference into a registration statement.[308] The Advisory Committee asserted that such a rule was needed to encourage the use of short forms of registration and to take into account the practical problems that confront underwriters attempting to improve disclosure in incorporated documents.[309]

The Advisory Committee's proposal was basically a reformulation of the proposed treatment of underwriters' liability in the American Law Institute's proposed Federal Securities Code.[310] Section 1704 of the official draft Code is basically comparable to section 11 of the Securities Act.[311] Section 1704(g) provides:

> In determining what constitutes reasonable investigation and reasonable ground for belief under section 1704(f)(3), the standard of reasonableness is that required of a prudent man under the circumstances in the conduct of his own affairs. Relevant circumstances include, with respect to a defendant other than the registrant, (1) the type of registrant, (2) the type of defendant, (3) the office held when the defendant is an officer, (4) the presence or absence of another relationship to the registrant when the defendant is a director or proposed director, (5) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of functions and responsibilities of the particular defendant with respect to the registrant and the filing), (6) when the defendant is an underwriter, the type of underwriting arrangement, the role of the particular defendant as an underwriter, and the accessibility to information with respect to the registrant, and (7) whether, with respect to a fact or document incorporated by reference, the

306 Comment letter, *supra* note 294, at 1.
307 283 F. Supp. at 697.
308 ADVISORY COMM. REP., *supra* note 175, at 454-55.
309 *Id.* at 454.
310 ALI FEDERAL SECURITIES CODE (1980).
311 Section 1704 would apply not only to effective registration statements but also to portions of required annual reports on Form 10-K and any other documents incorporated by reference therein.

particular defendant had any responsibility for the fact or document at the time of the filing from which it was incorporated.[312]

The drafters' comment on this section indicates that clauses (1)-(6) of the proposed standard are "designed to permit discrimination," which, with respect to underwriters, would include distinguishing "between ordinary and 'technical' underwriters and between managing underwriters and members of the underwriting group."[313] The comment adds that "[c]lause (6) is not intended entirely to relieve conventional underwriters other than managing underwriters of the duty to investigate regardless of obstacles that the issuer may put in the way of their access."[314] The rationale for clause (7), concerning incorporation by reference, is stated to be:

> (a) Furthering the "Form S-16" concept, which makes it impossible to ignore the underwriter's practical problems with respect to material incorporated in an offering statement by reference from the basic registration statement and subsequent reports, and
> (b) nondilution of the underwriter's standard of care, which is essential to the credibility of the offering statement.[315]

During the course of its extensive consideration of the draft Code, the Commission proposed a number of amendments to the official draft adopted by the American Law Institute in 1978. With respect to the reasonableness of underwriters' conduct, the Commission concluded that the phrase "and the accessibility to information with respect to the registrant" in section 1704(g)(6) should be deleted on the ground that the preceding phrase "the role of the particular defendant as an underwriter" in the same clause adequately recognized the junior role of nonmanaging underwriters without inviting undue dilution of their responsibilities. In September 1980 the Commission issued a release announcing its determination to support enactment of the Federal Securities Code as revised to incorporate this and the other changes which reflected agreements reached in discussions between the Commission and Professor Louis Loss, the American Law Institute's Reporter, and his advisors.[316]

The approach contained in section 1704(g) of the proposed Code, with the revision recommended by the Commission and agreed to by the Reporter, may, for several reasons, be an appropriate approach for the Commission to take now without awaiting enactment of the Code. First, it takes into account the circumstance of incorporation by reference, while at the same time not relieving underwriters of their basic duty to investigate all information contained in the registration statement. This approach thus retains the threat of liability for negligence which is the primary incentive for ensuring that adequate disclosure is made to investors.

The second major attribute of this approach is that it preserves the flexibility of the existing definition of reasonableness contained in section 11(c). The proposal merely amplifies, for the courts' assistance, the types of circumstances

312 ALI FEDERAL SECURITIES CODE § 1704(g) (1980).
313 *Id.*, Comment 2 at 714.
314 *Id.*
315 *Id.* at 714-15.
316 Securities Act Release No. 6242 (Sept. 18, 1980), [1980 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 82,655.

bearing on the question of whether the defendant's conduct was reasonable in light of all the surrounding circumstances. By so doing, it avoids the problems attending any effort to describe in the abstract what constitutes reasonable conduct under all the possible circumstances that could exist in the varied offerings being made today. Courts would continue to enjoy maximum latitude to adjust statutory responsibilities to changing circumstances, such as the evolution of different underwriting arrangements and the increasing efficiency of the securities markets.

Even if the Commission resolved to adopt a rule patterned after section 1704(g) of the proposed Code, it still would be necessary to address many specific questions about the meaning and application of the rule's terms. For example, how should the first clause—concerning the type of registrant—affect the underwriter's responsibility to investigate? Should external indicia of financial soundness—an AAA rating by Moody's, for example—mean the underwriter need do little or no investigation into the issuer's creditworthiness? To take another example, does clause (6) mean that a participating underwriter should be relieved entirely from liability when it has been informed by the managing underwriter that the managing underwriter has successfully completed its investigation, when in fact no reasonable investigation was ever made?[317] Answers to questions like these would have to be explored before the Commission could be assured that adopting such a rule would adequately serve the public interest and protect investors. It perhaps should be noted that neither competitive pressures nor the speed with which registration statements can be prepared under an integrated system appears to be a factor to be considered. Moreover, it is unlikely that a court will conclude that because an issuer prepared and filed a Form 10-K, the underwriter's sole obligation is to read it. Such a result would clearly contradict *BarChris*.

The strongest argument against this approach is actually a minor one—that the judiciary might well take into account the circumstances identified in section 1704(g) even if no such provision were available to provide guidance. A second argument is that the failure to specify in advance every other circumstance of importance could prompt courts to disregard altogether circumstances other than those enumerated. This result, however, seems most unlikely given the thorough manner in which the courts thus far have analyzed the factual circumstances surrounding suits involving section 11 claims.

VIII. Conclusion

This article has discussed the role of a critical professional group in the distribution of securities—investment bankers. Their rendition of a broad range of financing-related services makes them indispensible both to issuers and to effective capital formation.[318]

Traditional notions about underwriters' ability to satisfy their "due dili-

317 See the discussion in text accompanying notes 147-152 *supra*.

318 William C. Freund, senior vice-president and chief economist of the New York Stock Exchange, estimates there is a need for external equity financing of $275 billion during the 1980's. Only approximately $70 billion was raised by equity offerings in the 1970's. *See* Carson-Parker, *The Capital Cloud Over Smokestack America*, FORTUNE, Feb. 23, 1981, at 70.

gence" defense by reasonably investigating all information contained in the registration statement may have been stretched to the limit by a number of developments unforeseen by the drafters of the original securities acts. The general lack of public information about the securities offerings of the 1920's,[319] for example, stands in sharp contrast to the wide range of accounting and other company-specific information that is widely disseminated throughout increasingly efficient securities markets. But an efficient market merely conveys information effectively; it does not verify, correct or otherwise edit it.[320] This accentuates the continuing need for high standards of professionalism in the preparation and distribution of information to investors.

The evolving characteristics of the securities markets and experience in administering the federal securities laws have prompted the Commission to undertake a comprehensive program to integrate the disclosure requirements of the Securities Act and the Exchange Act. In the course of promulgating an integrated disclosure system, the Commission will be required to resolve a number of difficult technical and policy questions. Appropriate solutions to these problems are being sought by taking a flexible, pragmatic approach which seeks to strike a fair balance among competing considerations.[321]

One such problem now under consideration concerns the extent to which an underwriter is responsible for detecting and correcting inadequate disclosure in portions of Exchange Act reports incorporated by reference into short-form registration statements. This article has indicated that situations may occur in which the underwriter's opportunity to investigate and verify information might be restricted for reasons which appear to be ultimately beyond its control. In such circumstances, the need to avoid imposition of unreasonable burdens may require that the Commission and the courts be responsive to the underwriter's predicament.

Nevertheless, under an integrated disclosure system underwriters should be expected to do all they can to assure full and fair disclosure.[322] In the context of short-form registrations, underwriters should pay particular attention to the need to update disclosures made in incorporated documents so that the registration statement discloses all material changes in the issuer's affairs since the end of the latest fiscal year. To fulfill this responsibility, underwriters will invariably have to make some investigation so that they can verify the issuer's representations. It is only the degree of investigation which will, of necessity, vary depending upon the circumstances.

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319 One source provides this summary of disclosure practices prior to the Securities Act:

> A typical offering circular for that period contained little or no financial information, very little information as to the use of proceeds, a rather brief description of the securities themselves and few, if any, material facts relating to the business of the issuer. Furthermore the disclosures required today with respect to such matters as underwriting spreads, compensation of management and the possible interests of insiders in the financing or in recent transactions with the issuer were virtually unknown.

Halleran & Calderwood, *supra* note 9, at 94.

320 *See* text accompanying notes 185-86 & 250 *supra*.

321 In this connection, one commentator has observed that "[t]he challenge presented to any project for coordination is to preserve the best of what this law [the Securities Act] now provides while accomplishing the pruning and slicing that appear desirable and possible in a coordinated law." Cohen, *supra* note 176, at 1344.

322 As a general proposition, the author agrees with Professor Folk that "sanctions to compel careful scrutiny by underwriters must be sustained intact." Folk, *supra* note 56, at 39.

The Commission can assist underwriters in fulfilling these responsibilities in several ways. First, it can adopt provisions that remove legal uncertainty about the meaning of modifying or replacing previously disclosed information. Proposed instructions to the new short registration forms, if adopted, will accomplish this objective.[323]

Second, the Commission may be able to limit any further dilution of the underwriter's influence over the timing of securities offerings, which could affect the opportunity to investigate. Since the effective date of most registration statements is accelerated by the Commission, the Commission might consider, as a matter of policy, requiring that in every underwritten offering the managing underwriter must not only request acceleration of the effective date[324] but also indicate whether or not there has been time reasonably to review and comment upon documents incorporated by reference. This procedure would, by making the underwriter an equal participant in the decision to accelerate, provide a valid basis for underwriters to insist upon completion of their reasonable investigation prior to filing. When the underwriter requests acceleration it can be assumed that he is satisfied with the adequacy of disclosures in the registration statement.

Third, the Commission could encourage issuers to use shelf registration statements for various offerings through one or more underwriters named in the shelf registration. To the extent a shelf registration is filed and becomes effective before any particular offering is scheduled, the named underwriters will have more opportunity to investigate the issuer. When underwriters are not named in the shelf, the Commission should perhaps require a post-effective amendment describing the offering in which they will be involved. Such amendments must be declared effective by the staff (there is no twenty day period by which post-effective amendments may become effective) and the staff could request that the underwriters join in the request for the specific effective date.

Finally, the Commission should consider adopting a rule modeled after section 1704(g) of the proposed Federal Securities Code, with the revision suggested by the Commission. Such a rule would indicate to the courts that the Commission believes the specified circumstances should be taken into account in reviewing the adequacy of underwriters' conduct. The appropriateness of the circumstances set forth in revised section 1704(g) and their sufficiency as guides to a reviewing court could be ascertained in the public comment process and staff analysis which would precede adoption of such a rule.

As discussed above, the potential changes in the underwriter's role in an integrated disclosure system are not compelled by any rule change. Underwriters can still conduct their investigation prior to any filing; even after documents have been prepared by others and filed, changes can be made by filing amendments. To the extent integration simplifies the securities registration process, however, it may make certain traditional underwriting practices less convenient to underwriters. If this is so, then to a large degree the best solution may be to reassess inventively the structure of underwriters' practical relationship with issuers.

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323 These proposals are described in the text accompanying notes 264-70 *supra*.

324 Rule 461, 17 C.F.R. § 230.461 (1980), presently provides that: "[r]equests for acceleration of the effective date of a registration statement shall be made in writing by the registrant, the managing underwriters of the proposed issue, and the selling security holders, if any." However, in the past this rule has not always been strictly construed in situations where the issuer has not yet selected the underwriters.

This article has suggested several actions the Commission might take to help clarify the responsibilities of underwriters participating in distributions of securities registered on short forms. But it is well to emphasize that an integrated disclosure system will in no way affect the underwriter's role in securities offerings of new or relatively unseasoned issuers.[325] The Commission's Special Study of the Securities Markets concluded that the underwriter's role is "particularly important" when the offering involves new or unseasoned securities because

> under the statutory scheme of free access with full disclosure, the determination of which issues are suitable for public ownership depends primarily upon the underwriter who originates and sells the issue. Secondly since corporations going public for the first time are unlikely to be well known to the public and their managements are frequently inexperienced in public finance, the issuer or selling stockholders usually have to rely heavily upon the advice and assistance of the underwriter.[326]

The Commission's desire for full investigations when unseasoned issuers make offerings is also evidenced in its adoption in 1972 of Guide 16 of the Guides for Preparation and Filing of Registration Statements, which authorizes the Commission staff to review the adequacy of the steps taken by underwriters to verify information in the registration statements filed by such issuers.[327]

An integrated disclosure system holds the promise of providing issuers with less burdensome and more efficient mechanisms for raising capital in the securities markets.[328] To realize these objectives, the Commission must rely on investment bankers to adapt to the new system's requirements without sacrificing their basic responsibilities to the investing public. They will continue to be the gatekeepers at the junction of investor confidence and capital formation.

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325 Such issuers would use Form C and deliver to investors a prospectus containing all information needed for investment decisionmaking.

326 SEC REPORT, *supra* note 283, at 493.

327 The Guide states:

> Where a new or speculative issue of securities is being registered, the Division may request the underwriter of the issue to explain supplementally the steps taken to verify the disclosure in the prospectus and the Division will take into consideration such information in determining what action is to be taken in processing the registration statement, including whether additional disclosure is required.

33 Fed. Reg. 18,617 (1967). As part of the integration program, the Commission is proposing to incorporate this provision into a new Rule 400B. *See* Securities Act Release No. 6276 (Dec. 23, 1980), 46 Fed. Reg. 78, 94 (1980).

328 For example, SIA President Edward O'Brien has indicated that the new short form registration statements should promote capital formation. *See* Idaszak, *Brokers Cheery, Cautious*, Chicago Sun Times, Mar. 15, 1981, at 80-81.