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A. Introduction

Given the value of the prospectus as a disclosure document and the concentration of effort which goes into its preparation, it is sound policy to place restrictions on the use of written materials other than the prospectus in the solicitation of buyer interest connected with a registered offering. However, if such restrictions are carried too far, they can inhibit or prevent publicity which is beneficial to the interest of investors. There is a need for clearer standards to differentiate between helpful and informative publicity and publicity primarily designed to "condition" the market in such a way that the disclosure in the prospectus would be rendered ineffective. This is particularly true with regard to the publication activities of broker-dealer firms.

This chapter discusses the background of that need and recommends adoption of clarifying rules in particularly difficult areas.

A form of restraint in the publication of information and opinion by broker-dealers continues during the post-offering period by virtue of the prospectus delivery requirements of Section 4(3)(B) of the ’33 Act (the so-called “40 day” and “90 day” periods). This subject is dealt with in the previous chapter, and it is recommended in that chapter (at pp. 121-2) that the prospectus delivery requirement be eliminated in the case of reporting issuers.

B. More clearly defined policies should be adopted to deal with the publication of information during the time a company is “in registration.”

1. Nature of the problem

Where no exemption from registration is available, the statutory design of the ’33 Act clearly contemplates that any written offering of a security shall be made by means of the prospectus. Thus, Section 5(c) prohibits any written offerings during the period prior to the filing of the registration statement. Section 5(b)(1) provides that after the registration statement has been filed no prospectus may be used unless it meets the requirements of Section 10 of the Act. “Prospectus” is broadly defined in Section 2(10) to include any written material (or statement on radio and television) which offers any security for sale. (The typical “tombstone” advertisement is excepted).

These provisions have been interpreted broadly, in keeping with the statutory design. As the Commission observed in the leading case on the subject (which has become popularly known as the “Arvida case"), the definitions of "offer and prospectus"

> . . . are not limited to communications which constituted an offer in the common law contract sense, or which on their face purport to offer a security. Rather, as stated by our General Counsel in 1941, they include "any document which is designed to procure orders for a security"[1/]

Putting the matter in other words, the Commission emphasized that:

> The statute prohibits issuers, underwriters and dealers from initiating a public sales campaign prior to the filing of a registration statement by means of publicity efforts which, even though not couched in terms of an express offer, conditioned the public mind or aroused public interest in a particular security. [Footnote omitted][2/]

This reading of the statute has become generally known as the "gun jumping" doctrine. Those who "jump the gun" on a forthcoming offering, whether by interviews with newspaper or magazine reporters, speeches, reports to shareholders, market letters or otherwise, violate the basic prohibitions of Section 5 of the '33 Act.

There is sound justification in principle for the "gun jumping" doctrine. "Gun jumping" is fundamentally inconsistent with the rationale of the '33 Act. As the Commission noted in the Arvida case:

> One of the cardinal purposes of the Securities Act is to slow down this process of rapid distribution of corporate securities at least in its earlier and crucial stages, in order that dealers and investors might have access to, and an opportunity to consider,

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1/ Carl M. Loeb, Rhoads & Co., 38 S.E.C. 843-48 (1959).

2/ Id. at 850.

> the disclosure of the material business and financial facts of the issuer provided in registration statements and prospectuses . . . The entire distribution process was often stimulated by sales literature designed solely to arouse interest in the securities and not to disclose material facts about the issuer and its securities. [Footnote omitted][3/]

In practical application, however, the "gun jumping" doctrine presents numerous difficulties. With the growth of public participation in the markets it has become the practice of widely held companies to publish more and more information concerning their affairs. This practice has been encouraged by the Commission and stimulated by the "timely disclosure" policies of the New York and American Stock Exchanges. In Securities Act Release No. 3844 (October 8, 1957) the Commission specifically referred to the "increas[ed] tendency . . . to give publicity through many media concerning corporate affairs which goes beyond the statutory requirements," as "a commendable and growing recognition on the part of industry and the investment community of the importance of informing security holders and the public generally with respect to important business and financial developments."

Moreover, even the casual observer cannot fail to note the increase in the output of market letters, industry surveys, recommended lists and similar publications by the brokerage community. This flow of material to customers and prospective customers not only responds to investors' demands but constitutes a primary medium for the dissemination of information about securities to the investing public.

3/ Id. at 849.

The problem has two aspects.

First, there is the continuing need to strike a balance between two groups of investors: (1) those to whom securities are sold in registered public offerings and (2) those who purchase and sell securities in the trading markets. As observed in Chapter II of this Report, the volume of transactions by the latter group far exceeds the aggregate volume of sales made to the former. Second, there is a legitimate desire for clearer definition and greater certainty on the part of brokers who act as underwriters and dealers in connection with registered offerings.

2. A sound and generally workable standard has been developed dealing with publicity generated by the issuer of securities in registration; questions which arise concerning its applicability in particular situations should continue to be handled administratively

For many years, the standard for information published by the issuer of securities which plans, or is in the midst of, a registered public offering, has been what is normal and customary for that particular issuer. A careful statement of this standard appears in the Arvida case:

> We realize, of course, that corporations regularly release various types of information and that a corporation in which there is wide interest may be called upon to release more information more frequently about its activities than would be expected of lesser known or privately held enterprises. In the normal conduct of its business a corporation may continue to advertise its products and services without interruption, it may send out its customary quarterly, annual and other periodic reports to security holders, and it may publish its proxy statements, send out its dividend notices and make routine announcements to the press. This flow of normal corporate news, unrelated to a selling effort for an issue of

> securities, is natural, desirable and entirely consistent with the objective of disclosure to the public which underlies the federal securities laws.[4/]

The Study's conferences with members of corporate managements and of the financial community suggests that by and large the gun-jumping doctrine with respect to issuer-generated publicity has worked reasonably well and makes a sensible accommodation between the needs of the trading markets for a continuing flow of investment information and the underlying policies of the '33 Act.

Difficult and close questions inevitably arise as to whether particular items of publicity are part of a selling effort or are merely regular and customary disclosures unrelated to the selling effort for a particular registered offering. Even if the issuer and its counsel are satisfied that the publicity is legitimate, an informal consultation with the staff of the Commission may be desirable to avoid potential controversy. The Division of Corporation Finance and the Office of General Counsel of the Commission are accustomed to such informal consultation and in most instances are able to give a swift and definite response. The Study knows of no substitute for this procedure and issuers are encouraged to employ it.

There has, however, been one development during the decade since the Arvida opinion which requires consideration. As a result of the evolution of law and corporate practice in recent years,

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4/ Id. at 853.

publicly-owned corporations have come under increasing obligations and incentives to make timely disclosure of information which might materially affect the market for their securities. These developments include both the expanded policy on timely disclosure adopted by the major stock exchanges and the principles with respect to "insider trading" developed in the Texas Gulf [5/] and other cases. Thus, a question arises as to a possible conflict between an obligation to make disclosure under these principles and the "gun jumping" doctrine. The Study believes that such a question will not arise very often in view of the fact that events creating a duty to make prompt disclosure under the principles referred to above are relatively infrequent and consequently will not often occur during the period when the "gun jumping" doctrine inhibits corporate publicity. Furthermore, these events are of such a nature that they would undoubtedly require disclosure in the prospectus, so that the problem is apt to arise primarily during the pre-filing period. The Study believes that if such an event occurs and the issuer, in good faith, determines that it is obligated to make disclosure, the "gun jumping" doctrine should not be applied to preclude such disclosure, provided that, following the teaching of the court in the Texas Gulf case, it is purely factual and does not include predictions, conclusions or opinions.[6/]

5/ SEC v. Texas Gulf Sulphur Co., 401 F2d 833 (C.A. 2, 1968)

6/ It might be argued that insofar as the Texas Gulf problem is involved, the issuer could avoid the conflict by preventing any trading by insiders during the period when the "gun jumping" doctrine is applicable, thus avoiding a necessity for disclosure under the principles announced in Texas Gulf. It may, however, be impractical for the issuer completely to prevent such trading, particularly by "tippees."

Where an issuer is contemplating a public offering of securities to be registered under the '33 Act, the position has been taken by the Division of Corporation Finance that the issue might be "jumping the gun" if it announced that fact before a registration statement was filed. However, a considerable number of issuers have made such announcements without consulting the Division. Some financial publications contain lists of issuers contemplating offerings of securities to be registered. The Study believes that clarification could be achieved by amending Rule 135 to permit limited announcements of this nature. (A draft of such revision is included in Appendix VII-2).

The usefulness of Securities Act Release No. 3844 to illustrate a variety of "gun jumping" problems has not diminished with time. It is generally suggested in that release that projections of earnings, which are not permitted in prospectuses, should not be included in any publicity during the registration period. The Study agrees. However, it is not necessary to conclude that information which may not be permissible in a prospectus can under no circumstances be disseminated during that period. An example may help to illustrate this point. Certain public utility companies have been accustomed to estimate in advance their kilowatt hour sales for the forthcoming fiscal year. Such estimates in the public utility field are essential to a determination of financing needs; the character of such needs is important in analyzing the securities of public utility companies. In this limited area, the Study believes that the regular and customary publication of an estimate of kilowatt hour sales, not amounting to a projection of earnings, is proper.

It is suggested that a better understanding of the standards that govern issuer-generated publicity might be achieved by publication from time to time of positions taken by the Division of Corporation Finance.

3. Clearer standards defining the limits of permissible activity by brokers and investment advisers during the registration period are needed and should be published by the Commission in appropriate form.

(a) Background of recommendations.

The effect of '33 Act restrictions on the normal publication activities of the brokerage community can be substantial. On occasion, the restrictions may commence several months prior to the filing of the registration statement. This period is followed by the so-called "waiting period" between filing and effective date. After the effective date, the restrictions are modified: under Section 2(10) of the '33 Act, any written material offering the security for sale must be accompanied or preceded by a copy of the final prospectus for 90 days (in the case of first public offerings) or 40 days (in the case of repeat offerings).

The effect of the restrictions is particularly significant in the case of public utility companies, many of which make frequent registered public offerings for the purpose of obtaining additional debt financing.

Nevertheless, some interference with normal broker-dealer publication activities appears to be inevitable. Apart from the specific requirements of the statute, the question can be raised as to the independence of judgment of the broker-dealer who is participating in an underwriting. He has a given allotment of securities, frequently substantial in relation to the normal trading volume, which must be sole in a limited period. His compensation for this service is substantially higher than the usual commission. He faces, in a particularly hazardous form, the old conflict of interest between his functions as a "broker" and as a "dealer".

The pressures affecting a securities firm are of a different character when no underwriting is in prospect. Publications distributed by brokers to the trading market are more likely to reflect independent judgments and recommendations. In many instances, such publications are derived from research done by independent financial publishers and independent research organizations.

Thus, in considering what restrictions are appropriate and necessary, it is important to determine whether or not a particular publication was initiated and completed in the absence of the prospect of an underwriting commitment.

The Study made a careful survey of the informal rulings on “gun jumping” questions involving brokerage firms issued by the Division of Corporation Finance over a period of years. References in the remainder of this Chapter to the positions taken by the Division are derived from this survey. In addition, members of the Study conferred at length with groups of underwriters and analysts. A surprising diversity of views on the interpretation of existing law emerged from these conferences.

For example, one leading brokerage firm stated that it had been unable to include in its regular quarterly survey of stocks on its recommended list any recommendation concerning American Telephone and Telegraph for a period of two years, for the reason that AT&T was always “in registration” during this period. This was so, even though the brokerage firm was not a member of any underwriting syndicate or selling group for the security. It is noteworthy that a number of the AT&T registration statements during the period involved non-underwritten rights offerings of senior securities.

Another leading brokerage firm, on the other hand, advised the Study that it refrains from publishing a recommendation concerning a security in registration only when it will be included in the underwriting group.

Similarly, a leading financial publisher stated that it believed itself precluded from publishing opinions and recommendations in its regular subscription service concerning a company which was " in registration". A second leading publisher did not deem itself bound by any such restriction.

Other illustrations could be given. It is apparent that a considerable uncertainty pervades the application of '33 Act restrictions to the publication activities of brokers and investment advisers. This state of affairs underscores the need for a clearer articulation of standards.

The Study considered the question whether its recommendations as to standards should be in the form of proposed guidelines to be issued by the Commission or proposed rules. It is difficult to define with precision the kind of activity to be covered by a rule of the Commission where such wide diversity of practice exists in the financial community. Guidelines have the advantage of greater flexibility. On the other hand, rule making has two distinct advantages: (1) it would provide a greater degree of certainty and (2) it would give the investment community the protection afforded by Section 19(a) of the '33 Act, which provides that "no provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission . . ." The Study determined to attempt the drafting of three rules. These are contained in Appendices V-1 to V-3.

(b) The commencement of restrictions

It appears to the Study that there is some confusion, both within and without the Commission, as to when restrictions upon publication activities commence. One standard which has been applied involves a subjective concept, and is phrased in terms of a broker's "reason to believe that he will participate" in a forthcoming underwriting. The Study questions the ability of the Commission to administer or the industry to operate under such a standard. It is preferable, in the Study's view, to apply a more objective standard, similar to the standard which was ultimately adopted by the Commission as a part of the definition of "prospective underwriter" for purposes of Rule 10b-6.

Thus, a broker would become subject to restrictions at such time as he has reached an understanding with the issuer or other person on whose behalf a planned distribution is to be made that he will become a managing underwriter, whether or not the terms and conditions of the underwriting have been agreed upon.

Similarly, a broker (other than a managing underwriter) would become subject to restrictions at such time as he has reached an understanding with a managing underwriter, or with the issuer or other person on whose behalf a planned distribution is to be made, that he will participate in the underwriting.

Dealers would become subject to restrictions at such times as they are offered a participation, or request a participation, if they in fact participate in the distribution.

(c) The status of non-participants in the offering.

Does the "gun jumping" concept preclude non-participants from issuing written recommendations and opinions concerning a company with securities in registration? As noted above, investment advisory firms have responded differently to this question. Advice given on the question by the Division has not been consistent. A clearer answer is needed.

In the opinion of the Study, application of the "gun jumping" doctrine to non-participants has, at best, a dubious legal basis. Most non-participants would be able to demonstrate that their publications are designed only to stimulate trading interest in particular securities and use of the brokerage services they offer. Moreover, normal publication activities with respect to securities in registration by non-participants in the offering would not appear to be inconsistent with the scheme of the Securities Act. The publications of non-participants are not usually distributed in a context where extra compensation could operate to affect the independence of judgment of the publisher. Indeed, application of the “gun jumping” doctrine to publications of non-participants could well deprive potential purchasers of the securities being distributed of a primary source of independent opinion.

To the extent that the Division has applied the restrictions to non-participants, its action appears to have sprung from recognition of the fact that the relationships between brokers and investment advisers in the financial community are complex and interrelated and that it is difficult as an administrative matter to determine whether a non-participant is truly independent of the participants in an offering. One cannot deny the possibility of abuse. However, in attempting to strike a balance between the needs of the trading markets and the regulatory scheme affecting registered public offerings, the Study believes that it would be appropriate to recommend that the restrictions not be applicable to non-participants, subject to the qualifications outlined below:

> (1) The rule should be accompanied by conditions which serve to guard against the kinds of relationships which might impair independence;
>
> (2) The rule should be restricted to companies with a class of securities registered under Section 12 of the ’34 Act or subject to Section 15(d) of that Act. It is the securities of these companies that are likely to arouse trading interest apart from any registered public offering.

A proposed rule is submitted in Appendix V-1.

(d) Offerings of non-convertible senior securities.

Should the "gun jumping" doctrine apply to recommendations and expressions of opinion concerning the common stock of an issuer when the registration statement covers only non-convertible preferred stock or debt securities?

Relaxation of the restrictions under such circumstances would reduce the problem for the broker where it is most severe, viz., in the case of public utility companies whose needs for debt financing result in frequent registered offerings of senior securities.

Two arguments can be advanced in favor of such a relaxation. First, investment conditions with respect to common stocks and non-convertible senior securities are significantly different. Second, and equally important, the market for bonds and preferred stocks of public utilities and other sizeable corporations is largely an institutional one. In the case of pure preferred stock, the market consists to a great extent of corporations which, under existing tax laws, enjoy tax benefits on the receipt of preferred stock dividends.

These conditions, of course, do not apply in the case of convertible securities where the purchaser looks in substantial part to the opportunity for gain attributable to the conversion feature of the bonds or preferred stock, nor are they persuasive in those instances where an issuer in the promotional stage offers debt securities to the public with a coupon rate so high so as to excite substantial speculative interest. For these reasons, the Study recommends a rule (set forth in Appendix V-2) which would permit brokers to recommend common stock where the issuer is in the process of registering non-convertible senior securities, or vice versa, on condition that the issuer meets the standards recommended in Chapter III of this Report for Form S-7.

(e) Broad lists of recommended securities published on a regular basis

The Study has observed an increasing tendency on the part of securities firms to publish at relatively regular intervals broad general lists of recommended securities. If such a firm expects to participate in an underwriting on behalf of an issuer which appears in the list of recommendations, the broker today will typically delete all reference to the issuer from its publication or, in the alternative, will replace its recommendation with a footnote reference which may read: "prospectus requirements--no opinion or estimate can be given."

The Study believes that this procedure carries the "gun jumping" doctrine too far. It is recognized that a market letter relating to a specific company, or even a glowing survey of the particular industry to which that company belongs, could well play a major part in a selling effort geared to an offering of the company's securities. However, where the publication covers a broad range of companies in different industries and gives no great prominence to any one company, the danger that such a publication could condition the market for an offering is substantially reduced. This would be all the more true if the publication was not sporadic, but was issued on a regular schedule and if, as a condition, it were required that the broker must have previously published an equivalent recommendation of the securities in question.

Accordingly, the Study recommends a rule (set forth in Appendix V-3) which would permit publication by a broker of a recommendation despite a prospective underwriting of the securities of the company so recommended in which the broker expects to participate, if:

(1) The recommendation appears in a publication containing recommendations as to the securities of companies in a broad group of industries;

(2) The publication has in the past been distributed with reasonable regularity on an annual or more frequent basis;

(3) The data concerning the company which is "in registration" is no more extensive than that included as to

other companies and does not contain projected sales or earnings beyond the company's current fiscal year; and

(4) A recommendation no less extensive as to the security in question was contained either in the last previous publication of the same character, or in a subsequent publication of any other character which was distributed prior to the time the broker had reached an understanding that it would participate in the underwriting.

(f) Follow-up reporting where a security has previously been recommended by the broker

Brokers who met with the Study argued that when they place their customers in a particular security, they acquire a continuing obligation to report to those customers new information and revised opinions concerning the security. It appeared from these discussions that (a) the distribution of such follow-up material is not usually limited to actual holders of the security, but is mailed at the discretion of registered representatives to prospective customers and to existing accounts which may not own the security, and (b) it may well be impracticable to insure that such follow-up material goes only to existing holders of the security among the broker's customers.

To the extent that follow-up material is factual, there is considerable merit to the argument that severe restriction on its use may not serve the best interest of investors. To permit the broker to restate or revise his recommendation, however, when he expects to participate in a forthcoming underwriting of of [sic] the security, poses an unacceptable "gun jumping" risk. The Study, therefore, recommends that if events involving or affecting the issuer occur during the pre-filing period[7/], brokers who expect to participate in the underwriting be permitted to issue brief factual reports of such events, provided that the reports do not include projections of sales or earnings or a recommendation to buy.

(g) Market letters and industry surveys printed before a broker has reached any understanding as to participation in an underwriting

If a market letter or industry survey recommending a security is both prepared and published by a broker before that broker has reached any understanding as to participation in an underwriting of the security, no objection to such participation should be raised. The broker's activities may be presumed in such circumstances not to be part of the selling effort for the securities being registered.

7/ If the registration statement has been filed, written material mailed or published by an underwriter should, in the opinion of the Study, be confined to the preliminary prospectus or to the forms of advertising permitted by Section 2(10) and Rule 135.

It can be expected that practical problems will arise on occasion in applying this standard. Such problems should continue to be dealt with administratively through informal advice given by the Division on request. There have been a number of instances in which both the Commission and the Division have responded to such requests in a flexible and realistic fashion. For example, in one case a broker proposed to mail to its own customers in January a brochure evaluating in objective fashion recent events involving a company engaged in the transportation of natural gas. At the time, the broker knew that it would participate in an underwriting for the company scheduled to take place in May or June. Based upon a review of the brochure, the character of the company's financing plan and the lengthy interval between the publication and the proposed underwriting, the Commission interposed no objection to publication of the brochure.

Two specific problems were brought to the Study's attention on which the Study recommends that a flexible administrative position be taken:

(1) The Study recommends that the Division should generally permit a broker to distribute during the pre-filing period a market letter or industry survey which it can demonstrate to the Division's satisfaction was fully prepared and sent to the printer prior to the time the broker reached

any understanding as to participation in an underwriting of the security. One qualification is appropriate: the number of copies printed should be no greater and the distribution no more extensive than for similar publications issued by the firm in the recent past.

(2) In the case of registered secondary distributions at the market, where no particular securities firm or syndicate of firms has made arrangements with the selling stockholders to distribute the security, a broker should not be restricted in disseminating market letters or industry surveys which contain its recommendations as to the registered security until such time as it receives an order to sell securities covered by the registration statement. Appropriate restrictions should then be imposed until the broker has completed its participation in the distribution.

It may be appropriate for the foregoing recommendations, if adopted, to be published in the form of a Commission release.