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*

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* Member of the New York Bar; Director of the Division of Corporation Finance, Securities and Exchange Commission. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for articles by members of its staff. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or its staff. The author would like to thank Mr. Gregory H. Mathews, an attorney in the Division’s Office of Disclosure Policy, for his invaluable assistance in the research and writing of this article.
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...
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 spec-
ulation of the 1920’s brought discredit upon the entire banking industry, it is also
ture that the care and competence displayed by investment bankers since enact-
ment of the federal securities laws have contributed uniquely to the aura of confi-
dence 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 com-
prehensive program to integrate, streamline and make uniform the Acts’ disclo-
sure 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 de-
termining civil liabilities for misstatements and omissions in the information fur-
nished to investors or made available to the markets. With respect to disclosures
under the Securities Act, those who distribute11 or sell12 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

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,

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 neces-
sary or appropriate in the public interest or for the protection of investors. 15 U.S.C. § 78f (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. § 78g (1976). Companies subject to the Exchange Act
also must periodically file additional information and documents that the Commission designates as neces-
sary 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.

believe the statement was true.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{16} For a time it appeared that negligence might also be the standard under rule 10b-5, but \textit{Ernst & Ernst v. Hochfelder}\textsuperscript{17} and its progeny\textsuperscript{18} have established that in every case the plaintiff must prove scienter.\textsuperscript{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.\textsuperscript{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\textsuperscript{21} should substantially reduce the

\textsuperscript{13} This reasonable investigation and belief standard is discussed in the text accompanying notes 69-72 and in section III. A. \textit{infra}.


\textsuperscript{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, \textit{SECURITIES REGULATION} 1751 (2d ed. 1961).

\textsuperscript{16} 17 C.F.R. § 240.10b-5 (1980).

\textsuperscript{17} 425 U.S. 185 (1976).


\textsuperscript{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).

\textsuperscript{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. \textit{See} Ross v. A. H. Robins Co., 607 F.2d 545 (2d Cir. 1979), \textit{cert. denied}, 446 U.S. 946 (1980).

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.\textsuperscript{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\textsuperscript{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,\textsuperscript{24} the im-

\begin{footnotesize} 
\begin{enumerate}

\item 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-6, 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-15A, 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.

\item 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.

\item 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. 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, 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.

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

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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.\textsuperscript{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.\textsuperscript{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,\textsuperscript{30} but none is more crucial to efficient capital formation than their underwriting of external corporate financing.\textsuperscript{31} The underwriter's basic function is directly or

\textsuperscript{28} See text accompanying notes 15-20 supra.

\textsuperscript{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.

\textsuperscript{30} For a general description of the capital raising, counseling and support services provided by investment bankers, see P. Davey, \textit{Investment Banking Arrangements} 11-17 (Conference Board Report No. 681, 1976).

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. 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. 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. 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. The issuer receives the proceeds only to the extent the securities are sold. 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.

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. 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).


38 See generally Stewart, Underwriting Syndicates, in FUNDAMENTALS OF INVESTMENT BANKING 517-31 (1949).
participating in the distribution are set forth in the "agreement among underwriters." 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.

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. 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. 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. 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 utilized almost exclusively by issuers compelled to do so in regulated industries.

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 Origin 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. § 77k(2) (1976).


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, 35 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. 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.

With negotiated underwriting arrangements, the issuer, the managing underwriter and their counsel work together to prepare the registration statement and prospectus. 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. 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.

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, 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.
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 . . .". 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.

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. Noting the types of persons associated with a public offering who are excluded from liability under section 11, 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." Any purchaser of a security offered pursuant to an effective registration statement can sue any or all of the statutorily specified persons, who are made jointly and severally liable for damages. Although the measure of damages is the depreciation in the value of the security, in no case can the amount of damages be

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.

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).
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.
In order to recover, the plaintiff must prove that he purchased a security issued under an effective registration statement, that the registration statement contained a material omission or misstatement when it became effective, and that he has complied with the relatively brief statute of limitations. Plaintiff must also establish the extent of the security's depreciation in value 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. 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. The underwriter and other defendants, however, have several additional defenses available. 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. He can similarly notify the Commission and the public that part of the registration statement became effective without his knowledge.

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. This reasonable investiga-

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

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." 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. When investor confidence eventually collapsed, capital formation all but ceased. 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." 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."

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. 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 Id. at 2. As early as 1920, a committee of the Investment Bankers Association had criticized the spread of irresponsible underwriting practices: "At 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 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.\textsuperscript{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.\textsuperscript{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."\textsuperscript{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."\textsuperscript{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.\textsuperscript{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."\textsuperscript{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

\textsuperscript{79} H.R. Rep. No. 85 at 5.
\textsuperscript{80} Id. at 23.
\textsuperscript{81} Securities Act, § 11, 15 U.S.C. § 77k(c) (1976).
\textsuperscript{82} Gordon, Benefits of Security Regulation, in 4 INVESTMENT BANKING 4, 8 (Oct. 7, 1933).
\textsuperscript{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.
\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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:

\begin{quote}
[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 \textit{in iure} 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 . . . .\textsuperscript{89}
\end{quote}

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-

\begin{footnotes}
\textsuperscript{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.
\textsuperscript{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 . . . .”
\textsuperscript{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).
\textsuperscript{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. \textit{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. \textit{Id.}
\textsuperscript{89} Shulman, \textit{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, \textit{The Federal Securities Act of 1933}, 43 YALE L. J. 171, 173 (1933).
\end{footnotes}
denced by the very infrequent reported litigation involving section 11 claims. 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. Of this total, in only two cases did plaintiffs recover under section 11 while six others were judicially approved settlements of class action suits. 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., 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, 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; (2) the existence and nature of potential conflicts of interest relating to competitive real estate practices of its officers and

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.


93 See L. Loss, supra note 90, at 1688, 3823.


95 Id. at 404.

96 Id. at 401.
directors, 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.

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. 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." 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.

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." 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).
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." 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. 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.

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., 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, 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.

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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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."\textsuperscript{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.\textsuperscript{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.\textsuperscript{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\textsuperscript{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.\textsuperscript{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-

\begin{itemize}
\item \textsuperscript{108} \textit{Id.} at 654.
\item \textsuperscript{109} \textit{Id.} at 675-76.
\item \textsuperscript{110} \textit{Id.} at 676-78. A factor purchases trade receivables with or without recourse. The factor receives a commission on advances against receivables.
\item \textsuperscript{111} \textit{Id.} at 678.
\item \textsuperscript{112} \textit{Id.} at 668-71.
\item \textsuperscript{113} \textit{Id.} at 692.
\item \textsuperscript{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.
\item \textsuperscript{115} \textit{Id.} at 693-94.
\end{itemize}
Chris's minutes for the past five years and its major contracts. 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. 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." Noting that the positions of underwriter and issuer are somewhat adverse, 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.

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. 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.

The BarChris opinion engendered lively discussion among professionals. 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.
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.
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.
130 332 F. Supp. at 551.
of financial resources.” 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. 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. 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.

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.” 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. 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 take-over. 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. 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.

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.” Although the implications of
this statement vis-a-vis underwriters' responsibilities within an integrated disclosure system will be analyzed later in this article,\textsuperscript{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."\textsuperscript{141} In evaluating the reasonableness of the underwriters' conduct in \textit{Leasco}, the court considered the nature of the transaction, the underwriters' relationship to the issuer and their access to the underlying data.

In \textit{Leasco}, the apparent basis for the underwriters' reasonable reliance upon the issuer, \textit{Leasco}, was the unavailability of the information from the target, \textit{Reliance}, needed to verify the estimates of surplus surplus.\textsuperscript{142} Documents reviewed by the underwriters indicated that \textit{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 \textit{Leasco}'s officers, who asserted that without confirmation by \textit{Reliance} the estimate by \textit{Leasco} should not be included in the prospectus.\textsuperscript{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."\textsuperscript{144}

The court's extension of a variable standard applicable to underwriters, while criticized by some,\textsuperscript{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."\textsuperscript{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.\textsuperscript{147} The test in such cases

\begin{footnotesize}
\textsuperscript{140} See section VI infra.
\textsuperscript{141} 332 F. Supp. at 578 (emphasis added).
\textsuperscript{142} Even though \textit{Leasco} was making a hostile exchange offer, Form S-1 required the inclusion by \textit{Leasco} of information about \textit{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 \textsection{} 11, unless they were reasonably certain of its accuracy.
\textsuperscript{143} 332 F. Supp. at 550, 561-62, 582.
\textsuperscript{144} Id. at 582.
\textsuperscript{146} H.R. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933).
\textsuperscript{147} H.R. REP. NO. 152, 73d Cong., 1st Sess. 26 (1933).
\end{footnotesize}
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 "satisfies] 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.
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).
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 com-
pany’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 com-
pany’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 dismis-
sal of the section 10(b) claims in Sanders III because the scienter required by the
Court’s intervening decision in Ernst & Ernst v. Hochfelder¹⁶⁰ could not be shown.¹⁶¹

The case then was remanded to the district court for consideration of plain-
tiffs’ section 12(2) claims. Section 12(2) imposes liability on any person who “of-
ers 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.
¹⁶¹ Sanders III at 792.
¹⁶³ Sanders IV at 1227.
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.\textsuperscript{165} The court added that "[s]ince what constitutes reasonable care under \S\ 12(2) depends upon the circumstances, we, of course, do not intimate that the duty of a seller under \S\ 12(2) is always the same as that of an underwriter in a registration offering under \S\ 11."\textsuperscript{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\textsuperscript{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.\textsuperscript{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.\textsuperscript{169} Justice Powell expressed concern that the decision would "be read as recognizing no distinction between the standards of care applicable under \S\S\ 11 and 12(2), and particularly as casting doubt upon the reasonableness of relying upon the expertise of certified public accountants."\textsuperscript{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."\textsuperscript{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,\textsuperscript{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

\begin{itemize}
  \item [even 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.\textsuperscript{173}
\end{itemize}

\begin{footnotes}
\item 165 Sanders IV at 1227-28.
\item 166 Id. at 1228.
\item 167 Sanders II at 1067-68, cited in Sanders IV at 1227.
\item 168 15 U.S.C. \S\ 77k(b)(3)(C) (1976).
\item 170 Id. at 3707.
\item 171 Id.
\item 172 Sanders II at 1069.
\item 173 Brief for the United States as Amicus Curiae at 7-8 (Sanders IV) (footnote omitted).
\end{footnotes}
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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.


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 and first given concrete form by the Commission’s Advisory Committee on Corporate Disclosure. From these initiatives and an ongoing dialogue among professionals, 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).
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 1967178 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.
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).
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. 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. 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.

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. 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.

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 and in periodic corporate reports. 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).

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 and Regulation S-X. 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.

Under the integrated disclosure system, it is proposed that issuers be divided into three tiers. 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. 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-1. Much of the basic


192 Id.


194 Id.


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
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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.\footnote{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\footnote{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.\footnote{199} Much of the information required by Form B is the (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.


\footnote{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.\footnote{198} The conditions for the use of Form A are set forth in note 196 supra.

\footnote{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 sim-
ply 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 min-
imal 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 se-
curities 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) transac-
tions,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 use202 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 prospec-
tus contains only disclosures about the proposed business combination transac-
tion, 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” registration204 of securities that can reasonably be expected to be offered

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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.
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 sen-
tence 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
and sold within two years provided adequate current information is made available to investors by means of post-effective amendments. The proposed rule would restrict shelf registration to certain types of offerings. 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."

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,
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.


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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 markets213 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

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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 underwriting debt offerings in particular:

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

* Information through third quarter only.

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.
216 SEC ANNUAL REPORT 102 (1940).
by only twenty percent\textsuperscript{217} while the number of reporting companies has tripled, and the number and complexity of filings has increased enormously.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{221}

A viable integrated disclosure system will depend, in part, upon upgrading and maintaining the quality of Exchange Act filings.\textsuperscript{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.\textsuperscript{223}

\textsuperscript{217} SEC Annual Report 65 (1979).
\textsuperscript{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.
\textsuperscript{220} See Comment letter of 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").
\textsuperscript{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).
\textsuperscript{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.
\textsuperscript{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. 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 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.

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. 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-

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).


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.  

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. 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.'" It should be emphasized, however, that apart from regulated industries, competitive bidding is not a widespread practice.

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. 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-

\(^{233}\) Robertson, Future Shock at Morgan Stanley, FORTUNE, Feb. 27, 1978, at 90.

\(^{234}\) Id.

\(^{235}\) 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 authorities 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.

\(^{236}\) Welles, supra note 231, at 134.

\(^{237}\) 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.

\(^{238}\) 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. 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." 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.

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.\textsuperscript{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 suc-
cessful without reducing the quality of disclosure available to the market. As
discussed above,\textsuperscript{242} Form S-16 requires the incorporation by reference of the is-
suer’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 re-
quirements of the form or the other circumstances surrounding S-16 offerings.
And as discussed above,\textsuperscript{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 as-
sociate 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 \textit{BarChris} decision, attorney Kenneth J. Bialkin provided advice which
should be as valuable to investment bankers as it is to securities lawyers:

\begin{quote}
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. Per-
haps 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.\textsuperscript{244}
\end{quote}

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

\begin{flushright}
\textsuperscript{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."
\textsuperscript{242} See text accompanying notes 177-81 supra.
\textsuperscript{243} See text accompanying notes 183-88 supra.
\textsuperscript{244} Panel Discussion, supra note 123, at 623 (remarks of Kenneth J. Bialkin).
\textsuperscript{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.
\end{flushright}
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


\(^{249}\) 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.”\(^\text{251}\)

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.\(^\text{252}\)

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.”\(^\text{253}\)

For several years, the SIA has been attempting to persuade the Commission that underwriters need and deserve relief.\(^\text{254}\) 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.\(^\text{255}\)

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

The SIA is not alone in this view.\footnote{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).}

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.\footnote{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).}

Neither choice would appear to serve the interests of full and fair disclosure for the protection of investors.\footnote{259}{It is argued that if reputable houses withdrew from an offering they would be replaced by less reputable firms.}

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

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,\footnote{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.} to attempt to resolve this controversy.\footnote{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.}

In publishing for public comment proposed Forms A, B, and C,\footnote{263}{Securities Act Release No. 6235 (Sept. 2, 1980), 45 Fed. Reg. 63,693 (1980).} the Commission did, however, include in the proposals several provisions\footnote{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.} intended to prevent extraneous factors from impeding the ability of issuers, underwriters, and others to assure adequate di-

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

\footnote{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).}

\footnote{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).}

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

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\footnote{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.}

\footnote{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.}


\footnote{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
proposals 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.\textsuperscript{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."\textsuperscript{271} American Telephone and Telegraph Company has opined that "the procedures outlined . . . are sufficient protections for underwriters."\textsuperscript{272} Other commentators, however, have urged the Commission to provide even greater protection to underwriters.\textsuperscript{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. \textit{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.\textsuperscript{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.

\textsuperscript{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.


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.
discharge its obligation to the investing public.\textsuperscript{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,\textsuperscript{280} whose disclosure practices characteristically may be self-serving,\textsuperscript{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.\textsuperscript{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:

\textsuperscript{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).

\textsuperscript{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.

\textsuperscript{281} F. Supp. at 697.

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 markets284 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 inquiry290 and that the principal or managing underwriter certify that an adequate

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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.
286 Id.
287 Id. at 16,013.
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
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." 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." Smith, Barney & Co. wrote that "[e]stablishment of written procedures will open a Pandora's Box to the detriment" of underwriters.

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. 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

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.


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.


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.\textsuperscript{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,\textsuperscript{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.\textsuperscript{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-

\textsuperscript{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-77-5 (Form 19b-4B filed with the SEC).

\textsuperscript{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 . . . ." \textit{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.

\textsuperscript{305} The possibility of judicial deference springs from the \textit{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.
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.\footnote{Comment letter, supra note 294, at 1.}

This also seems to be the position of the court in \textit{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."\footnote{283 F. Supp. at 697.}

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. \textit{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.\footnote{ADVISORY COMM. REP., supra note 175, at 454-55.} 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.\footnote{Id. at 454.}

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.\footnote{ALI FEDERAL SECURITIES CODE (1980).} Section 1704 of the official draft Code is basically comparable to section 11 of the Securities Act.\footnote{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.}

\begin{align}
\text{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}
\end{align}
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 under-
writing 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 refer-
ence, 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 credi-
bility of the offering statement.\(^{315}\)

During the course of its extensive consideration of the draft Code, the Com-
mission proposed a number of amendments to the official draft adopted by the
American Law Institute in 1978. With respect to the reasonableness of under-
writers' conduct, the Commission concluded that the phrase "and the accessibil-
ity 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 de-
fendant as an underwriter" in the same clause adequately recognized the junior
role of nonmanaging underwriters without inviting undue dilution of their re-
sponsibilities. 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 circum-
stance of incorporation by reference, while at the same time not relieving under-
writers of their basic duty to investigate all information contained in the
registration statement. This approach thus retains the threat of liability for neg-
ligence 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 flex-
ibility 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.
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? 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.

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 Smokey 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, 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. 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.

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. 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.

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.

See text accompanying notes 185-86 & 250 supra.

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.

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.\textsuperscript{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\textsuperscript{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.

\textsuperscript{323} These proposals are described in the text accompanying notes 264-70 supra.

\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.\textsuperscript{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.

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

\textsuperscript{326} SEC REPORT, supra note 283, at 493.

\textsuperscript{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.

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