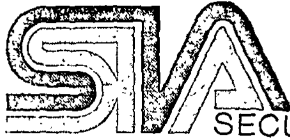

SECURITIES INDUSTRY ASSOCIATION
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April 1, 1985

CHAIRMAN'S OFFICE
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SEC. & EXCH. COMM.

Mr. John P. Wheeler, III
Secretary
Securities and Exchange Commission
450 Fifth Street, N.W., Stop 6-9
Washington, DC 20549

Dear Mr. Wheeler:

The Federal Regulation, Syndicate and Corporate Finance Committees (the "Committees") of the Securities Industry Association ("SIA")[1/] hereby petition the Commission, pursuant to Rule 4(a) of the Commission's Rules of Practice, to shorten the 90-day prospectus delivery requirement for newly issued securities currently

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1/ The Securities Industry Association is the trade association representing over 500 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types--investment banks, brokers, dealers, and mutual fund companies as well as specialists and other firms functioning on the floors of exchanges. SIA members are active in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

prescribed by the Securities Act of 1933 (the "1933 Act").[2/] The Committees' proposal entails amending Rule 174 under the 1933 Act for the purpose of reducing to 25 calendar days the prospectus delivery requirement for dealers following initial public offerings of all securities that are quoted in the NASDAQ system or are listed on a national securities exchange.

I. Background

At present, the 1933 Act and Rule 174 require all dealers to deliver a statutory prospectus in connection with any transaction in a newly issued security which takes place in the 90 days following the later of the effective date of the registration statement or the first *bona fide* offering.[3/] As a consequence of this regulatory

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2/ The Commission has explicit statutory authority to shorten the 90 day period. *See* note 3 *infra* and textual discussion on pages 4 to 8 of this letter concerning the legislative and administrative background of the quiet period.

3/ Section 4(3) of the 1933 Act exempts from Section 5 "transactions by a dealer (including an underwriter no longer acting as an underwriter in respect of the security involved in such transaction), except

> (A) transactions taking place prior to the expiration of 40 days after the first date upon which the security was *bona fide* offered to the public by the issuer or by or through an underwriter,
>
> (B) transactions in a security as to which a registration statement has been filed taking place prior to the expiration of 40 days after the effective date of such registration statement or prior to the expiration of 40 days after the first date upon which the security was *bona fide* offered to the public by the issuer or by or through an underwriter after such effective date, whichever is later (excluding in the computation of such 40 days any time during which a stop order issued under section 8 is in effect as to the security), or such shorter period as the Commission may specify by rules

(Footnote continued on next page)

scheme, a broker-dealer may not, as a practical matter, issue research reports containing earnings projections, opinions or recommendations regarding the issuer of a newly issued security during the 90-day period. Such reports would in all likelihood be deemed to be prospectuses within the meaning of Section 2(10) of the 1933 Act, but would not normally meet the statutory requirements for prospectuses. Research reports are frequently distributed to persons who have not bought in the initial distribution (and therefore do not already have a statutory prospectus), and it would be impractical for each research report to be delivered simultaneously with, or preceded by, a prospectus meeting the requirements of the 1933 Act. Therefore, distributions of research reports would violate the 1933 Act.

Both the philosophy of the securities laws as a whole and the efficient capital market theory favor the circulation of current information with regard to an issuer. The distribution of information by the issuer and by broker-dealers that follow the issuer improves investment decisions of public investors. For

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(Footnote continued from previous page)
and regulations or order, and

(C) transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter.

With respect to transactions referred to in clause (B), if securities of the issuer have not previously been sold pursuant to an earlier effective registration statement the applicable period, instead of 40 days, shall be 90 days, or such shorter period as the Commission may specify by rules and regulations or order."

example, investors rely on broker-dealers to disseminate and analyze press releases, published earnings statements, quarterly reports filed under the Securities Exchange Act of 1934 (the "1934 Act") and other relevant information. The prospectus delivery requirement effectively prevents for 90 days such dissemination and analysis of information by dealers.

Similarly, the 90-day quiet period prevents dissemination of information by issuers. For example, release of information regarding new contracts or orders received could well be deemed a prospectus by cautious issuer's counsel; comments on the beneficial results of such a contract or order might also be considered a prospectus by counsel. The inability of issuers to distribute current releases with regard to activities results in their increased desire that broker-dealers carry on that function, which, as described above, they are prohibited from doing.

II. Legislative and Administrative History of Quiet Period

The original architects of the 1933 Act were "in the main, concerned with the problem of distribution as distinguished from trading".[4/] They therefore exempted from Section 5 "all transactions except by an issuer, underwriter or dealer".[5/] They also exempted in Section 4(1) transactions by a dealer (including an underwriter no longer acting as an underwriter with respect to the security involved), except transactions by a dealer as a participant in the distribution or by any dealer "within one year after the last

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4/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933).

5/ *Id.*

date upon which the security was bona fide offered to the public."[6] One year was "arbitrarily" selected as marking the line between distribution and trading on the ground that "the average public offering [was] distributed within a year, and the imposition of requirements upon the dealer so far as that year [was] concerned [was] not burdensome".[7] The one-year requirement was believed to be necessary to prevent dealers participating in the distribution from evading the provisions of the 1933 Act by falsely claiming that the securities they were offering for sale were acquired after the disposition of their allotment or subscription.[8]

Eight years after adoption of the 1933 Act, the Commission expressed its willingness to eliminate the one-year period during which all dealers were subject to the prospectus provisions upon condition that Congress enact a more stringent rule with respect to sales during the initial distribution (the rule would require that a purchaser have a prospectus 24 hours prior to agreeing to purchase).[9] The war interrupted discussion of the 1941 proposals. In 1947 a new and tentative Commission proposal reduced the one-year period to three months.[10]

The amendment of Section 4(1) that was actually adopted in 1954 reduced the one-year period to 40 days. The House committee

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6/ Section 4(1).

7/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 16 (1933).

8/ Id.

9/ 1 L. Loss, Securities Regulation 200, 256 (2d ed. 1961).

10/ Id. at 256.

report described the unworkability of the one-year rule:

> The 1-year provision with respect to trading transactions has long been recognized as unrealistic. Moreover, dealers trading in a security publicly offered within 1 year find themselves unable to obtain prospectuses. This fact has rendered compliance by dealers and enforcement by the Commission difficult.[11/]

Apart from the reduction of the one-year period, no substantive change in the dealers' exemption was effected at that time.[12/]

In 1964 the dealers' exemption was again amended. Two substantive changes resulted from the 1964 amendment. First, the 40-day period was extended to 90 days for transactions in the securities of an issuer which had not previously sold securities pursuant to an effective registration statement.[13/] Second, the amendment gave the Commission the authority to shorten the 40-day and 90-day periods by regulations and rules or order.[14/] The dealers' exemption, which was renumbered Section 4(3), remains today as amended in 1964.

The extension of the period during which all dealers in the securities of new issuers are subject to prospectus delivery

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11/ H.R. Rep. No. 1542, 83d Cong., 2d Sess. 14 (1954).

12/ The exemption was reworded in order to subject all dealers to the prospectus provision for 40 days after the effective date or initial offering date, whichever occurred later, or after the first *bona fide* offering to the public without a filing. The latter clause was inserted to permit lawful trading to begin in securities that had been illegally offered to the public without registration. 1 L. Loss, *supra*, at 257.

13/ 4 L. Loss, *Securities Regulation* 2328 (Supp. ed. 1969).

14/ *Id*.

requirements was a reaction to the "hot issues" problem. As described in the Commission's Special Study of the Securities Markets,[15/] offerings by companies during the years 1959-61 which had not previously offered securities to the public reached the highest level in history. A voracious public demand for certain of these new "hot issues" led to rapid rises in the prices of such securities to premiums over the initial offering prices. In this regard, the Special Study concluded that:

> * * * persons who bought in the after-market often were less sophisticated and more susceptible to the allure of publicity and rumor about 'hot issues.' These persons, who frequently purchased at premium prices, probably needed the benefits of the information contained in the prospectus more than the original distributees. Yet in many cases they never received a prospectus as required during the first 40 days of the offering.[16/]

The Commission noted that the prospectus delivery requirement was more important in offerings by new issuers, about which there was no "reservoir of existing information," than in offerings by seasoned issuers subject to periodic reporting requirements.[17/] It therefore recommended the extension of the requirement for issues by newly registered companies.[18/] This recommendation was accepted by Congress.[19/]

15/ Report of the Special Study of the Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

16/ *Id*. Pt. 1 at 556.

17/ *Id*. at 550.

18/ *Id*. at 558.

19/ *See* Senate Rep. No. 379, 88th Cong., 1st Sess. 28 (1963).

The Commission exercised its rule-making authority under Section 4(3) by adopting Rule 174 in 1964.[20/] Subject to the dealer's overriding obligation to deliver a prospectus while acting as underwriter or disposing of an unsold allotment, the rule as originally adopted shortened or eliminated the prospectus delivery period in several circumstances. First, the period was fixed at 40 days if the issuer had a security listed and registered on an exchange pursuant to the 1934 Act. Second, for shelf registrations no new period applied following the first *bona fide* offering. Finally, the statutory period was waived altogether when certain registration statement forms were used. The Commission commented in adopting the rule that "[o]ther suitable relaxations of the dealers' exemption in Section 4(3) will doubtless become apparent as the Commission and the financial community gain experience under the amended requirements of the Securities Act."[21/]

In 1970, the Commission amended Rule 174 to eliminate the statutory period for transactions in the securities of issuers required to file reports under the 1934 Act.[22/] As a result of the 1970 amendment, the only prospectus delivery requirement that remains for dealers not engaging in the distribution is the 90-day period following initial public offerings.

III. Discussion of Rule Proposal

The principal justification for the 90 day period following initial public offerings -- the need to protect investors in a

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20/ Securities Act Release No. 4749 (December 23, 1964).

21/ *Id.* at 3.

22/ Securities Act Release No. 5101 (November 19, 1970).

disorderly and thinly traded market -- no longer exists for NASDAQ securities.[23/] Whereas the over-the-counter market was characterized in 1963 by delays in the execution and reporting of transactions and a cumbersome system (i.e., the "pink sheets") that provided stale quotations and did not ensure public exposure of timely market and corporate information, the NASDAQ system (now the principal quotation medium for actively traded over-the-counter securities) provides for the dissemination of real-time competitive quotations for all securities quoted in the system. In addition, NASDAQ's filing and disclosure requirements are intended to assure that information about a NASDAQ issuer is available to the marketplace and is updated on a timely and continuous basis.[24/] Continuously updated information relating to freely traded securities, combined with a prospectus widely disseminated upon initial distribution of securities, creates a "reservoir of existing information" pertaining to new issuers at the level of available information pertaining to seasoned issuers. Thus, changes in the market environment produced by NASDAQ have outmoded a

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23/ Although most new issues are traded in the over-the-counter market, newly issued securities are being listed on national securities exchanges with increasingly greater frequency. The requirements imposed by Section 12(b) of the 1934 Act for registration of securities on an exchange are extremely comprehensive and more than adequately assure the dissemination of timely and material information to public investors. Newly issued securities that are traded on a national securities exchange have therefore been included in the Committees' proposal.

24/ A good comparison between NASDAQ and the pink sheets can be found in the Commission's recent release adopting amendments to Rule 15c2-11 under the 1934 Act. See Securities Exchange Act Release No. 21470 (November 8, 1984).

distinction between new and seasoned issuers that was designed to address the Commission's concerns in 1963.

Efficient capital market theory also argues for the reduction of the 90-day period. The theory, which has been supported by a wealth of empirical evidence and upon which the Commission's integrated disclosure system and 1933 Act Rule 415 are based, indicates that all available information about a company's financial prospects is fully and virtually instantaneously incorporated into the market price of the company's securities. Supply and demand equilibrate the price of traded securities until such price reflects all available information.

The implication of the theory is that prior to the existence of a marketplace for the securities, investors require the kind of direct protection afforded by a prospectus delivery requirement. Investors' only source for the information included in the prospectus is very likely the prospectus itself. Thus, the prospectus delivery requirement which applies to underwriters and dealers participating in the distribution serves an important function. However, once dissemination of the prospectus has created a reservoir of available information, and trading (which equilibrates the market price of the security) has commenced, no real benefit results from a prospectus delivery requirement. All the information contained in the prospectus is already reflected in the security's market price.

The express policy of the 1933 Act is to encourage the dissemination of information to aid the public in making investment decisions. Efficient capital market theory is in accord with such policy. The 90-day quiet period, as it applies to actively traded

securities of new issuers, circumscribes, rather than encourages, the dissemination of information about an issuer. Amendment of Rule 174 to reduce the 90-day period, at least as to some new issuers, would carry out the purposes of the 1933 Act and promote greater efficiency in the securities markets.

Accordingly, the Committees propose to amend Rule 174 by shortening to 25 calendar days the prospectus delivery requirement for newly issued securities that are quoted in NASDAQ or traded on a national securities exchange.[25/] Although the number we have chosen is admittedly arbitrary, it assures the dissemination of a statutory prospectus (and thus a reservoir of existing public information) for an adequate period of time. On the other hand, a 25 calendar day period is a substantial reduction from the present 90-day quiet period and allows dealers to disseminate material supplementary information in a more timely manner.[26/] Moreover, a 25 calendar day period minimizes the possibility that some broker-dealers might deliberately make materially false and misleading statements in research reports concerning newly issued securities for the purpose of facilitating the sale of such securities to the public.

25/ Our proposal does not alter the dealer's overriding obligation to deliver a prospectus while acting as an underwriter or disposing of an unsold allotment.

26/ In the Committees' view, once a broker-dealer has ceased to be an underwriter and has sold its entire allotment in the initial distribution, and the 25-day delivery period has elapsed, there is no longer an obligation on the dealer's part to sticker the prospectus used in the initial offering if a research report it distributes contains information that was not contained in the prospectus or is materially different from what was contained in the prospectus.

IV. Text of Rule Proposal

In accordance with the foregoing discussion, the Committees propose that the Commission amend Rule 174 by adding a new subsection (d) and redesignating present paragraphs (d) and (e) as paragraphs (e) and (f), respectively. New subsection (d) would read as follows:

> (d) Where securities of an issuer have not previously been sold pursuant to an earlier effective registration statement, and such securities are listed on a national securities exchange or quoted in an electronic inter-dealer quotation system sponsored and governed by the rules of a registered securities association, a prospectus must be delivered prior to the expiration of 25 calendar days after the registration statement by which the securities are being sold has been declared effective.

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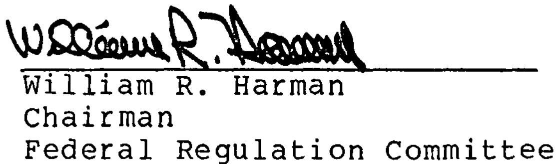
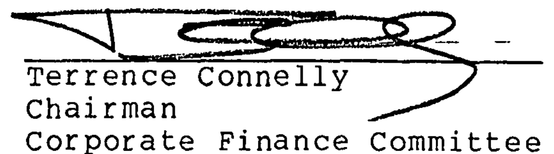
Representatives of our respective Committees are available to discuss this submission with members of the Commission or its staff.

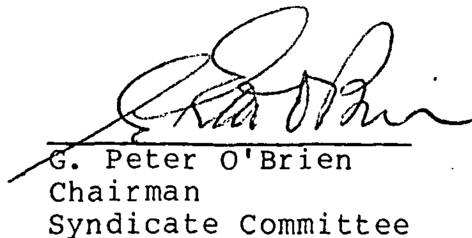
Respectfully submitted,



William R. Harman
Chairman
Federal Regulation Committee



Terrence Connelly
Chairman
Corporate Finance Committee



G. Peter O'Brien
Chairman
Syndicate Committee

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