Mr. Jonathan G. Katz, Secretary
Securities and Exchange Commission
450 Fifth Street, N.W.
Stop 6-9
Washington D.C. 20549

May 13, 2005

Re: <u>Securities Offering Reform (File No. S7-38-04)</u>

Dear Mr. Katz:

I am submitting this letter in response to the invitation of the Securities and Exchange Commission (the "Commission") to comment on the proposed Securities Offering Reform (the "Proposal").[1] I apologize for submitting this letter after the end of the comment period. I nonetheless hope that the Commission will consider my views.

I am writing on my own behalf as a concerned citizen, small investor, and student of the law. I do not represent any association or client; my concern is with striking a fair balance between the interests of sellers of securities and those of smaller investors.

I. OVERVIEW

This comment addresses how the Proposal might affect litigation pursued under Section 12(a)(2).[2] More specifically, this comment focuses on proposed Rule 159. According to Rule 159, information conveyed to the purchaser after the time of sale will not be taken into account for purposes of determining whether, under Section 12(a)(2), a prospectus, oral statement, or a statement, includes an untrue statement of material fact or omits to state a material fact.[3]

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[1] Securities Offering Reform, 69 Fed. Reg. 67392 (proposed Nov. 3, 2004).

[2] Section 12(2) of the Securities Act of 1933 establishes a private right of action against sellers of securities who employed false or misleading statements. The section states, in relevant part, the following:

> Any person who . . . offers or sells a security . . . by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the *purchaser not knowing of such untruth or omission*), and who shall not sustain the burden of proof that he did not know, *and in the exercise of reasonable care could not have known*, of such untruth or omission, shall be liable . . .

Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(a)(2) (2000) (emphasis added to highlight two clauses which are relevant to later sections of this comment).

[3] Rule 159 proposes the following:

> For purposes of Section 12(a)(2) and Section 17(a)(2) only, and without affecting any other rights under those Sections, for purposes of determining at the time of sale (including the time of the contract of sale), whether a prospectus, oral statement, or a statement, includes an untrue statement of material fact or omits to state a material fact

This interpretation appears intuitively sound; however, comments in the docket, as well as other portions of the Proposal, raise a number of concerns over how it might be interpreted, either by the Commission or by the courts. This comment will address four of these concerns.

1. Definition of the term "conveyed"

Should the Commission define the term "conveyed" as used in Rule 159, and if so, how? I recommend that the Commission not define this term. It is better left for the courts to determine whether or not information has been conveyed to a purchaser for purposes of Section 12(a)(2) by using a facts and circumstances analysis.

However, because many well-esteemed organizations have submitted comments requesting that the Commission clarify the meaning of the term conveyed, the Commission may decide to so. In that case, I respectfully urge the Commission to clarify that there is no intention to impose or imply a duty of constructive knowledge on plaintiffs. Such a duty would be inconsistent with prevailing jurisprudence related to Section 12(a)(2).[4]

In spite of the clear and consistent interpretation of the courts on this point, some comments suggest that the "access equals delivery" principle,[5] discussed elsewhere in the Proposal, may be stretched to encompass the quite different notion that access to information, and hence, constructive delivery, supports an inference of knowledge on the part of that investor. This inferential chain, from access, to constructive delivery, to constructive knowledge, would place a duty of constructive knowledge upon plaintiffs pursuing claims under Section 12(a)(2): Their knowledge would be construed to encompass all information to which they have access.[6]

> necessary in order to make the statements, in light of the circumstances under which they were made, not misleading, any information conveyed to the purchaser only after that time of sale will not be taken into account.

Securities Offering Reform, 69 Fed. Reg. 67,392, 67,424 (proposed Nov. 3, 2004).

[4] In general, courts maintain that plaintiffs have no burden of constructive knowledge and have no duty to verify that the information actually delivered to them is accurate, complete, or honest. *See, e.g.*, *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 n.10 (5th Cir. 1990) (stating that the concept of a plaintiff's constructive knowledge has no place in Section 12(2) actions), *overruled on other grounds by Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

[5] In the Securities Offering Reform (the "Proposal"), the Securities and Exchange Commission (the "Commission") proposes a new "access equals delivery model." Under this model, the Commission would deem a final prospectus delivered to an investor as long as it was on file with the Commission by the required date. Securities Offering Reform, 69 Fed. Reg. 67,392, 67,438-39 (proposed Nov. 3, 2004).

[6] The Commission does not draw an explicit link between the access-equals-delivery model and Section 12(a)(2); however, it is apparent from the comments in the docket that a connection comes readily to mind. *See, e.g.*, Letter from the American Securitization Forum to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/asf020405.pdf 48 (Feb. 4, 2005) (proposing that the Commission adopt an access-equals-delivery rule for purposes of determining what information was conveyed to investors under Section 12(a)(2)).

It is doubtful that the Commission intended to suggest that this inferential chain might constitute a plausible defense under Section 12(a)(2); it would obviously be inconsistent with the Commission's stated purpose for proposing Rule 159, which is to protect the rights of investors.[7] Further, a defense based on this inferential chain is unlikely to pass muster in the courts. Therefore, for the sake of all industry participants, it would be helpful for the Commission to disavow any implication that plaintiffs pursuing a claim under Section 12(a)(2) have a duty of constructive knowledge.

2. **Clarification of the "Exercise of Reasonable Care"**

Second, should the Commission offer additional guidance as to what constitutes the "exercise of reasonable care," as the term is used in Section 12(a)(2)? Comments in the docket have made a variety of suggestions related to this question,[8] including requests for the Commission to do the following:

(1) Extend Rule 176[9] to cover Section 12(a)(2);[10]

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[7] In the Proposal, the Commission states that, "[w]e find that our interpretation and believe that our proposed interpretive rule are in furtherance of the objectives of Section 12(a)(2) and Section 17(a) and are necessary for the protection of the rights of investors intended to be provided by those sections." 69 Fed. Reg. 67424 (Nov. 3, 2004).

[8] *See, e.g.*, Letter from Sullivan & Cromwell LLP to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/sullivan013105.pdf 30 (Jan. 31, 2005).

[9] Rule 176 provides a recommendatory, non-exclusive list of relevant circumstances which courts may consider in determining whether or not "the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in Section 11(c) . . ." 17 CFR 230.176 (1982) These include

(a) The type of issuer;
(b) The type of security;
(c) The type of person;
(d) The office held when the person is an officer;
(e) The presence or absence of another relationship to the issuer when the person is a director or proposed director;
(f) Reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the issuer and the filing);
(g) When the person is an underwriter, the type of underwriting arrangement, the role of the particular person as an underwriter and the availability of information with respect to the registrant; and
(h) Whether, with respect to a fact or document incorporated by reference, the particular person had any responsibility for the fact or document at the time of the filing from which it was incorporated.

Id.

[10] For example, the Sullivan & Cromwell LLP comment, referring to the November 13, 1998 Regulation of Securities Offerings proposal ("Aircraft Carrier" proposal) states,

> [t]he Aircraft Carrier proposals would have amended Rule 176 to provide guidance to underwriters and courts about what due diligence practices might be indicative of a "reasonable investigation" under Section 11, and would have extended then existing and proposed guidance of Rule 176 to "reasonable care" under Section 12(a)(2). The Aircraft Carrier release indicated that this was based on the fact that underwriters face substantial time pressure in conducting their due diligence investigations, which would only increase

(2) expand the list of factors in Rule 176 to cover "fast deals;"[11] and

(3) clarify that the duty to exercise reasonable care implied under Section 12(a)(2) is a lower standard than the duty to investigate imposed under Section 11.[12]

In response to these requests, I concur that Rule 176 could be extended to Section 12(a)(2). Rule 176 recommends a nonexclusive list of factors for courts to consider when determining whether or not "the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief . . ."[13] Courts already typically analyze whether or not a defendant has satisfied the Section 12(a)(2) standard of reasonable care through what is often a far ranging facts and circumstances analysis. In substance, this analysis often incorporates factors similar or identical to those suggested by Rule 176. Therefore, extending Rule 176 to Section 12(a)(2) will have little impact on the outcome of Section 12(a)(2) actions. At the same time, if it provides additional clarity for sellers of securities, then such an extension probably would be beneficial.

Further, I would not object to expanding Rule 176 to include a list of factors specifically relevant for fast deals. However, I would respectfully urge the Commission to clarify that the fact that a deal is a fast deal does not lower the requisite standard of reasonable care under Section 12(a)(2). Even implying that a lower standard of care might be countenanced in high-pressure situations will lead to unfortunate results.

Finally, I do not agree that the duty of reasonable care imposed under Section 12(a)(2) is necessarily a lower standard than the duty to investigate imposed under Section 11(b).[14] Circumstances do and will continue to arise in which the exercise of

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> if the Aircraft Carrier proposals providing issuers with greater ability to register and complete offerings more quickly were adopted.
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> We respectfully suggest that the Commission's observations about the opportunity for reasonable due diligence in an expedited offering remain true today and will be even more so upon adoption of the Proposals. Accordingly, we respectfully urge the Commission to address underwriter due diligence by extending the relevant factors under Rule 176 to specifically address "fast deals" and extending the coverage of the rule to "reasonable care" for Section 12(a)(2) purposes.

Letter from Sullivan & Cromwell LLP to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/sullivan013105.pdf 30-31 (Jan. 31, 2005).

[11] *Id.*

[12] *Id.* Further to this point, in the Aircraft Carrier Proposal, the Commission reiterated its view that "Section 11 requires a more diligent investigation than Section 12(a)(2) . . ."

[13] 17 CFR 230.176 (1982).

[14] Section 11(b) of the Securities Act of 1933 allows a non-issuer to avoid liability for materially untrue or incomplete statements made in registration statements if he had,

> after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.

reasonable care under Section 12(a)(2) should provoke an inquiry no less searching than the investigation called for under Section 11.

3. Cross-Liability of Individual Underwriters in Syndicates

What will change, in terms of liability, for individual underwriters in syndicates with the adoption of these new rules involving a free-writing prospectus ("FWP")?

Currently, under the U.S. Supreme Court decision *Pinter v. Dahl* a seller is defined not only as someone who passes title of a security, but also as "[a] person who successfully solicits a purchase of securities, so long as he is motivated at least in part by a desire to serve his own financial interests or those of the securities owner." Given that the Proposal is facilitating and potentially accelerating the ability of sellers to release information, for example, via FWP's, members of syndicates have increase liability exposure based on incomplete or misleading info sent out by other syndicate members. Given that, these companies want to clarify the limits of their cross-liability.

In addition, there has been some confusion over the liability that issuers face for information conveyed to investors.

Therefore, I would ask that the Commission adopt the idea that if an underwriter is in a syndicate, then any FWP that are issued by another member of that syndicate will bring liability for any material mistake of fact contained in that FWP to every member of that syndicate. This presumption can be rebutted by an individual underwriter demonstrating that they did not utilize or incorporate information contained in another syndicate member's FWP, but the burden is on that individual underwriter to demonstrate that they have not utilized that information.

I would also ask the Commission to adopt the idea that sellers are always issuers in terms of FWP that they may convey to investors.

4. Which law should determine the time of formation?

Should federal securities law or state law govern the time of contract formation? The ability to form contract that take advantage of any favorable state law which might exist is an obvious advantage which many securities dealers would want to keep. In addition, having the ability to predict the limits of contract language allows securities dealers to keep prices competive because they have the ability to mitigate any potential unknown liability. However, it is also important to make certain that individual investors can get the protection that they need.

Therefore, I would ask that the Commission to adopt that state law should govern the time for formation.

Securities Act of 1933 § 11(b), 15 USC § 77*k*(b)(3). Section 11(c) defines the applicable standard of reasonableness as "that required of a prudent man in the management of his own property." 15 USC 77*k*(c).

II. IMPETUS BEHIND RULE 159 - A REQUEST FOR CLARIFICATION

Before reaching the substance of the comment, I submit one request for clarification. A number of the comments in the docket ask why the Commission is proposing Rule 159 at this time. These comments, which I take at face value for purposes of this discussion, suggest that the widely-accepted best practice, at least in the asset-backed security ("ABS") industry, is to make contracts for sale of securities either implicitly or explicitly contingent upon the condition of no material change in information subsequent to contract formation.[15] The Commission itself appears to at least acknowledge this practice as well.[16] If, in fact, this practice were widely accepted both in and beyond the ABS industry, it would seem to lessen the need for Rule 159.

On the other hand, if defendants have successfully defended against Section 12(a)(2) actions by relying on corrected information released after the time of contract formation, regardless of whether the plaintiff had actual knowledge that the earlier information was incomplete or inaccurate, and regardless of whether the plaintiff had a chance to rescind or alter the agreement, then the impetus behind Rule 159 would be clear.

However, the Commission has not cited any cases where such a defense was successful, and research has not uncovered any court decision endorsing such a defense. The absence of such specific examples makes it more difficult to predict how Rule 159 might work in practice, and makes commentary somewhat speculative.

Therefore, I respectfully request that the Commission provide examples of cases in which such a defense has been successful. This would allow those concerned with Rule 159 to measure it against the problem it appears designed to resolve. If there are no

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[15] For example, the Bond Market Association states in their comment that,

> [o]ur members' understanding is that, under current law as well as practice, if a security is sold (that is, a contact of sale is entered into) based on Preliminary Information, and if there are Material Changes between the Preliminary Information and the final prospectus, then the investor has the right to break the trade based on the Material Change until the time of settlement. . . . If the investor decides not to break the trade, and to go forward, then a final investment decision, subject to no further conditions subsequent, has been made.

Letter from The Bond Market Association to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/bma013105.pdf 8-9 (Jan. 31, 2005). *See also* Letter from the American Securitization Forum to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/asf020405.pdf 46 (Feb. 4, 2005).

[16] The Commission states that Rule 159

> would not, of course, affect the ability of the seller and the purchaser to consider subsequently provided facts or disclosure and by agreement revise their sale contract and by agreement enter into a new contract for sale with respect to the offered securities. In such a case, for purposes of our interpretation and proposed rule, the time of contract of sale to that purchaser would be the time of the new contract of sale.

Securities Offering Reform, 69 Fed. Reg. 67,392, 67,424 n.247 (proposed Nov. 3, 2004).

examples, then I would respectfully request that the Commission elaborate on why it feels Rule 159 is necessary at this time at all.

III. DEFINITION OF THE TERM "CONVEYED"

A. Issue Statement

Rule 159 provides that, for purposes of determining whether liability should attach for misleading statements or omissions, the Commission will not consider information that has been conveyed to a buyer after the point in time when the buyer decides to make the purchase.[17] Should the Commission define the term "conveyed" for purposes of Rule 159, and if so, how?

It is obviously crucial to understand what constitutes a conveyance of information to a buyer for purposes of Section 12(a)(2) liability. For example, is it to be limited to information of which the buyer has actual knowledge? Does it include information that the buyer has gained actual access to, for example by receiving a prospectus in the mail, or by visiting a webpage on which the information is posted? Does it include that information regardless of whether the buyer reads it? Should the term extend even so far as to encompass all information registered with the Commission or available online at a website, regardless of whether the investor ever actually accessed the information or even knew it existed?

B. The Commission's Current Position Is Not Clear

The Commission's position on the meaning of the term conveyed as used in Rule 159 is not clear. Of concern, however, certain parts of the Proposal indicate that the term might be given broad construction. For example, there is some suggestion in the Proposal that merely making information available,[18] or simply disseminating information "by means reasonably designed to convey such information to investors" might be sufficient to achieve a conveyance.[19]

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[17] The Commission states that,

> evaluation of information prior to the time of sale (including the contract of sale) would not take into account any modifications, corrections, or additions that are made available subsequent to the time of sale (including the contract of sale), including information contained in any final prospectus, prospectus supplement, or Exchange Act filing that is only filed or delivered subsequent to the time of sale (including the contract of sale).

Securities Offering Reform, 69 Fed. Reg. 67,392, 67,424 (proposed Nov. 3, 2004).

[18] As an example of the kind of statement that implies mere availability might suffice, the Commission states:

> We interpret Section 12(a)(2) and Section 17(a)(2) as reflecting a core concept of the Securities Act - that materially accurate and complete information regarding an issuer and the security being sold should be *available* to investors at the time of the contract of sale . . .

Securities Offering Reform, 69 Fed. Reg. 67,392, 67,423 (proposed Nov. 3, 2004) (emphasis added).

[19] The Commission states that information considered to have been "conveyed" to an investor could include

The "access-equals-delivery" discussion related to proposed Rule 172[20] adds to the sense that the Commission may be inclined to endorse a broad construction of the term conveyed. According to the Commission, "under an 'access equals delivery' model, investors are presumed to have access to the Internet, and issuers and intermediaries can satisfy their delivery requirements if the filings or documents are posted on a Web site."[21]

The Commission does not explicitly state that the access-equals-delivery model could be employed in a defense against a Section 12(a)(2) action. However the Commission does indicate some linkage between the two issues by stating that the protection provided to investors by Rule 159 allows the Commission to adopt the access-equals-delivery model for purposes of prospectus delivery.[22]

Gathered together and cast in a particular light, these statements suggest that the following scenario might be possible: A seller could send a prospectus containing misleading or incomplete information to a potential investor. The seller and investor could then contract on the basis of that misleading or incomplete information. Later, the seller could defend against Section 12(a)(2) liability if a truthful or complete version of the information had been posted to a website prior to the formation of the agreement, regardless of whether or not the investor knew of the existence of the information.[23]

> information in the issuer's registration statement and prospectuses for the offering in question, the issuer's Exchange Act reports incorporated by reference therein or information disseminated by means reasonably designed to convey such information to investors. . . . [S]uch information also could include information contained in free writing prospectuses.

Securities Offering Reform, 69 Fed. Reg. 67,392, 67,423-24 (proposed Nov. 3, 2004).

The inclusion of free writing prospectuses opens the door to the wider possibility that an issuer, by releasing information to the financial press, if the release otherwise satisfied the definition of a free writing prospectus, could also satisfy the requirement to "convey" information to the investor. *See* Securities Offering Reform, 69 Fed. Reg. 67,392, 67,409 (proposed Nov. 3, 2004)

[20] *Id*. at 67,438-39.

[21] *Id*. at 67438.

[22] The Commission states the following:

> We have attempted to address the goal of ensuring that investors have materially complete and accurate information at the time of their investment decision through other aspects of our proposal and believe it is also appropriate at this time to modify the prospectus delivery provisions. . . . [W]e believe that [the final prospectus delivery obligations] could be satisfied through a means other than physical delivery.

Id.

[23] Certainly, many comments appear to have taken the Commission's statements in this light. *See e.g.*, Letter from the American Securitization Forum to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/asf020405.pdf 50 (Feb. 4, 2005) (requesting that the access-equals-delivery rule be applied to Rule 159, such that liability under 12(a)(2) could be avoided if corrective information was posted to a website truthful or complete information was published in a free writing prospectus on a website); Letter from the Mortgage Bankers Association of America et al. to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/group021505.pdf 11 (requesting that that Proposed Rule 159 be modified so that there would be no Section 12(a)(2) claim based solely on a material error or omission in the preliminary information delivered at the time of the initial investment

C. **The Weight of Docketed Comments Favors a Broad Construction.**

There is some range of opinion in the docket on how the Commission should define the term conveyed. However, the great majority of the comments submitted by industry associations and leaders would have the Commission construe the term broadly.

The comment of the Bond Market Association is representative of this perspective. Their comment states that the filing of information with the Commission via EDGAR should constitute conveyance to an investor.[24] This would include the issuer's registration statement; any prospectus that the issuer files under Rule 424; any Exchange Act report filed by the issuer and incorporated by reference in the issuer's registration statement; any free writing prospectus of the issuer that has been filed under Rule 433 or for which a notice filing has been made; any information filed on EDGAR that is in any filing pertaining to the issuer, depositor, sponsor, trustee, and any servicer, significant obligor, credit enhancer or derivatives counterparty related to the ABS transaction; and any information not covered under the previous points and filed on EDGAR, where the filing is specifically referred to the investor.[25]

Further, and perhaps of greatest interest, the Bond Market Association suggests that "any information on any website, where the website address is specifically referred to the investor" should be considered to have been conveyed to the investor.[26] There is little doubt that such an approach rests squarely on the notion that access or general availability to an investor equals delivery.[27]

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indication, if . . . the investor had a reasonable opportunity to review the final prospectus prior to settlement).

[24] Letter from The Bond Market Association to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/bma013105.pdf 15-16 (Jan. 31, 2005).

[25] *Id.*

[26] *Id.*

[27] Although far from complete, a sampling of comments suggesting a broad definition of the term conveyed based on the principle of access-equals-delivery would include the following:

(1) Letter from the Commercial Mortgage Securities Association to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/cmsa021405.pdf 19 (undated) (requesting that information conveyed to an investor for purposes of Section 12(a)(2) and Rule 159 include: (i) the issuer's registration statement; (ii) any prospectus that the issuer files under Rule 424; (iii) any Exchange Act report filed by the issuer and incorporated by reference in the issuer's registration statement; (iv) any free writing prospectus of the issuer that has been filed under Rule 433 (or that, in accordance with the final rules, has otherwise been made available to investors); and (v)any information not covered under the foregoing points and filed on EDGAR, where the filing is specifically referred to the investor);

(2) Letter from Citigroup to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/efgreene013105.pdf 9-10 (Jan. 31, 2005) (suggesting a non-exclusive safe harbor for information that will be considered to have been conveyed to an investor under proposed Rule 159A, which would include information provided in a registration statement and any preliminary prospectus or prospectus supplement, Exchange Act reports incorporated by reference, other EDGAR filings, press releases that have been widely and publicly distributed, or some other form of public disclosure reasonably designed to provide broad, non-exclusionary distribution of the information to the public).

(3) Letter from Cleary Gottlieb Steen & Hamilton LLP to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/cleary013105.pdf 18 (Jan. 31, 2005)

Few comments argue against a definition of conveyed that implies access-equals-delivery. The American Association of Retired Persons ("AARP") is one of the few organizations that have taken this stance. Their comment argues that,

> [t]he proposal will shift responsibility away from the broker's obligation to 'push' a prospectus to the purchaser, to an obligation for the investor to 'pull' the information off the Internet. The proposed change marks a major shift from the existing rules that have been designed to further investor education and to better protect investors.[28]

Although this is a minority opinion in the docket, I believe it expresses a valid cautionary note that should guide the Commission in its analysis of the meaning of the term conveyed.

D. Broad Construction of Conveyed Based on Access-Equals-Delivery Implies Duty of Constructive Knowledge

Courts have held that Section 12(a)(2) "preclude[s] recovery whenever a plaintiff actually knows that a representation is false or knows that existing information has been withheld."[29] Courts have further held that under Section 12(a)(2), the burden of pleading and proving lack of actual knowledge rests on the plaintiff.[30]

However, courts have also plainly stated that a plaintiff's actual knowledge should not be confused with a duty on the part of the plaintiff to investigate for fraud; there is no such duty.[31] A purchaser who is actually ignorant that a seller's representation

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(recommending that conveyance includes filings with the Commission, as long as the filing is made prior to the open of business on the date of sale or contract of sale);

(4) Letter from Merrill Lynch to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/merrilllynch013105.pdf 5 (suggesting that all information incorporated by reference into the registration statement or otherwise on file with the Commission prior to the time of sale also would be included).

[28] Letter from the American Association of Retired Persons to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/rgreen8205.htm (Mar. 1, 2005).

Also in contrast to many of the comments, the Bar Association of the City of New York suggests maintaining the current facts and circumstances test to determine when and if information has been "conveyed" to an investor, though the reasoning for their argument is not made explicit. Letter from the Association of the Bar of the City of New York to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/mjholliday021005.pdf 20 (Feb. 10, 2005).

[29] *Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990) (plaintiffs cannot recover if they know of misstatement or omission upon which claim of fraud is based; knowing that misstatement or omission has been has been made is not same as knowing true fact that was misrepresented or omitted), *overruled on other grounds by Gustafson v. Alloyd Co., Inc.*, 513 U.S. 561 (1995).

[30] *Junker v. Crory*, 650 F.2d 1349, 1359 (5th Cir. 1981).

[31] *See Wright v. National Warranty Co.*, 953 F.2d 256, 262 (6th Cir. 1992) (stating that Section 12(2) imposes no requirement on a purchaser to either investigate a seller's possible fraud or verify the accuracy of the seller's statements).

is inaccurate or incomplete may recover even though the full truth is apparent from materials in his or her possession.[32]

While the link has not been made explicit in the comments requesting a broad construction of the term conveyed, it is highly likely that the logic behind these requests is that information considered conveyed to an investor should also be considered known to that investor for purposes of Section 12(a)(2). A broad definition of the term conveyed, based on the argument that access-equals-delivery, would serve to limit seller liability only if we accept the notion that investors have some degree of duty to find, read, and understand all information to which they have access. This, however, would be in conflict with the prevailing notion that an investor has no duty of constructive knowledge under Section 12(a)(2).

E. <u>Policy Analysis</u>

1. Practical Effect of Imposing a Duty of Constructive Knowledge

Imposing a duty of constructive knowledge would make it considerably more difficult for plaintiffs to win under Section 12(a)(2). Defendants would be able to rely on a complete body of information filed in any one of a number of locations, available at one or more websites, or released in free writing prospectuses, that could be construed as having corrected or completed the information actually provided to the investor. This runs strongly counter to the Commission's stated intent behind Rule 159, which is to preserve the protection of the rights of investors as intended by Section 12(a)(2).[33] It further runs strongly counter to the intent of Congress in drafting the Securities Act.[34]

Second, imposing a duty of constructive knowledge on plaintiffs, such that investors would be required to actively investigate all information released by a seller, or allowing liability under 12(a)(2) to be avoided under an access-equals-delivery model, would undermine investor confidence in the capital formation process. In a worst case scenario, less scrupulous sellers of securities might engage in strategic releasing of information such that positive-sounding, though misleading or incomplete, information is delivered directly to prospective buyers, while corrective information is released more quietly via filings with the Commission, on EDGAR, on websites, or through free writing prospectuses.

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[32] *See Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989).

[33] Securities Offering Reform, 69 Fed. Reg. 67,392, 67,424 (proposed Nov. 3, 2004).

[34] *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986) (stating that "the 1933 Act is intended to do more than ensure that defrauded investors will be compensated: the Act also 'aim[s] ... to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation [and] to place adequate and true information before the investor'"), *citing* S. Rep. No. 47, 73d Cong., 1st Sess., 1 (1933).

2. Access-equals-delivery may rest on an overly-optimistic premise.

It is neither reasonable nor desirable to expect an investor to (1) doubt each material statement made by a seller, (2) search for and find all documents related to each material statement made by the seller, (3) analyze each document to find the inconsistency between the new information and the information communicated by the seller, and (4) accurately judge the import of each discrepancy. Yet the access-equals-delivery principle, at least if applied to Section 12(a)(2), seems to anticipate that buyers would do exactly that.

Experience teaches that searching the Internet for accurate and up-to-date information on almost *any* subject can be extremely challenging. The challenge is compounded in a specialized field such as the securities industry, as such research often requires advanced skills. Individuals working in the securities industry or in related areas of the law often acquire these skills. However, outside of these professions, advanced Internet research skills are far less prevalent.

Further, finding relevant information is only part of the challenge: Analyzing and understanding the variety of documents related to a particular securities offering also requires specialized skills. People generally don't acquire these analytical skills unless they are employed in a field that requires them to conduct this type of analysis. Unfortunately, even those with the most advance skills are often misled by the information in securities-related documents.

In light of these considerations, the Commission's statements that 75% of Americans have access to the Internet in their homes, that Internet usage is increasing among all age groups, and that the digital divide is diminishing,[35] may be missing the point. These facts should not be confused with the separate requirement that buyers have the skills necessary to use the Internet to find and evaluate accurate and complete information on a securities offering.

F. <u>Recommendations</u>

Given the possibility for confusion, I respectfully suggest that the Commission refrain from clarifying the definition of the term conveyed as used in Rule 159. The question is better left to the courts to resolve on a case-by-case basis using a facts and circumstances analysis.

However, should the Commission choose to define the term, I respectfully suggest that the Commission make two additional clarifications: First, regardless of the definition of the term conveyed, a plaintiff pressing a Section 12(a)(2) claim still has no duty to investigate the statements made to him or her by the seller. Second, for purposes of Section 12(a)(2), access does not necessarily equal delivery; it will be left to the courts to determine if a plaintiff had actual knowledge of the untruth or omission.

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[35] *See* Securities Offering Reform, 69 Fed. Reg. 67,392, 67438 n.353 (proposed Nov. 3, 2004).

IV. STANDARD OF REASONABLE CARE

A. Issue Statement

A number of the comments in the docket[36] call for clarification of the reasonable care requirement of Section 12(a)(2).[37] The issue is whether or not the Commission should provide this additional guidance, and if so, how.

This comment addresses three of the specific suggestions that have been made:

1. Should Rule 176[38] be extended to apply to Section 12(a)(2)?

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[36] The comment of Merrill Lynch is typical of these requests:

> [W]e ask that the Commission acknowledge that circumstances in the highly competitive financial market place have evolved. The offering process for seasoned issuers has increased dramatically and, in light of the Proposal, will increase even further. At the same time, there is increased competition in the financial market place. The underwriting relationship has transitioned from one based on long-term relationships between issuers and underwriters to transactional investment banking. As the speed of the offering process has increased, the ability of underwriters to act as a gatekeeper in this process has changed in certain cases. In this environment and in light of the potential increase in liability for underwriters presented by the Proposal, we believe financial markets participants would benefit from SEC clarification as to what constitutes "reasonable care" within the meaning of Section 12(a)(2) and "reasonable investigation" within the meaning of Section 11. Among other things, we ask the Commission to provide further guidance as to how issuers and underwriters would satisfy the reasonable care standard as applied to e-mails, press communications and other written communications that are classified as FWPs subject to Section 12(a)(2).")

Letter from Merrill Lynch to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/merrilllynch013105.pdf 5 (Jan. 31, 2005). Similarly, the comment of Sullivan & Cromwell is instructive:

> The Aircraft Carrier proposals would have amended Rule 176 to provide guidance to underwriters and courts about what due diligence practices might be indicative of a "reasonable investigation" under Section 11, and would have extended then existing and proposed guidance of Rule 176 to "reasonable care" under Section 12(a)(2). The Aircraft Carrier release indicated that this was based on the fact that underwriters face substantial time pressure in conducting their due diligence investigations, which would only increase if the Aircraft Carrier proposals providing issuers with greater ability to register and complete offerings more quickly were adopted. We respectfully suggest that the Commission's observations about the opportunity for reasonable due diligence in an expedited offering remain true today and will be even more so upon adoption of the Proposals. Accordingly, we respectfully urge the Commission to address underwriter due diligence by extending the relevant factors under Rule 176 to specifically address "fast deals" and extending the coverage of the rule to "reasonable care" for Section 12(a)(2) purposes.

Letter from Sullivan & Cromwell LLP to the Securities and Exchange Commission, *at* http://www.sec.gov/rules/proposed/s73804/sullivan013105.pdf 30 (Jan. 31, 2005).

[37] Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(a)(2) (2000).

[38] 17 CFR 230.176 (1982)

2. Should the Commission expand Rule 176 include a set of factors for courts to consider when evaluating whether or not the standard of reasonable care has been met in the context of a "fast deal?"

3. Should the Commission reiterate that the duty of reasonable care imposed under 12(a)(2) is a lower standard than the duty to conduct a reasonable investigation imposed under Section 11?

B. Extension of Rule 176 to Section 12(a)(2)

I would not object to the extension of Rule 176 to Section 12(a)(2). Rule 176 provides a non-exclusive list of factors that the Commission recommends that courts consider when determining whether or not "the conduct of a person constitutes a reasonable investigation or a reasonable ground for belief meeting the standard set forth in Section 11(c)."[39] Courts performing a Section 12(a)(2) reasonable care analysis already consider a broad list of factors, often including and exceeding those listed in Rule 176.[40]

In the November 13, 1998 Regulation of Securities Offerings proposal ("Aircraft Carrier" proposal), the Commission made several points which are important to putting Rule 176 in its proper context. First, Rule 176 does not represent an exclusive list of factors that the courts should consider.[41] Second, and in keeping with the first point, courts should continue to analyze all relevant circumstances.[42] Third, Congress intended to make underwriters liable for misleading or incomplete information.[43] Fourth, the

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[39] Securities Act of 1933 § 11(c), 15 USC § 77*k*(c).

[40] Courts already conduct a Rule 176-type analysis to determine whether a defendant has met the 12(a)(2) "reasonable care" standard. For example, in *Davis v. Avco Financial Services, Inc.*, 739 F.2d 1057, 1068 (6th Cir. 1984), the court focused on "(1) the quantum of decisional (planning) and facilitative (promotional) participation, such as designing the deal and contacting and attempting to persuade potential purchasers, (2) access to source data against which the truth or falsity of representations can be tested, (3) relative skill in ferreting out the truth (for example, in this case Avco's manager had comparatively greater skill in evaluating judgments based on subsidiary facts, since he performed a similar function in the process of investigating the creditworthiness of borrowers), (4) pecuniary interest in the completion of the transaction, and (5) the existence of a relationship of trust and confidence between the plaintiff and the alleged 'seller.' *See also*, Sanders v. John Nuveen & Co., 619 F.2d 1222, 1228 (7th Cir.1980) (stating that the exact requirements of the duty of care depend on the nature of the relationship of the seller at issue to the buyer.

[41] The Regulation of Securities Offerings, *at* http://www.sec.gov/rules/proposed/337606a1.txt, paragraph containing citation to note 454 (Nov. 13, 1998) ("Rule 176 identifies circumstances relevant in determining whether a person's conduct satisfies the due diligence standard in Section 11. . . We adopted Rule 176 to provide guidance to courts assessing the reasonableness of an investigation under the integrated disclosure system.").

[42] *Id.*, paragraph following citation to note 460 ("[T]hese practices in no way constitute an exclusive list or serve as a substitute for a court's analysis of all relevant circumstances.").

[43] The Commission observed that,

> Congress recognized that underwriters occupied a unique position that enabled them to discover and compel disclosure of essential facts about the offering. Congress believed that subjecting underwriters to the liability provisions would provide the necessary incentive to ensure their careful investigation of the offering.

Id., section following citation to note 446.

analysis done in the courts recognizes the central role that Congress envisioned for underwriters, and that the Commission agrees with the courts that a rigid rule does not apply.[44]

Assuming that the Commission has not changed its view on these matters, and as long as Rule 176 retains its non-exclusive, recommendatory character, extending it to cover Section 12(a)(2), will, by itself, have little impact on the liability exposure of sellers, or the ability of buyers to recover under Section 12(a)(2). On the positive side, to the extent that it helps focus sellers on at least some of the relevant factors related to reasonable care under Section 12(a)(2), extending it might provide some useful benefit.

C. <u>Expansion of Rule 176 to Cover "Fast Deals"</u>

1. Background: The Aircraft Carrier Proposal

In the 1998 Aircraft Carrier proposal, the Commission proposed to expand Rule 176 by adding six factors which courts could view as positive when assessing whether an underwriter had performed an adequate due diligence investigation in the context of "expedited offerings."[45] A number of comments currently docketed on the Proposal have requested that the Commission implement the expansion of Rule 176.

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[44] The Commission observed:

> As the U.S. Court of Appeals for the Second Circuit noted, '[n]o greater reliance in our self-regulatory system is placed on any single participant in the issuance of securities than upon the underwriter....' Accordingly, courts have found that underwriters must conduct an investigation 'reasonably calculated to reveal all of those facts [that] would be of interest to a reasonably prudent investor.' As the courts have noted, it is impossible to have a rigid rule defining what is a reasonable investigation or how far an underwriter must go in order to verify an issuer's statements.

Id., section following citation to note 451.

[45] The six practices proposed for courts should consider as positive factors in expedited offerings are:

> 1. Whether the underwriter reviewed the registration statement and conducted a reasonable inquiry into any fact or circumstance that would cause a reasonable person to question whether the registration statement contains an untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading;
> 2. Whether the underwriter discussed the information contained in the registration statement with the relevant executive officer(s) of the registrant (including, at a minimum, the chief financial officer ("CFO") or chief accounting officer ("CAO") or his or her designee) and the CFO or CAO (or his or her designee) certified that he or she has examined the registration statement and that to the best of his or her knowledge, it does not contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein not misleading;
> 3. Whether the underwriter received a Statement on Auditing Standards ("SAS") No. 72 comfort letter from the issuer's auditors;
> 4. Whether the underwriter received a favorable opinion from issuer's counsel opining that nothing has come to its attention that has caused it to believe that the registration statement contains an unfair or untrue statement or omits to state a material fact;
> 5. Whether the underwriter employed counsel that, after reviewing the issuer's registration statement, Exchange Act filings and other information, opined that nothing

However, one concern is that sellers could interpret the expansion of Rule 176 factors as an indication by the Commission that the standard of Section 12(a)(2) reasonable care is relaxed if the underwriter is under time pressure. The Commission took evident care to exclude this interpretation when the Commission drafted the Aircraft Carrier proposal. In that proposal, the Commission stated that, when it first promulgated Rule 176 in 1982, it "expressly rejected the consideration of competitive timing and pressures when evaluating the reasonableness of an underwriter's investigation."[46]

Further, in the Aircraft Carrier proposal, the Commission stated,

> [t]he registration system we are proposing, among other things, would allow more reporting issuers to register capital faster and more efficiently. Consequently, underwriters may experience marginal additional timing pressures in conducting their due diligence investigations. Under those circumstances, underwriters must take care not to allow competitive pressures and issuers' demands for speed to lessen their due diligence investigations.[47]

These same wise words apply to any expansion of Rule 176 to cover fast deals.

2. Congressional Intent and Policy Concerns

In the Aircraft Carrier proposal, the Commission went beyond the policy argument discussed above, adding as well an argument based on Congressional intent. The Commission noted that when Congress initially passed the Securities Act in 1933, "Congress was acting on its concern that misleading disclosure and high pressure sales tactics had over-stimulated investors' demand for securities."[48]

It is clear that the time pressure that sellers themselves may feel in an expedited offering is an issue distinct from the employment by sellers of high-pressure sales tactics. However, it is equally clear that the two issues are related: Time pressure on sellers will encourage them to employ high-pressure sales tactics. Further, it is clear that time pressure on sellers makes the release of misleading information more likely than would otherwise be the case. This brings the notion of expedited offerings directly within the scope of the original Congressional concern, and it fully justifies the Commission's

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came to its attention that would lead it to believe that the registration statement contains an untrue statement or omits to state a material fact; and

6. Whether the underwriter employed and consulted a research analyst that:

(i) has followed the issuer or the issuer's industry on an ongoing basis for at least the 6 months immediately before the commencement of the offering; and

(ii) has issued a report on the issuer or its industry within the 12 months immediately before commencement of the offering.

Id., section preceding paragraph containing citation to note 461.

[46] *Id.*, paragraph containing citation to note 456.

[47] *Id.*, section preceding paragraph containing citation to note 461 (emphasis added).

[48] *Id.*, paragraph containing citation to note 445 (emphasis added).

earlier counsel that issuers should maintain a high standard of care under Section 12(a)(2), even in the context of expedited offerings.

On the other hand, making it clear that the standard of care under Section 12(a)(2) will not be relaxed even in the case of an expedited offering will probably result in a "speed bump" in the offering process. I concur with many of the comments that this is unfortunate, and that it works against the general intent of the Proposal, which is to allow firms to leverage technology to expedite offerings.

However, it appears that Congress explicitly intended to locate a speed bump at exactly this point in the issuance process. Further, as a policy matter, buyers should be able to count on receiving accurate and complete information from sellers regardless of the time pressure imposed on the seller. If this forces the issuance process to proceed at a more deliberate pace, it is clearly preferable to the alternative.

3. Recommendation

Therefore, I would not object if the Commission were to extend Rule 176 to Section 12(a)(2), or further expand it with a list of factors for courts to consider in the context of expedited offerings. However, I respectfully suggest that the Commission clarify that these changes would in no way indicate a relaxing of the Section 12(a)(2) reasonable care standard merely because sellers find themselves under time pressure. I further suggest that the Commission reiterate its endorsement of the all-factors analysis currently performed by the courts. The wording originally used in the Aircraft Carrier proposal should suffice.

D. The standard of reasonable care under Section 12(a)(2) is not necessarily a lower standard than the duty to investigate imposed by Section 11.

In the Aircraft Carrier proposal, the Commission stated that "Section 11 requires a more diligent investigation than Section 12(a)(2) . . ." This was not the first time that the Commission expressed this perspective,[49] and some courts have followed that line of

[49] For example, in *John Nuveen & Company., Inc. v. Sanders*, 450 U.S. 1005 (1981) (Powell, J., dissenting from denial of cert.), the dissent argued that the Seventh Circuit had seriously misapplied Section 12(2) by implying that the duty of reasonable care could encompass a duty of reasonable investigation. *Id*. at 1008 - 09. In support of its view, the dissent drew extensively on a brief filed by the Commission with the Court of Appeals, quoting the following section:

> [I]t would be inconsistent with the statutory scheme to apply precisely the same standards to the scope of an underwriter's duty under Section 12(2) as the case law appropriately has applied to underwriters under Section 11. Because of the vital role played by an underwriter in the distribution of securities, and because the registration process is integral and important to the statutory scheme, we are of the view that a higher standard of care should be imposed on those actors who are critical to its proper operations. Since Congress has determined that registration is not necessary in certain defined situations, we believe that it would undermine the Congressional intent--that issuers and other

reasoning.[50] However, this is not in accord with the general consensus among the courts.[51]

Reflecting upon the varying opinions among the courts and upon the Commission's prior statements on the subject, it seems improbable that Congress intended that the Section 12(a)(2) standard of reasonable care necessarily be a lower burden than the Section 11(2) duty to investigate. Attempting to draw that conclusion does not seem helpful either as a matter of statutory interpretation or as a matter of policy.

First, there is nothing in the text of Section 12(a)(2) that would suggest that the standard of reasonable care extends up to but does not encompass a duty to investigate. Section 12(a)(2) simply provides that a defendant may avoid liability if he or she can sustain "the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission . . ."[52]

Second, as noted in *In re Software Toolworks Inc.*, 15 U.S.C. § 77*k*(c) provides that, in determining what constitutes a reasonable investigation for purposes of Section 11, "the standard of reasonableness shall be that required of a prudent man in the management of his own property." There is nothing in that plain language that suggests a statutory conflict would be presented if the reasonable care standard of Section 12(a)(2) should overlap the duty to investigate of Section 11.

Further, from a policy perspective, it seems desirable that if, in an initial exercise of Section 12(a)(2) reasonable care, which nonetheless fell short of a Section 11 reasonable investigation, a seller uncovered troubling information, the seller should be required to inquire further to satisfy the standard of reasonable care. If that further

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> persons should be relieved of registration--if the same degree of investigation were to be required to avoid potential liability whether or not a registration statement is required."

Id.

[50] For example, *In re WorldCom, Inc. Securities Litigation*, 346 F.Supp.2d 628 (S.D.N.Y. 2004), the court stated the following:

> [W]hile Section 11 imposes a duty to conduct a reasonable investigation as to any portion of a registration statement not made on the authority of an expert, Section 12(a)(2) . . . only requires the defendant to show that it used reasonable care. This difference is attributable to the emphasis placed on the importance of registration statements and the underwriter's vital role in assuring their accuracy.

Id. at 663-64 (internal citation to *Nuveen* omitted).

[51] For example, in *In re Software Toolworks Inc.*, 38 F.3d 1078 (9th Cir. 1994), the court stated that the duty of reasonable investigation imposed under Section 11 is "similar, if not identical" to Section 12(2)'s reasonable care standard. *Id.* at 1083. Citing to 15 U.S.C. § 77k(c), the court stated that "[i]n determining whether an underwriter meets the due diligence test under either provision, 'the standard of reasonableness shall be that required of a prudent man in the management of his own property.'" *Id.*

The Seventh Circuit's holding in *Sanders v. John Nuveen & Co., Inc.*,619 F.2d 1222, 1228 (7th Cir. 1980), which prompted Justice Powell's dissent from the Court's subsequent denial of certiorari, provides detailed statutory analysis to justify its conclusion that the difference in statutory language does not imply that the duty of reasonable investigation is a lower standard than the duty to investigate.

[52] Securities Act of 1933 § 12(2), 15 U.S.C. § 77*l*(a)(2) (2000).

inquiry should overlap in form or substance with what would be required under the Section 11 reasonable investigation standard, I see no conflict. As a policy matter, it would seem that a lower expectation would be completely unsatisfactory.

F. Recommendation

Therefore, I recommend that the Commission not reiterate its previous statements to the effect that the standard of reasonable care under Section 12(a)(2) is a lower standard than the duty to investigate imposed by Section 11(c). There is no compelling basis either in the statutes or in policy for such a conclusion.

V. CROSS LIABILITY ISSUES FOR INDIVIDUAL SYNDICATE MEMBERS UTILIZING A FREE-WRITING PROSPECTUSES

A. Issue Statement

What should the Section 12(a)(2) liability be for a member of an underwriting syndicate if another member of that syndicate issues an FWP that includes a material misstatement of fact or an omission?

In addition, what should the liability be for issuers who release an FWP that includes a material misstatement of fact or an omission?

A free-writing prospectus is defined as, "written communication about an issuer or its securities that is published or disseminated by a person unaffiliated with the issuer."[53] And it is further defined as,

> Any written communication that constitutes an offer for registered offering that is used after the registration statement is filed, other than by means of a prospectus satisfying the requirements of Section 10(a) of the Securities Act or that does not fall within the exceptions from the definition o prospectus in clause (a) of Section 2 (a) (10) of the Securities Act because a final prospectus accompanied or preceded the offer.[54]

B. Comments from the Docket

Unsurprisingly, most investment companies and their advocates would like to limit the potential cross-liability of an FWP.[55] For example, Davis Polk & Wardwell advocates,

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[53] Securities Offering Reform, 69 Fed. Reg. 67392 (proposed November 17, 2004) (to be codified at 17 C.F.R pt. 228, 229, et al.).

[54] Proposed Amendment to Rule 405.

[55] Letter from Carlos Morales, Co Chairman, SIA Federal Regulation Committee, Howard Steinberg, Co Chairman, John Faulkner, Chairman, SIA Capital Markets Committee and Co Chairman, SIA `33 Act Reform Task Force, Edward F. Greene, Co Chairman, SIA `33 Act Reform Task Force to the Securities and Exchange Commission *at* http://www.sec.gov/rules/proposed/s73804/cmorales013105.pdf (January 31, 2005) "SIA suggest that Rule 433 state that a person will not be liable under Section 12 (a)(2) in respect of any underwriter free-writing prospectus as to which the person is not a seller, and that a person

> The Commission should provide that the filing of a free-writing prospectus by any offering participant does not create any presumption that any other offering participant, other than the participant that prepared the free writing prospectus used such prospectus to offer or sell securities. We believe that, absent clear evidence of affirmative use, liability should only attach to the offering participant that actually used the free writing prospectus to sell securities.[56]

Most other firms echo this position.[57]

C. Status of the Law

In *Pinter v. Dahl,* the court expanded the definition of the term "seller" beyond meaning a person who conveys title to include, "a broker or other person who successfully solicits a purchase of securities, so long as he is motivated at least in part by a desire to serve his financial interests or those of the securities owner."[58] The court expanded the definition of seller because "of Section 12 (1)'s language and history as well as the statutory purpose of protecting investors."[59]

Based on the Supreme Court's reasoning in *Pinter* it is likely that an individual syndicate member would face liability for an FWP in much the same way they face liability currently. In *In re Westinghouse Securities Litigation,*[60] the court found that a plaintiff did not have to prove that an individual underwriter specifically sold them a security in order for other members of that syndicate to be held liable for losses sustained by the plaintiffs. Building on this the court in *In re Flag Telecom Holding Ltd. Securities Litigation* said, "A party that is not in privity with the plaintiff may still be liable under section 12(a)(2) if he solicited the plaintiff's purchase and was motivated by his own financial interest."[61] In that case, the plaintiffs brought a class action lawsuit against Telecom Holding Group, Ltd., Salmon Smith Barney, Citigroup, Verizon Communications, Inc., and nine individual defendants for violation of securities laws

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will not be deemed a seller for this purpose if the underwriter free-writing prospectus is not delivered or refereed to by the person making offers or sales.

[56] Letter from David Polk & Wardwell to the Securities and Exchange Commission *at* http://www.sec.gov/rules/proposed/s73804/dpw013105.pdf (January 31, 2005).

[57] Letter from Sarah M. Starkweather, Regulatory Counsel, The Bond Market Association *at* http://www.sec.gov/rules/proposed/s73804/bondmarket013105.pdf (January 31,2005), "We request further clarification from the Commission that the use of a fwp by one offering participant does not subject other offering participant that have neither used nor distributed such fwp to liability under 12(a)(2).
Letter from John H. Faulkner, Managing Director, Morgan Stanley to the Securities and Exchange Commission *at* http://www.sec.gov/rules/proposed/s73804/jhfaulkner021505.pdf (February 15, 2005) "that underwriters that do not deliver or refer to a free writing prospectus when making offers or sales are not sellers for purposes of Section 12(a)(2) and therefore do not have any cross liability for free writing prospectuses used by other underwriters."

[58] *Pinter v. Dahl,* 486 U.S. 622, 623, 108 S.Ct. 2063, 2065, 100 L.Ed.2d 658 (1988).

[59] *Id*

[60] *In re Westinghouse Securities Litig.,* 90 F.3d 696, 718 (1996).

[61] *In re Flag Telecom Holding Ltd. Securities Litig.,* 352 F.Supp 429, 454 (2005) *citing Pinter v. Dahl,* 486 U.S. at 647.

based on misleading information in a prospectus.[62] Citigroup attempted to argue that they should not be held liable under Section 12(a)(2) because the plaintiffs had not purchased stock directly from them. Therefore, they were not sellers.[63] The court rejected this argument and held that because Citigroup was an underwriter that sufficient allegations existed to support a claim under Section 12(a)(2).[64]

Putting *Pinter, Westinghouse,* and *Flag Telecom*, together it is clear that courts have moved to expand the definition of a seller (and therefore liability under Section 12(a)(2)) to underwriters, including individual members of underwriting syndicate. Therefore, it would seem contrary to the purpose that Congress espoused when it enacted the Securities and Exchange Act of 1933[65] to allow a plaintiff to recover against a seller for a material mistake of fact or omission contained in a formal prospectus, but not in a less formal FWP.

While the courts have expanded liability in a horizontal manner with *Pinter*, they have not expanded liability vertically up the ladder to include the original issuers of a security. In *Lone Star Ladies Investment Club v. Schlotzsky's* the court held that a buyer could not bring a claim against "a seller's seller."[66] In that case, the plaintiffs brought suit against a sandwich shop franchisor for violation of securities laws. The court held that while *Pinter* had broadened the definition of a seller to encompass the entire selling process, but that *Pinter* only allows for liability from the immediate seller, remote purchasers are precluded from bringing claims "a buyer cannot recover against his seller's seller." [67]Therefore, the plaintiff could only bring claims against the underwriter, not the issuer.

D. Recommendation

I would add my voice to the chorus of people who commend the Commission for seeking additional protections for investors. With that overall purpose in mind, I ask the Commission to adopt the following:

1. The Commission should adopt the presumption that if an underwriter is in a syndicate, then any FWP that is issued by any other member of that syndicate will bring liability for any material mistake of fact or omission to every other member of that syndicate. This presumption can be rebutted if a individual underwriter can demonstrate that they did not utilize or incorporate information contained in another syndicate member's FWP but the burden is on the individual members of the syndicate to demonstrate that they have not utilized that information.

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[62] *Id.* at 434.
[63] *Id.* at 455-56.
[64] *Id.*
[65] "To provide full and fair disclosure of the character of securities sold in interstate commerce and foreign commerce and through the mails and to prevent fraud in the sales therefore." Securities Act of 1933 (Fletcher-Rayburn Securities Act of 1933) 15 U.S.C §77a (1997).
[66] *Lone Star Ladies Inv. Club v. Schlotzsky's,* 238 F.3d 363, 370 (2001).
[67] *Id.*

The Commission should adopt the idea of a rebuttable presumption of liability because it is the only one that balances the need to protect investors with the desire by investment firms to avoid "speed-bumps" in capital formation.

A rebuttable presumption of liability will protect investors because it will decrease litigation costs. It will do so because individual underwriters will be unable to shift blame from one member to another, requiring the harmed investor to unravel a maze of complex financial transactions. Having a blanket presumption that an underwriter is liable will decrease discovery costs, which in turn will decrease litigation cost. A decrease in litigation costs will remove a barrier for a small harmed investor to recover on a legitimate claim.

Initially some large intuitional investors may not consider being held potentially liable to be a positive thing. Many companies and institutions have a rather knee-jerk reaction to liability issues because they view it in terms of short-term potential litigation costs. However, if the Commission creates a bright-line rule, then in the long run companies will be able to predict with greater certainly what their costs will be (both legal and economic), and will be able to allocate risk accordingly.

Therefore creating a rebuttable presumption can create a situation that is win/win for both individual investors, and large investment firms. Therefore, the Commission should adopt it in their final rule

2. The Commission should adopt the standard that issuers should always be considered sellers in terms of FWP liability.

In *Rosenzweig v. Azurix Corp.,* the Fifth Circuit was able to piece together enough law to conclude that the plaintiffs lacked standing to sue under Section 12(a)(2).[68] In that case, the plaintiffs had relied upon the information that the company had been releasing, which turned out to not be particularly accurate, in making their buying decisions.[69] However, because the plaintiffs had purchased their securities from an underwriter, not the company itself, they could not sue under Section 12(a)(2).[70]

The financial world has changed since 1933, and in our global marketplace companies no longer provide information about their business solely to professional stock brokers and then rely on those stock brokers to raise the necessary capital. Instead, today many companies actively solicit investors by issuing press releases and providing investment materials. However, individual investors often lack the legal understanding to know that if they do not buy shares directly from the issuer that they cannot rely on information provided by a company in making their decision.

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[68] *Rosenzweig v. Azurix Corp.,* 332 F.3d 854, 871-72 (2003).
[69] *Rosenweig,* 332 F.3d at 859-60.
[70] *Rosenweig,* 332 F.3d at 872.

Therefore, the Commission should make it clear in its final rule that issuers should always be considered sellers.

VI. CONTRACT FORMATION

A. Issue Statement

Judging from the number of comments currently in the docket, most parties who would be affected by Rule 159 would prefer to have state law determine the time of contract formation, or in the alternative, to have the contract itself determine time of formation. The standard practice of the industry seems to be to have state law determine time of formation. If the Commission were to adopt this standard practice the industry would be able to manage costs and/or risk because the industry would be maintaining the status quo. However, there is a risk that large institutional firms will be able to exert political influence in order to craft legislation in state houses that would further their interests at the expense of smaller investors. While my research has not found a specific example of this type of law; the financial scandals that have surfaced over the last several years have demonstrated the need to be proactive, rather than reactive, in terms of protecting individual investors.

B. Purpose of a Contract

In order to help establish which law would be the most beneficial, it is useful to look at the underlying purposes of a contract. According to the Contract Restament Second § 1 a contract is "a promise or set of promises for which the breech of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty."[71]In addition, historically and philosophically the fundamental concept of contracts is that promises ought to be kept—*pacta sunt servada*.[72] Therefore, the law that should be adopted is the one that will most adequately fulfill the purposes of contacts.

C. Comments in the docket

Most institutions, advocates, and individuals making comments in the docket would like the Commission to adopt the standard that state law should determine the timing of a contract has formed. For example, Sullivan & Cromwell LLP states,

> We believe that proposed Rule 159 must more clearly state how the terms 'time of sale' and 'contract for sale' are to be defined. We suggest that the rule clearly state the those terms are defined by state law and not federal securities law…when, as a matter of state law, the buyer is unconditionally obligated to purchase the offered securities without any right of cancellation based on additional information conveyed.[73]

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[71] Restament of Contracts § 1

[72] "What is so suitable to the good of mankind as to observe those things which parties have agreed upon"

[73] Letter from Sullivan & Cromwell LLP to the Securities and Exchange Commission *at* http://www.sec.gov/rules/proposed/s73804/sullivan013105.pdf (January 31,2005).

Merrill Lynch says, "We ask the Commission to clarify that the determination of the time of sale should be made be reference to state contractual law," but then goes on to say, "The parties should be free to determine when the time of sale occurs….An underwriter and a buyer should be able to agree that there will be a binding contact of the sale upon the buyers subsequent action or inaction."[74]

D. Recommendations

I agree with the majority of those making comments in the docket that state law should govern the time of contract formation. However, I would also echo the statement raised by several other comments that the Commission should clarify exactly what it means by "would not take into account information conveyed only after the time of sale (including the contract of sale)." Additional clarification would help alleviate much of the confusion that seems to be in the docket and allow for additional meaningful comments.

I advocate for state law to govern the time of contract formation not simply because I believe that it will create greater economic efficiency, and reduce costs for institutions. Rather, I believe that the Commission should adopt the standard that state law should govern the time of formation because state law has a greater opportunity to protect individual investors than federal securities law.

Individual investors will be able to gain greater protections under state law than under federal securities law because of the expedited fashion in which a claim can be resolved in state court. On average, it takes 10.7 months to get a final disposition from a federal district judge, and an additional 15.2 months for final resolve from a federal appellate court.[75] In contrast, it takes 7.6 months to get a final disposition from state court judge, and an additional 6.4 months for state appellate court.[76] The ability to get relief quickly is important because protracted litigation is costly, and because of this potential cost many investors may be reluctant to bring a legitimate claim. Therefore, we would recommend that the Commission make clear in its final rule that an individual or organization who is litigating in state court for breech of contact be allowed to pursue their claim in additional to any potential securities claim.

The ability to get relief in a more expedited fashion will protect individual investors because most individual investors have limited resources to allocate to legal representation (especially in comparison to large intuitional firms). If these individual investors believe that they will have to spend significant resources to recover on a claim, they may decide that it is cheap in the long run to not pursue a claim, which would reward unscrupulous securities dealers.

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[74] Letter from Christine Walsh, First Vice President and General Counsel, Global Origination Counsel Group, Merrill Lynch & Co., Inc. to the SEC *at* http://www.sec.gov/rules/proposed/s73804/merrilllynch013105.pdf (January 31, 2005).

[75] Judicial Business of the United States Courts 2002; Table B4 *at* http://www.uscourts.gov/judbus2002/appendices/b04sep02.pdf

[76] Court Statistics Project, State Court Caseload Statistics, 2002 *at* http://www.ncsconline.org/D_Research/csp/2002_Files/2002_SCCS.html

In *Kelly v. McKesson HBOC Inc.,* the court found that a plaintiff could bring an action in state court based on a breech of contract claim.[77] The court in interpreting 15 U.S.C.§77v(a) stated, "The Securities Act of 1933 confers subject matter jurisdiction over federal claims to state courts and allows them to hear what has traditionally been matters considered by the federal courts."[78] However, the court also found that unless a defendant falls into one of the "long-arm" statutes that the court will lack personal jurisdiction.

In addition to providing additional protection for individuals, adopting the standard that state law should determine the time of formation of contracts is potentially beneficial for large institutional investment firms. Most of these firms who have made comments in the docket favor the adoption of state law.[79] This indicates that most firms are either using state law currently, or that they believe that state law will be the most efficient law in order for them to minimize legal costs. If the firms are already utilizing state law, then it is unlikely that implementing this change will result in any sort of speed-bump to capital formation.

VII. CONCLUSION

First, the Commission should not define the term conveyed as used in Rule 159. However, if the Commission does try to clarify the construction of the term, the Commission should also make it understood that the Commission does not intend to impose a burden of constructive knowledge upon plaintiffs pursuing a Section 12(a)(2) action.

Second, with regard to clarifying the standard of reasonable care imposed by Section 12(a)(2), it may be useful for the Commission to extend Rule 176 to encompass that section. It may further be helpful for the Commission to expand Rule 176 with a list of factors that courts may consider as positive in the context of an expedited offering.

However, the Commission should also make clear that the fact that the expansion of Rule 176 with fast deal factors does not in any way imply a lower standard of care in fast deals than would otherwise be the case. Finally, the Commission should not repeat its previous position that Section 11 reasonable investigation is a higher standard than the Section 12 reasonable care.

Third, the Commission should adopt the idea of a rebuttable presumption of liability for individual underwriters in a syndicate for information conveyed in an FWP.

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[77] *Kelly v. McKesson HBOC, Inc.,* 2002 WL 88939 (Del.Super.).
[78] *Kelly v. McKesson HBOC, Inc,* 2002 WL 88939 *18 (Del.Super).
[79] Letter from Christine Walsh, First Vice President and General Counsel, Global Origination Counsel Group, Merrill Lynch & Co., Inc. to the SEC *at* http://www.sec.gov/rules/proposed/s73804/merrilllynch013105.pdf (January 31, 2005); Letter from John H. Faulkner, Managing Director, Morgan Stanley to the Securities and Exchange Commission *at* http://www.sec.gov/rules/proposed/s73804/jhfaulkner021505.pdf (February 15, 2005.

In addition, the Commission should include in their final rule the idea that issuers should always be considered sellers.

Fourth, the Commission should provide additional clarification in its thinking so as to facilitate additional meaningful comments. However, baring additional negative information, the Commission should adopt the standard that state law should govern the time of contract formation.

If I can provide additional information please contact me.

Thank you,

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