Special Report

NASD

Due Diligence Seminars

About the NASD

The NASD is the self-regulatory organization of the securities industry responsible for the regulation of the over-the-counter securities market. The NASD was established under the authority granted by the 1938 Maloney Act amendments to the Securities Exchange Act of 1934. As of July 1, 1981, the NASD membership totaled 3,073 broker-dealers, or approximately 90 percent of all broker-dealers in this country doing business with the public. The Asssociation also operates the NASDAQ System through a subsidiary company, NASDAQ, Inc. The NASDAQ System is a computerized communications system which stores up-to-the-second price quotations from a nationwide network of dealers for over 3,400 over-the-counter securities. Through the facilities of NASDAQ, broker-dealers retailing over-the-counter securities to the public as well as professional traders and investors have immediate access to the quotations of all dealers making markets in securities displayed on the NASDAQ System.

SPECIAL REPORT

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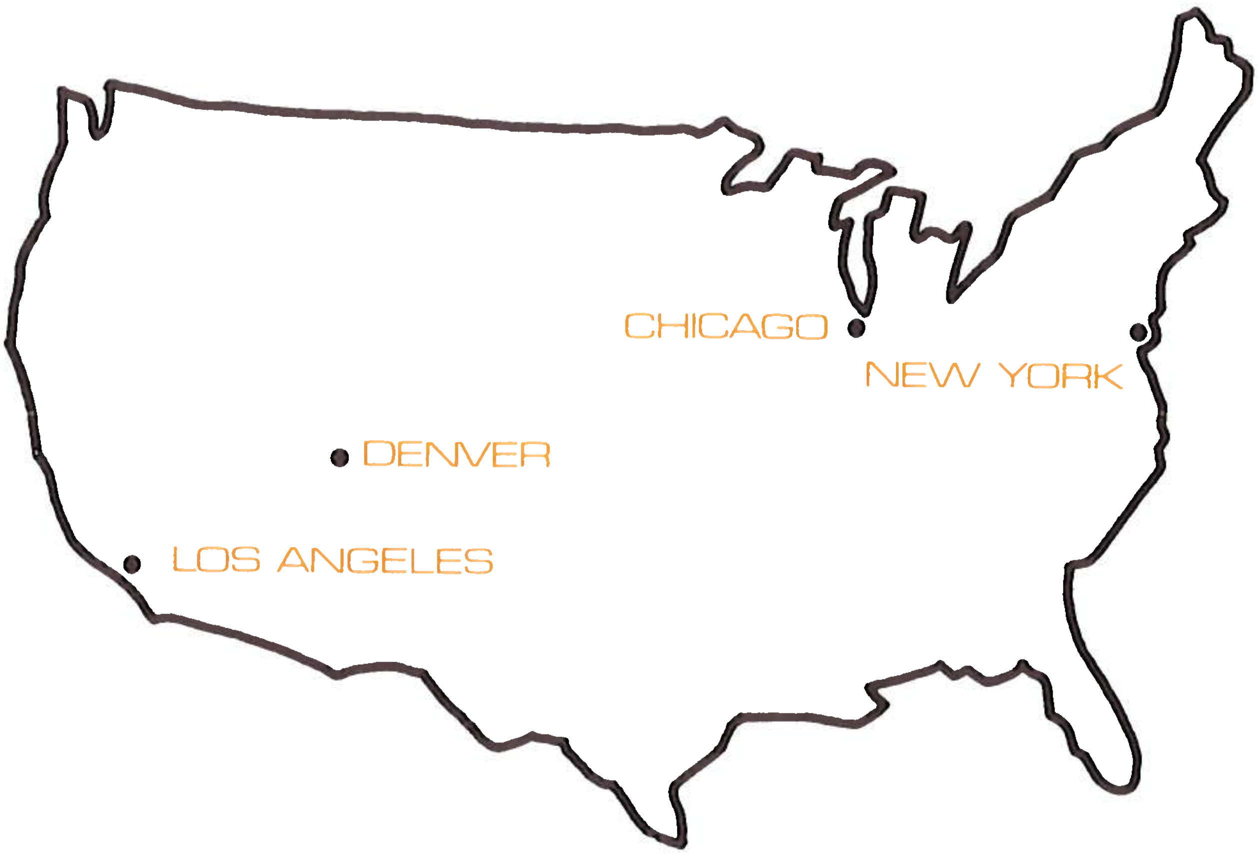

NASD

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

PREFACE

The National Association of Securities Dealers, Inc. ("NASD" or "Association") sponsored a series of seminars during June and July 1980 relating to the responsibilities of broker/dealers in performing due diligence investigations of new issues of securities. The Association presented the seminars as a service to members in response to frequent questions on due diligence. Over 400 persons attended the seminars, which were held in New York, Chicago, Los Angeles and Denver. Leading figures from the securities industry and the securities bar made presentations in each city on legal questions relating to due diligence, practical procedures for underwriters, and special considerations relating to partnerships and private offerings. The remarks of those speakers are presented in this book, along with selected questions and answers. These remarks are being published in the hope of the Association that they may provide valuable guidance to members.

It is important for the reader to bear in mind that the views presented here are those of the seminar speakers and do not necessarily reflect the policy of the Association. The Association does not currently have any rule which affirmatively requires particular steps to be taken in the course of a due diligence investigation. In the final analysis, what constitutes an adequate due diligence investigation is a matter of opinion and varies with each offering.

This book is not intended to contain a definitive statement as to the requirements for a due diligence investigation for any particular type of offering. By its very nature, the type of investigation which a member performs for any offering will vary with the type and size of the offering and the circumstances surrounding the issuer, the underwriter or other broker/dealers, and the offering. Members are strongly urged to contact their own experienced securities counsel in determining the nature of the due diligence investigation which is appropriate for any particular offering. Members and their associated persons are particularly cautioned not to rely exclusively upon investigations performed by issuers or issuers' counsel or affiliates as alleviating the need for an investigation by the member. This is especially true in offerings of limited partnership interests, offerings made pursuant to a private offering exemption, and offerings which claim not to involve the sale of a security.

This book is divided into four sections corresponding to the four major presentations made at each of the seminars. Since several speakers addressed each of the topics in various cities resulting in some inevitable repetition, the remarks of all speakers on each topic have been combined. A particular effort has been made, however, to assure that all major points made by each of the speakers are incorporated in this Report. Each speaker has reviewed and approved the compilation of his or her remarks. A sampling of questions and answers appears at the end of each section.

The Board of Governors of the Association is publishing this Special Report as a service to members, particularly those firms whose business activities include the underwriting of new issues of securities. Through the publication of this report, the NASD's Board hopes to promote an improved understanding of the elements of due diligence and the steps involved in the due diligence process. Copies of this Special Report are being sent to all members. Other interested parties may obtain a copy of the Special Report by writing the NASD, Corporate Financing Department, 1735 K Street, N.W., Washington, D.C. 20006, or by calling (202) 833-7240.


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As an introduction to the subject of due diligence, and before getting into the substantive discussions, let us review some of the background behind these seminars as well as the purpose for which the Association sponsored them. The Association has long sought a way to be of service and assistance to its members in the area of due diligence, but what initially appeared to be a relatively easy problem which could be addressed through normal rulemaking procedures has led to eight years of effort in search of the ultimate answer.

Going back a few years, some regulatory concerns arose about due diligence as a result of the new issue market in the late 1960's. The Securities and Exchange Commission conducted a set of hearings on hot new issues and determined that they should address, among other things, the adequacy of due diligence investigations performed by broker/dealers.

In mid-1972, the Association received a letter from then SEC Chairman William J. Casey, setting forth the Commission's concern. That letter stated in part as follows:

> There is diversity in due diligence practices among underwriters and some disagreement as to which statements in a registration statement must be verified, the extent to which they should be verified and how much verification should be made.
>
> The other problem is that in a minority of cases the due diligence practices of underwriters apparently are inadequate to satisfy the reasonable investigation requirement of Section 11 of the Securities Act.
>
> The Commission believes that these problems make it both necessary and appropriate to establish standards to guide underwriters in making a due diligence investigation.

The Association's initial response to this request was positive. It was thought that it might be possible to provide valuable assistance to NASD members through the development of specific standards for due diligence. The Association proceeded to develop a set of minimum procedures which would have required members to perform at least 15 specific steps in any due diligence investigation. A proposed rule incorporating this requirement was published for industry comment in March of 1973.[1]

The March 1973 proposal generated many comments, most of which raised serious concerns. Commentators noted that a strict interpretation of the Securities Act of 1933 holds that due diligence is only a defense, and not an affirmative obligation. They maintained that minimum standards for due diligence investigations had been established by the courts and that any NASD rule would lead to increased litigation and greater potential liability for underwriters.

Commentators also argued that any specific checklist for due diligence investigations could constitute a trap for underwriters because each offering is different and there can always be one offering which does not require every step to be taken. They argued that an underwriter could be potentially liable, however, for not performing each step. A number of persons suggested that if the Association took any action in the area of due diligence, it should adopt general guidelines, not specific rules.

As a result of these comments, the Association reviewed its proposal, and, in April 1975, produced a new set of proposals.[2] Instead of a rule with specific steps to be followed, the new proposal constituted a guideline which was intended to alert members to their potential liability and highlight certain factors which they might wish to consider in conducting due diligence investigations. The proposed guideline

[1] A copy of that proposal appears as Exhibit A to this book.

[2] A copy of the 1975 proposal appears as Exhibit B to this book.

stated, however, that adequate due diligence was a mandatory obligation of underwriters.

After the guideline was filed with the SEC, additional comments were received raising many of the concerns which had been expressed about the earlier rule proposal. Because of the nature of these comments, the Association withdrew the guideline from the SEC.

It is important to bear in mind, therefore, that the NASD does not now have in effect any rule which specifically requires members to conduct a due diligence investigation. There is a rule proposal relating only to direct participation programs which contains some general due diligence standards for those programs. The possible need for more guidance with respect to members' potential liability in selling private offerings is also under study. There is no present or proposed NASD rule, however, which would affirmatively require that any specific steps be taken in the conduct of a due diligence investigation for publicly sold corporate offerings.

All during the time that the Association has been seeking a means of providing assistance to members in conducting due diligence investigations, a number of requests have been received from members, mostly small to medium-sized firms, asking for guidance as to what constitutes adequate due diligence for particular types of offerings. Without specific rules, the Association has not been in a position to give the type of guidance which might be beneficial. After considerable discussion at the committee and Board of Governors levels, it was decided that the best way for the Association to provide guidance on due diligence was to sponsor a series of seminars.

Thus the purpose of the seminars was to bring nationally-recognized attorneys and industry experts together with NASD members to discuss the legal aspects and practical procedures relevant to the conduct of due diligence investigations. The views presented are those of the seminar speakers and do not necessarily reflect any Association position or policy. The Association is hopeful, however, that this sharing of opinions and information will prove to be of benefit to our members, their attorneys, and all other interested persons.

PART TWO

LEGAL ASPECTS OF DUE DILIGENCE

Bruce A. Mann

Mr. Mann is a partner in the San Francisco law firm of Pillsbury, Madison & Sutro. He received his B.B.A. and LL.B. degrees from the University of Wisconsin. Author of numerous law journal articles on securities law subjects and a frequent participant in Practising Law Institute, ALI-ABA and Law Journal securities law programs, Mr. Mann is Chairman of the Subcommittee on Investment Securities of the Uniform Commercial Code Committee of the ABA Section of Corporation, Banking and Business Law, a member of the Federal Regulation of Securities Committee of that Section and former chairman of the Securities Committee of the ABA Section of Administrative Law. He is an Advisory Board Member for the *BNA's Securities Regulation and Law Report*, the University of California Securities Regulation Institute and The Corporation Law Review.

A. A. Sommer, Jr.

Mr. Sommer is presently a partner of Morgan, Lewis & Bockius, Washington, D.C. From 1973 to 1976 he was a Commissioner of the Securities and Exchange Commission and, prior to that time, practiced in Cleveland, Ohio. He is a graduate of the University of Notre Dame and the Harvard Law School.

He is presently a member of the Advisory Council of the Financial Accounting Standards Board, Chairman of the American Bar Association's Section of Corporation, Banking and Business Law, a trustee of the Financial Analysts Research Foundation, a director of the American Institute of Certified Public Accountants, Chairman of the Notre Dame Law School Advisory Council, Chairman of the University of California, San Diego Securities Regulation Institute, and a member of the American Law Institute, the American Judicature Society, the New York Stock Exchange Legal Advisory Committee and a number of other professional committees and groups. He was formerly a member of the Board of Governors of the National Association of Securities Dealers, Chairman of the Securities and Exchange Commission's Advisory Committee on Corporate Disclosure, Chairman of the American Bar Association Federal Regulation of Securities Committee, and Chairman of the Ohio State Bar Association Corporation Law Committee. He is presently a director of Gould Inc. and Consolidated Natural Gas Company.

He has written extensively and lectured frequently with respect to accounting, corporate and securities matters.

Arthur Fleischer, Jr.

Mr. Fleischer, a member of the New York firm of Fried, Frank, Harris, Shriver & Jacobson, is a graduate of Yale College and Yale Law School. He is a member of the American Bar Association, Section of Corporation, Banking and Business Law, Committee on Federal Regulation of Securities; a former member of the Committee on Corporate Financing, National Association of Securities Dealers, Inc.; a member of the Board of Governors of the American Stock Exchange, Inc.; and Chairman of the Annual Institute on Securities Regulation of the Practising Law Institute.

Mr. Fleischer was a member of the Special Committee on Lawyers Role in Securities Transactions, and former Chairman of the Committee on Securities Regulation, of the Association of the Bar of the City of New York; an Advisor to the Advisory Committee of the Federal Securities Code Project of the American Law Institute; and a member of the Advisory Committee on Corporate Disclosure of the Securities and Exchange Commission.

Mr. Fleischer is the author of *Tender Offers: Defenses, Responses and Planning*. He is also the author of several articles in the securities, corporate and tax fields as well as being the co-editor of the *Annual Institute On Securities Regulation*.

LEGAL ASPECTS OF DUE DILIGENCE:

PROGRAM

The discussions of requirements for due diligence are divided into consideration of legal aspects and practical aspects, with special attention given to partnerships and private offerings. In considering the legal aspects of due diligence, we will study the statutory provisions under which due diligence is conducted and the standards established by such provisions. The "landmark" cases on due diligence will also be analyzed. Practices which many follow to assure compliance with the statutory provisions will be considered. Finally, specific items which one should consider in conducting a due diligence investigation will be outlined.

Statutory Provisions on Due Diligence

Before considering the statutes and case law on due diligence, let us define the type of offering to which those criteria generally apply. Unless otherwise specifically stated, you may assume that the discussion here relates to a public offering of securities registered under the Securities Act of 1933. Although the discussion here will deal to some extent with all parties involved in a public offering, the primary focus will be upon the underwriter.

Let us first examine the legal framework of due diligence and the sections of the 1933 Act from which the concept is derived. There are two types of provisions in the federal securities laws under which violations or liability may be found. First, both the 1933 Act and the Securities Exchange Act of 1934 contain anti-fraud provisions. These are found in Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act.

The anti-fraud provisions do not contain any express concept of due diligence. Under the anti-fraud provisions one generally is not going to be held liable for damages unless he is found to have acted with "scienter." Cases ranging from the *Hochfelder* case[1] through the *Aaron* case,[2] decided by the Supreme Court, support this conclusion. The same is true of injunctive proceedings sought by the SEC under Rule 10b-5, but not under some parts of Section 17. The requirement for a finding of scienter certainly goes beyond the need to prove ordinary negligence. The courts have not specifically passed upon whether the criterion is gross negligence or wanton disregard, but one is probably playing with words when he gets down to the level of precision.

Generally speaking, then, under the anti-fraud rules, if a court is convinced that the defendant has only been negligent, or just incompetent, or not lived up to the highest standards, the court probably will not hold him financially liable. If the court is convinced that he should have done a lot more or that he consciously closed his eyes to what was there to see, the court is likely to find scienter and therefore liability.

The second category of statutory provisions with which we are concerned, those which contain due diligence requirements, are found in Sections 11 and 12 of the 1933 Act.[3] In contrast to the anti-fraud provisions, it is less difficult for a plaintiff to prove liability under Sections 11 and 12. There is no requirement for a finding of scienter under these sections.

Section 11 Liability

Section 11 of the 1933 Act imposes liability upon various classes of persons for any material misrepresentation or omission in a registration statement (which includes the prospectus). Any purchaser of the registered shares, whether in the offering or in the aftermarket, may recover. If a registration statement has become effective and contains an untrue statement of a material fact or fails to state a material fact necessary to make the statement not misleading, any person acquiring a security registered under the registration statement may sue the issuer, its directors, its principal executive and financial officers, certain experts who participate in the preparation of the registration statement, and each underwriter.

Section 11 makes it easier for a purchaser to sue than do some other sections. A plaintiff does not have to prove reliance upon the registration statement or prospectus; he does not have to prove that he even saw it. All that he must prove is that he bought the security that was registered, that the statute of limitations has not run out, and that there was a material misstatement or omission in the registration statement or prospectus. There is no requirement of showing "privity" between the purchaser and defendant or scienter on the part of defendants.

More specifically, Section 11(a) creates liability for the various categories of persons noted above, but provides different defenses for the different categories. Section 11 provides the issuer only very limited defenses. An issuer can avoid liability if the purchaser knew of the untruth or omission. The plaintiff must prove reliance on the registration statement only if he bought the security after the issuer made certain information generally available more than a year after the effectiveness of the registration statement. The issuer can also show that the reduced value of the security claimed by the purchaser was not due to the misstated or omitted fact. However, the issuer is liable for any material misstatement or omission under Section 11(a) without regard to what it did to avoid the material misstatement or omission. In

[1] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1974).

[2] Aaron v. SEC, 446 U.S. 680 (1980).

[3] The text of Sections 11 and 12 are reproduced as Exhibit C to this book.

other words, the issuer has no due diligence defense.

The practical problem for others, of course, is that when problems arise with respect to the registration statement, the issuer may be bankrupt. Plaintiffs' attorneys then begin looking to the second line of persons liable, the officers and directors of the issuer, the experts, and the underwriters.

While those persons are subject to liability under Section 11(a), they are provided varying degrees of protection in Section 11(b) of the 1933 Act. Under that section, underwriters and persons other than the issuer have an affirmative defense if they can prove that they made a reasonable investigation and thereafter had a reasonable basis for believing, and did believe at the time the registration statement became effective, that there were no material misstatements or omissions.

Section 11(b) contains four defenses which turn upon the distinction between "expert" and "nonexpert" statements in the registration statement. "Expertised" portions of a registration statement include financial statements reported upon by independent accountants and geological reports and oil and gas reserve reports prepared by an independent engineer.

For "non-expertised" portions of a registration statement, a defendant must establish that, after a reasonable investigation, he had reasonable grounds to believe and did believe at the time the registration statement became effective that the statements therein were true and that there was no omission of a material fact required to be stated or necessary to make the statements in the registration statement not misleading. That is the essence of due diligence: a reasonable investigation resulting in reasonable grounds to believe and an actual state of mind in which the underwriter does believe that the registration statement was correct.

With respect to the "expertised" portions of the registration statement, the burden on the underwriter (and directors and officers) is less than with respect to "non-expertised" portions. With respect to the "expertised" portions, to escape liability, a defendant (other than the expert in reliance upon whom the expertised portion is included) is not required to have made an investigation but must establish that he had no reasonable grounds to believe and did not believe that there was a material misrepresentation or omission in those portions. If an underwriter believes that there is something wrong with the audited financial statements, for example, he cannot simply remain silent and let the registration statement become effective without incurring potential liability. If he has reason to think that there is something wrong, he should make his concern known.

Experts have no liability on any portion of the registration statement other than those which they have "expertised" and have a defense as to portions which they have "expertised" similar to that available to officers and directors with respect to "non-expertised" portions of the registration statement. They must prove that, after reasonable investigation, they had reasonable grounds to believe and did believe that the statements in the "expertised" portion were true and that there was no material omission. Experts may also escape liability if the portion of the registration statement was not a fair copy of their report. Similar defenses are provided with respect to statements made by an "official person" or statements from official documents.

The notion of "underwriter" under the 1933 Act is broad. It includes any person who has purchased securities from an issuer intending to distribute them or who actually offers or sells them for an issuer in connection with a distribution, and includes everyone who participates in, or facilitates a distribution of securities. It is not restricted just to members of the formal underwriting syndicate, but may include selling shareholders to the extent they appear to have acquired the securities from the issuer with a view to a distribution.

The category of persons who may be subject to liability under Section 11 is rather broad. Section 11(e) of the 1933 Act, however, places a limitation on such liability. Each underwriter's exposure to damages is limited to the aggregate amount of the securities, at the public offering price, which it actually underwrites and distributes, unless the underwriter receives special benefits from the issuer. Furthermore, the total amount recoverable from all defendants in a Section 11 action is limited to the aggregate public offering price of the entire issue. By the terms of Section 11(f), the liability of certain persons, including underwriters, is joint and several and such persons are specifically entitled to contribution from other parties.

Standard of Reasonableness

What standard is applied to determine whether an underwriter made a reasonable investigation and had reasonable grounds for his action? Section 11 of the 1933 Act states in Subsection (c) that:

> In determining . . . what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

This language is rather abstract and there is no "magic formula" to determine reasonableness in a particular case. It is interesting to note, however, that the standard here is not as onerous as, for example, the standard applicable to a fiduciary managing the property of another. It is not the "widow and orphan trustee" standard which is much higher and is tantamount to strict liability for loss in many cases.

The standard of reasonableness under Section 11 is, in a sense, a "standard of the street." In considering whether an underwriter has conducted a reasonable investigation, therefore, one must realize that the standard of reasonableness is not an absolute standard that never changes. Rather, "due diligence" may be construed as a standard that depends to some extent on what constitutes commonly accepted commercial practice. If you can establish that the steps taken meet the standard of the trade as it presently exists, a court should not, in applying the Section 11(c) standard, hold you liable for not being duly diligent despite the fact that you missed something and there was a material omission in the registration statement. What other underwriters are doing and the due diligence standards that are followed on the street are highly relevant in establishing one's defense.

Since the prudent man standard may be construed as a "standard of the street," one is very reluctant to do anything that varies from street practice because that may weight heavily in establishing liability. If every other underwriter uses a particular procedure, anyone who varies from that procedure is inviting trouble.

It is important, then, to be aware of what other people are doing in similar transactions. This does not mean that that is as far as one should go, but if one does not go as far as the standard of the street, he may be exposing himself to potential liability.

Materiality

There is another critical factor which must be dealt with in fully understanding an underwriter's potential liability, and that is the concept of materiality. Section 11 of the 1933 Act provides that a misstatement or omission will result in liability to the underwriter (and other defendants) only if the misstatement or omission is of a *material* fact. What is material depends on the facts and circumstances in each case. While the issuer and its management are often in the best position to determine what is material, underwriters must test their judgement independently.

The concept of materiality has been undergoing change in recent years. Several years ago, most securities attorneys believed that materiality related strictly to financial matters, balance sheet or income statement items, contingent liabilities that would affect the assets or earnings of the corporation. In the post-Watergate era, however, the SEC expanded the concept of materiality beyond financial materiality and included with it matters related to the integrity of management and financial records. That expanded concept of materiality has perhaps particular relevance to proxy statement disclosure in connection with the election of directors, and tender offers, although in some cases it would have relevance in public offerings.

What are some guides to determine the materiality of particular items of information? In a sense, the SEC forms and guidelines set forth the basic standards. Prospectuses of similar companies may contain helpful suggestions as to what others in the industry regard as important. A review of securities firms' research reports or industry and trade periodicals may also be helpful. It is important to remember, however, that each case is different and that materiality depends upon a whole host of circumstances that vary from company to company. There is no "bright line" for determining materiality questions.

Timing of Liability

Let us now consider the question of timing, *i.e.*, the point in time at which one's liability is determined with respect to the contents of a registration statement. By the terms of Section 11, liability attaches at the time when the part of the registration statement in question becomes effective. Due diligence must continue up to that moment.

In the past, there have been instances in which persons performed due diligence up until the point when the registration statement was filed and then did not bother to bring their due diligence down to the date of effectiveness. It is possible for significant events to occur between filing and effectiveness and it is important to be aware of them. Liability does not attach as of the signing of the letter of intent, it does not attach at signing of the underwriting agreement, and it does not attach at the filing of the registration statement; liability attaches at the moment when the registration statement becomes effective.

In bringing due diligence down to the effective date of the registration statement, it is particularly important to assure that representations received from third parties are still valid. You should not assume that a third party is going to come forward and alert you to an event which occurs after you have received verification from the third party but prior to effectiveness of the registration statement.

Recent innovations by the SEC, in adopting Forms S-16 and S-15, have created a problem relating to the time at which liability attaches. Those forms, and other proposed forms, permit registration of offerings with abbreviated disclosure. These forms are predicated upon the assumption that there is sufficient information available in the marketplace on a company as a result of continuous reporting under the 1934 Act so that a lengthy prospectus is not necessary. The forms permit use of a prospectus which simply describes the offering itself and incorporates by reference into the prospectus the last annual report (Form 10-K) and intervening quarterly reports (Form 10-Q) as well as any Form 8-K that has been filed. It is not considered necessary that a person purchasing the securities have available in the prospectus the information filed with the Commission since (1) it is assumed that the market price for the securities reflects the information in the documents, and (2) if an offeree does want to read such filings, they are readily available.

There is likely to continue to be a movement by the SEC toward greater use of incorporation by reference for short-form registrations and simplified prospectuses.

The problem with incorporation by reference results from the fact that the material is not contained in the registration statement and prospectus over which an underwriter and his counsel exercise some control, but is contained in documents that have been prepared by the issuer and in some cases filed many months prior to the offering.

In performing due diligence in such a situation, you should look to incorporated documents, not in light of the facts as they existed at the time of their preparation, but as they exist today. If there are any misstatements or omissions in those documents which are material in the light of the facts as they exist when the registration statement becomes effective, the prospectus should reflect the current facts.

One further point on timing should be noted for an underwriter who becomes such after the registration statement becomes effective. In that case, the accuracy of the registration statement at the time the underwriter becomes such is determinative.

A final subject for consideration as part of this analysis of Section 11 is the different treatment accorded portions of registration statements which are expertised. Although this question was discussed briefly above, it is worth noting which portions of the registration statement may be considered to be expertised. As noted earlier, the standard of care required of an underwriter with respect to statements contained in expertised portions of a registration statement is lower than in the case of other portions.

The lesser standard applies to any portion of a registration statement which is included on the authority of an "expert." Accountants are generally considered to be experts although it is important to note that their expertise for purposes of Section 11 may not include all of the items which you would expect. In particular, courts have held that unaudited financial statements are not expertised for purposes of Section 11 liability. The accountant's certificate states exactly what it is that is expertised. A "comfort letter" at closing may help establish a due diligence defense with respect to non-expertised financial information, but it does not make interim unaudited financial statements into expertised portions of the registration statement.

It is important to bear in mind that lawyers are generally not to be considered experts. In some narrow areas, such as patent or tax matters, you may have protection as to a specific opinion, but the fact that a lawyer has prepared the registration statement does not mean that the entire statement is expertised.

Section 12 Liability

Having studied Section 11 of the 1933 Act, let us now consider the provisions of its companion section, Section 12. Section 12 establishes liability for a person who sells a security through a prospectus "or otherwise" by means of an untrue statement of a material fact or a failure to state a material fact necessary to make the statements made not misleading. Liability under Section 12 extends to both registered and unregistered offerings and applies to representations made in a prospectus or oral communication. Section 12 permits the purchaser to recover whether or not he relied upon the misstatement, although a purchaser may not recover if he knew of the untruth or omission.

Liability under Section 12 has certain limitations. The seller can avoid liability, under the terms of the statute, if he 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. . . .

This section also restricts a purchaser in his suit to the seller from whom he purchased, i.e., Section 12 requires privity between the parties.

The amount of recovery to which a plaintiff is entitled under Section 12 is also limited. If a plaintiff still owns the security in question, he is entitled to rescission of the transaction (that is, he can get his money back with interest, but less any income received) but not damages. If the plaintiff no longer owns the security, he is entitled to money damages.

The due diligence standards under Sections 11 and 12 are arguably at variance in that Section 11 contains a specific reference to a reasonable investigation. In practice, however, the standards may be indistinguishable, and at least one court has so indicated.

An important distinction between Section 11 and Section 12 relates to the time at which liability attaches. As discussed above, liability under Section 11 attaches at the time the registration statement becomes effective. Section 12 liability occurs on the basis of the prospectus delivered or oral statements made at the time of sale, hence liability is determined as of that time. If events occur after effectiveness of the registration statement and prior to sale which make the prospectus deficient in its disclosure, Section 12 liability may occur. It is for that reason that prospectuses are "stickered" and post-effective amendments to the registration statements are filed to correct misstatements or omissions.

In the past, many securities lawyers maintained that it was necessary to both file a post-effective amendment and sticker the prospectus in order to properly disclose a material development occurring after the registration statement became effective. Recently, however, the SEC has taken the position, which has been endorsed by a federal district court, that a post-effective amendment need not be filed unless the issuer has filed an undertaking with the SEC that all changes in the prospectus will be made by post-effective amendment. For purposes of avoiding liability, more securities lawyers have taken the position that all that is required is that a sticker be filed with the SEC correcting the prospectus and that there is no greater protection achieved if a post-effective amendment is filed.

The substantial liability to which underwriters are subjected under the 1933 Act has been discussed. Why did Congress impose these rather heavy burdens on underwriters?

First, in the view of Congress, the underwriter was uniquely able to adopt an objective or even adverse posture toward the issuer regarding the accuracy of the registration statement. The underwriter was in a good position to investigate the truth of matters about the company and had the expertise and resources to do so.

Second, Congress believed that the public relied upon underwriters and that, when a reputable underwriter's name appeared on a prospectus, the public would think more highly of the issue and have confidence in it. Congress was of the view that, since underwriters were going to be relied upon by the public, the underwriters ought to assume a commensurate responsibility.

Between 1933 and 1968, there was relatively little private litigation involving registration statements under the 1933 Act. In 1968, however, a court opinion was issued in what has become the "landmark" case on due diligence. That case merits our close consideration.

The BarChris Case

The case was *Escott v. BarChris Construction Corporation* (283 F.Supp. 643 (S.D. N.Y. 1968)) which is perhaps the most important decision yet rendered under the Securities Act of 1933. *BarChris* held that a prospectus for publicly distributed convertible debentures contained misleading statements and omissions of material facts, and imposed liability upon the directors, the officers who signed the registration statement, underwriters of the issue, and the accountants who certified the financial statements. This case is the "bible" on the subject of due diligence.

The primary business of BarChris, the issuer, was constructing bowling alleys. During the 1950's, public enthusiasm for bowling boomed, resulting in extensive construction of bowling alleys, rising sales and earnings in the industry, and great interest in the securities of bowling-related enterprises. The officers of BarChris, the founders of the company, were men of relatively limited education and limited financial sophistication. With the boom in the bowling industry, BarChris experienced dramatic growth in sales. Needing additional working capital in late 1960 and early 1961, BarChris filed a registration statement with the SEC covering a $3.5 million issue of subordinated convertible, 15 year, five and one-half percent debentures. The effective date of the offering was 1961. The offering was made through a well-known underwriting group.

Beginning at least in early 1961, public enthusiasm for bowling alleys had begun to lag, the industry had been overbuilt, and bowling alley operators began to fail. BarChris itself starting in 1960 was in constant need of cash to finance its operations. At the time of the closing in May 1961, BarChris was experiencing severe difficulties. On October 29, 1962, it filed a petition for a Chapter XI arrangement and on November 1, 1972, defaulted on interest payable on the debentures.

Purchasers of certain of the debentures brought a class action under Section 11 of the 1933 Act alleging misrepresentations and material omissions in the registration statement for the debenture offering. The defendants included eight underwriting firms as well as a director of BarChris who was also a member of the firm that managed the debenture offering.

The district court found various misstatements in the registration statement relating to the company's earnings, contingent liabilities, backlog of orders, customer delinquencies, intended use of proceeds, and other items. As one reads the court's opinion, there is really no doubt that there were indeed material omissions and misstatements. There was a statement, for instance, that a $6.9 million backlog of orders existed. That figure had been correct before cancellations which brought it down to $2.4 million. Some of the purchase contracts included in the sales figures had never been signed. There were obvious errors in the financial statements. Working capital was overstated through the use of a conditional transaction which the court described as bordering on the fraudulent.

There was a misstatement in regard to the use of proceeds. Many of the proceeds were in fact to be used to pay indebtedness rather than for expansion as stated. The description of BarChris' business was deemed to be incorrect because it stated that the company was in the business of constructing bowling alleys, whereas a substantial part of the company's business consisted of operating bowling alleys which it had taken over from customers who were unable to meet their obligations. There was a failure to disclose certain loans to the company from officers, a failure to accurately describe customer delinquencies, and a whole host of other deficiencies.

The BarChris offering was underwritten by a group of eight underwriters. The lead underwriter handled the details of the registration statement on behalf of the participating underwriters. They followed the industry practice of not assisting in the preparation; they relied entirely upon the lead underwriter.

The lead underwriter did conduct an investigation. Several months before the offering, a partner of the lead underwriter was introduced to the company and began familiarizing himself with general conditions in the industry, reading, among other things, reports and prospectuses of the two leading firms in the industry. To obtain information on BarChris, he read an earlier prospectus, annual reports for prior years, and a recent unaudited financial statement. He inquired of certain banks. All of this preliminary investigation was apparently conducted to determine whether the lead underwriter would undertake the contemplated financing.

About the time the lead underwriter had decided to proceed with the financing (some four months before the offering became effective), his partner attended a series of meetings with representatives of the company. He continued his general investigation and met with company counsel and representatives to go over early proofs of the prospectus. The partner inquired as to particular aspects of the prospectus and the proposed financing and obtained answers believed to be satisfactory from representatives of BarChris. The management of BarChris gave generally inaccurate information to the underwriters at these meetings.

Approximately one month before the effective date of the registration statement, the lead underwriter's partner was elected a director of BarChris. After that time, the partner made no further independent investigation as to the accuracy of the prospectus, but instead relied upon his attorney, acting on behalf of the lead underwriter and the participating underwriters.

Counsel for the underwriters conducted an examination of the company. Much of the work, however, was assigned to a junior associate who, in the court's judgement, handled the investigation in an inadequate fashion.

In conducting the investigation, the attorney examined minutes of the board of directors and the executive committee. Some of those minutes had not been typed, however, and the attorney accepted assurances by officers of the company that they pertained only to routine matters. Unfortunately, if those minutes had been examined, they would have revealed some of the difficulties which the company was experiencing, including customer delinquencies and the downtrend in the backlog of orders.

The investigation did not include a detailed review of relevant contracts. Even a cursory examination of major contracts would have shown that some of them were not even signed and that in many instances there were conditions to the obligations of the customers that were not being fulfilled. The number of contracts was relatively limited, and in the court's opinion, the defendants should have been able to look at them carefully.

Counsel to the underwriters made brief inquiries of the company's attorney concerning certain matters, considered minor by underwriters' counsel, identified in the investigation. General assurances relating to these were obtained from BarChris's management and underwriters' counsel did not pursue the matter further.

A large part of the financing of BarChris' activities came from one factor. There had been a good deal of correspondence between BarChris and that factor concerning various adverse developments. In conducting the due diligence investigation, however, counsel to the underwriters did not make inquiry of the factor or examine the financing agreements between BarChris and the factor.

Underwriters' counsel did not look into the composition of BarChris' claimed backlog of contracts. He did not inquire adequately about loans by officers, although there was a pattern of such loans. He was not aware of the seriousness of the company's cash position nor the intended use of a large part of the proceeds. He did not know that BarChris was operating as well as constructing bowling alleys.

In general, the court concluded that there was a failure of the lead underwriter to verify data submitted to it by the issuer.

The court in *BarChris* summarized what the obligation of an underwriter is under the 1933 Act. The court stated as follows:

> The purpose of Section 11 is to protect investors. To that end the underwriters are made responsible for the truth of the prospectus. If they may escape that responsibility by taking at face value representations made to them by the company's management, then the inclusion of underwriters among those liable under Section 11 affords the investors no additional protection. To effectuate the statute's purpose, the phrase "reasonable investigation" must be construed to require more effort on the part of the underwriters than the mere accurate reporting in the prospectus of "date [sic] presented" to them by the company. It should make no difference that this data is elicited by questions addressed to the company officers by the underwriters, or that the underwriters at the time believe that the com-

pany's officers are truthful and reliable. In order to make the underwriters' participation in this enterprise of any value to the investors, the underwriters must make some reasonable attempt to verify the data submitted to them. They may not rely solely on the company's officers or on the company's counsel. A prudent man in the management of his own property would not rely on them. It is impossible to lay down a rigid rule suitable for every case defining the extent to which such verification must go. It is a question of degree, a matter of judgment in each case. In the present case, the underwriters' counsel made almost no attempt to verify management's representations. I hold that that was insufficient. (283 F.Supp. at 697.)

In this case, a good deal of due diligence was conducted by underwriters' counsel. In some cases, it is at least a mitigating factor if a defendant relied in good faith upon the advice of counsel. This is a very dangerous concept and a very limited one, but it can be useful in some circumstances. In this case, however, that notion was totally rejected by the court because the court held that, in effect, counsel to the underwriters was an agent of the underwriters and, as its principal, the underwriters were responsible for whatever insufficiencies occurred.

What were the faults of the underwriters in *BarChris*? The court indicated that they relied upon the company without investigating as much as they reasonably could the truth of statements made. Management's statements should have been examined critically and verified through outside sources.

As noted earlier, officers of BarChris signing the registration statement and the directors were held liable. The accountants also failed to sustain their burden of proof with respect to that part of the registration statement made upon their authority. Of particular relevance, the court noted that the accountants failed to adhere completely to their own checklist for investigations of registration statements.

In contrast to the *BarChris* case, one should consider *Feit v. Leasco Data Processing Equipment Corporation* (332 F.Supp. 544 (E.D. N.Y. 1971)). In that case, the court found a registration statement to be incomplete and in violation of the 1933 Act but held that the dealer-managers (underwriters under Section 11 of the 1933 Act) had met their due diligence burden.

Leasco offered its shares in exchange for those of an insurance company, but the registration statement failed to reveal that the acquired company had available some $100 million "surplus surplus" which Leasco could utilize after gaining control. A former shareholder of the acquired company who exchanged his shares filed a class action alleging material omissions in the registration statement and seeking money damages.

In *Leasco*, the court found that counsel for the dealer-managers had conducted a thorough review of all available financial data, independently examined financial statements and actuarial reports, made inquiries of Leasco's major bank, and studied corporate minutes and major agreements. The dealer-managers were found to have been "particularly careful" in inquiring about "surplus surplus," utilizing one of their associates with extensive experience in dealing with this concept. A series of meetings was held where representatives of the company and the dealer-managers went over proofs of the registration statement in detail.

Even with this type of investigation, the court held that the dealer-managers "just barely" established that they had conducted a reasonable investigation and had reasonable ground to believe that the omission of a specific figure for "surplus surplus" was justified.

Considering *BarChris* and *Leasco*, one can appreciate the high standards to which the courts hold underwriters under the 1933 Act and the importance of conducting a thorough due diligence investigation.

Some General Principles to Follow in Conducting Due Diligence Investigations

The sections of the 1933 Act relating to due diligence and the principal cases interpreting those sections have been examined. Now some principles which can be derived from the statutory language and court opinions will be studied. While this group of principles is not all-inclusive, it includes some of those basic principles which are usually followed by underwriter's counsel in advising clients.

The first is perhaps the most basic principle: perform appropriate due diligence for every offering regardless of whether it is registered or not. A due diligence investigation may not literally be a statutory requirement in some cases, but an underwriter is subjecting himself to serious potential liability if he does not make some reasonable attempt to verify data submitted to him. The underwriter may not blindly rely on the truthfulness of information supplied by the issuer.

Secondly, it is necessary to custom tailor the due diligence investigation performed for each offering. The nature and extent of verification of data which is required will vary with the circumstances of each offering.

In tailoring the scope and content of the due diligence investigation, consideration should be given to the nature of the offering, the SEC form with which the securities are being registered, the size of the issuer, the availability of public information about the company, the issuer's operating and business history, the nature of the legal structure of the issuer (a corporation or limited partnership), the nature of the offering (whether, for instance, it is a "shelf" registration), and the type of security being offered (debt or equity). The underwriter should also consider whether the offering is the issuer's initial public offering. He must analyze potential problems relating to the particular issuer and its industry. The underwriter should determine the competence of the company's inside counsel and the extent to which one can rely on the company's previous filings at the SEC.

The underwriter should exercise great caution in utilizing checklists or guidelines which specify steps to be taken in performing due diligence. There is simply no way to develop a checklist which is appropriate for every offering.

The difficulty which the NASD encountered in trying to develop specific guidelines has been alluded to in the first section of this book. Similar problems exist for individual firms. Checklists are often so general as to be useless or so specific as to be a trap for the unwary which may lead to additional liability.

Notwithstanding their limitations, a checklist can be helpful in preparing for a due diligence review by reminding the underwriter of areas for exploration. Checklists can be helpful training tools and can be structured in a "building block" manner so as to be adaptable to particular fact situations.

Requiring strict adherence to any kind of checklist can produce problems. Perhaps the most serious of these results from a failure to follow the checklist strictly. This translates into evidence that the whole investigation was inadequate. Other problems occur when adherence to the checklist causes the underwriter to ignore important areas. At the other extreme, a checklist can lead to inquiries which are totally irrelevant for the particular situation.

If a checklist is used, it must be borne in mind that it provides no substitute for good judgement. It must be clearly explained that the checklist is illustrative only and that it is not necessary to take all steps in any given case.

The basic SEC registration forms used for offerings can be viewed as checklists, together with related guides and releases. The underwriter should assure that each item in the form is answered.

The next principle is to obtain competent and experienced counsel who is familiar with the concept of due diligence. Underwriters have experienced problems in the past because the attorneys on whom they relied either expressly or impliedly represented that they had competence, ability and experience beyond that which they actually possessed. Also, since issuer's counsel typically furnishes a variety of opinions, it is important for the underwriter to develop confidence in the professional skills of the issuer's counsel.

While it is important to work closely with competent counsel, an underwriter must recognize his responsibility for carrying out his due diligence and should not delegate the entire investigation to counsel. In any case, many attorneys believe that they should not undertake this function. This was one of the reasons for the court's finding fault in the *Bar Chris* case. As a practical matter, there are situations in which a lawyer will not receive the same cooperation, from customers or suppliers for example, which would be accorded to an underwriter. Most importantly, lawyers are not well-suited for making practical business decisions as to likely performance on contracts or probable reaction of customers in pressing economic situations. Indeed, it is the underwriter's business to know the companies which it underwrites.

The underwriter should also have confidence in the auditors for the company. It is not necessary for the issuer's auditors to be one of the "big eight" firms. Many smaller firms have substantial experience in handling SEC matters. It is important, however, for the underwriter to feel comfortable that the auditor is familiar with SEC requirements and that the people working on the account are competent, have a good reputation and have experience in working on registration statements.

The underwriter should work closely with the company's auditors and interrogate them as to their work product. The auditor should be viewed as the principal window through which the underwriter can obtain insight into the company. Auditors are typically candid and forthcoming if asked for information. The underwriter willprobably want to follow what has now become a relatively common practice of securing two "comfort" letters from the auditors, one at the time the registration statement becomes effective and the other at the time of closing.

In reviewing the financial statements, it is important for the underwriter to be very careful of interim figures not covered by the accountant's opinion. The accountants will give "comfort" letters on interim statements but their responsibility as to those numbers is highly attenuated. As to those unaudited numbers, the underwriter has an obligation of reasonable investigation and cannot rely upon those figures to the same extent as audited figures.

The next principle to bear in mind is basic and one which may seem readily obvious. To emphasize its importance, however, we restate it here: the underwriter should have full confidence in the integrity of the management of the company. If the underwriter does not have such confidence, he probably should not even be participating in the transaction. As was made painfully clear in the *BarChris* case, an underwriter who cannot rely on the integrity of the issuer's management may be faced with substantial liability.

Even if the underwriter has confidence in management, he should not take the word of management at face value, no matter how honest the source seems to be. By their nature, businessmen tend to be optimists and in many cases they are the last ones to see the darkening clouds on the horizon. Management with the best of intentions will sometimes be guilty of optimistic exaggeration. Sometimes issuer's management adopts its own definition of "materiality" so that anything which reflects adversely on the company's prospects is automatically deemed to be immaterial. For that reason, an underwriter should be sure to verify the word of company management.

As part of the process of verification, another principle comes into play: be sure that questions directed to officers, directors and other representatives of the issuer are clearly understood. Questionnaires given to officers and directors should be tailored to the particular company and situation. In *BarChris*, officers and directors were asked to complete a quetionnaire which was apparently intended to determine whether there had been any recent loans between the officers and the company. The questionnaire was written in such a manner, however, that the officers and directors apparently did not understand the type of information being sought.

In performing a due diligence investigation, an underwriter should make use of whatever expert or technological assistance is available. Many companies going public are high technology companies and a high degree of sophistication is required if an underwriter is to understand the business of the issuer and the potential dangers which the company may face, both from competition and from advances in technology. Expert assistance may be necessary in such offerings.

The underwriter should identify the "high-risk" areas of the company. The idea here is to identify the aspects of the company's business that are critical, the areas in which difficulty could have a serious impact upon the issuer's overall business. Although the underwriter should not ignore other areas of the issuer's business, by thoroughly investigating the "high-risk" areas, he is providing greater assurance against future problems.

The next guiding principle in the conduct of due diligence investigations is one on which there exist directly opposing views among members of the securities bar. One school of thought holds that it is critical to maintain detailed documentation on the development of the registration statement and the due diligence investigation. Some attorneys believe that, since due diligence must be affirmatively proved, evidence should be maintained to demonstrate the nature of investigation conducted. Such a record would consist of documents showing what meetings were conducted in the course of the investigation and who participated, what tasks were performed, who was interrogated, what information was secured.

In support of this approach, it is noted that lawsuits occur and testimony is taken several years after the relevant events, making it difficult to establish without documentation what transpired. There is turnover in the investment banking business and individuals who perform an investigation may not be available later as witnesses or, if available, may not be particularly interested in the litigation because of other commitments.

The opposite school of thought maintains that any permanent records beyond the registration statement as it became effective (and the usual closing documents) are extraneous and can be misleading and misunderstood in the context of later litigation. The concern here is that notes of various changes in the registration statement and of discussions at meetings will invariably contain questions which remained unanswered or which were answered but never noted. Such documentary evidence may be harmful to an underwriter in litigation. Although some proponents of this theory advise clients to maintain only a statement that due diligence was conducted in the normal manner, others suggest maintaining a record of the time spent in conducting a due diligence investigation, the number of meetings held, the number of people participating in the process, and the number of drafts of the registration statement. These attorneys would also retain a series of proofs of the registration statement as it evolved, without any notations.

In view of the division of opinion among securities attorneys on this point, an underwriter will want to consult his counsel for guidance.

The last principle which underwriters should note relates to time: be sure to bring the due diligence investigation down to the point in time at which the registration statement becomes effective or the prospectus is used. As discussed above, liability attaches at those points in time and it is important to assure that no events have transpired up to those points which should be reflected in the statement or prospectus.

Items to Investigate in Performing Due Diligence

Having studied some guiding principles for due diligence investigations, let us now look at some specific items which may merit scrutiny in conducting a due diligence investigation. As noted earlier, each investigation must be tailored to the particular company and offering. These items should not, therefore, be viewed as all-inclusive and all of these items need not necessarily be reviewed for every offering.

First, an underwriter should learn about the company and its industry. There are a number of sources for this information, including journals, competitors, files which the underwriting firm or counsel may have accumulated, banks, and credit agencies.

For detailed information on the company itself, there should be a review of the issuer's corporate charter, noting particularly the amount of its authorized stock and any restrictions on its activities. It should be determined whether the corporation has perpetual existence. An analysis should be conducted of the stock transfer records. The company's by-laws and corporate minutes, including executive committee minutes, for an appropriate period of time should be reviewed. Similar minutes of any parent or important subsidiary should be reviewed.

A basic examination of the issuer's business should be conducted. This will include a review of the issuer's principal lines of business, its manner of distribution, its sources of supply, its competitive position, its dependence on particular products, customers or suppliers, and its parents and trademarks. In general, such an examination should determine what makes the issuer "tick."

It is critical to formulate an opinion on the company's management. This process should include meetings by the underwriter with key management officials, as well as appropriate marketing and operating personnel. The extent and nature of these meetings will depend upon various factors, including the complexity of the business and the underwriter's past and continuing familiarity with the business. The underwriter may also wish to meet with senior officers' peers in the same industry. The background of each person in management should be considered and the underwriter should reach a determination as to whether each member of management appears to have the qualifications and education to properly perform the job that he or she holds.

A third item for careful review is the company's financial statements. The financials are key; the registration statement is basically an explanation of the financials. The underwriter should carefully review the financial statements to determine the trends indicated. The review should include the audited annual and unaudited quarterly financial statements, including footnotes, for five years commencing with the most recent statement. Underwriters should not limit themselves to these documents, however, but should also look at the issuer's budgets and forecasts and meet with the auditors to discuss the financial statements and to review internal accounting controls. The underwriter should also investigate any change of auditors during the past five years.

The underwriter or his representative should confer with the company's outside counsel and obtain any opinions which may be necessary. An underwriter should examine any opinions carefully to determine exactly the extent of "comfort" which they provide. Pending litigation should be reviewed; again, in the case of important litigation, counsel handling the proceedings could be contacted.

Important company documents, including contracts, leases, mortgages, financing arrangements, contractual arrangements between the company and its management, employment agreements, and stock option plans should all be reviewed. In reviewing contracts, an underwriter may wish to have counsel review the terms of the contract to determine their meaning. The underwriter is better suited to determine the practical impact of the contract, and the likelihood of compliance through conversations with customers, suppliers, and other industry participants.

The relationship of the company to its banks, customers' suppliers, and creditors should be explored. This investigation should focus upon both current and past relationships and usually should include discussions with the parties.

The underwriter should familiarize himself with the company's physical properties. There should be a physical inspection of those major properties or facilities which are important to an investor's understanding of the issuer's business. If you are underwriting General Motors, you probably do not go out and look at every General Motors plant. If you are underwriting a company which has only one plant, however, it would be advisable to visit the plant, to ascertain that it in fact exists, and that the representations made about the adequacy of the equipment are accurate.

In one SEC proceeding, an underwriter was found to have performed inadequate due diligence because, when visiting a plant, he accepted assurances that the non-functioning production line was only temporarily out of order and normally operated efficiently. As a matter of fact, the breakdown was a routine occurrence.

Another important item relates to the proposed use of proceeds. The underwriter should be very careful in determining what is going to happen to the investors' money. Is it really going to be used for the purposes stated? The SEC is very meticulous in requiring an explanation of what is going to happen to investors' money. This question is of course complicated by the fact that dollars are fungible and any particular dollar may be drawn out of the internal workings of a company and not out of the proceeds of an underwriting, but this is nonetheless an important area which deserves careful scrutiny.

In conducting a thorough due diligence investigation, the underwriter should also review an array of other documents. These include all filings with the SEC for the prior five-year period, including all annual and quarterly reports, any periodic reports on Form 8-K, and previous registration statements. Any filings with stock exchanges or the NASDAQ System should also be reviewed. All exhibits to the registration statement should be scrutinized carefully.

The underwriter should review any marketing, engineering, or similar studies conducted for or by the company. The underwriter should also review, directly or through counsel, applicable government regulations.

Prior to completing a due diligence investigation of a technological company, an underwriter may want to consult with experts in any relevant scientific or technological fields if the underwriter believes that it lacks sufficient capabilities to conduct a proper inquiry of its own.

As noted at the outset, each of these specific steps may have greater or lesser importance depending on the particular situation. There may be other steps called for in certain types of offerings. As a practical matter, in the case of a first time to market, promotional company, the effort expended in the due diligence inquiries should be greater than otherwise. All of these steps should be viewed as suggested items for consideration and not as definite requirements with respect to every offering, and the inclusion of an item here would not be seen as constituting an NASD requirement or NASD approval of any particular due diligence procedure.

* * * * *

This concludes the review of legal aspects of due diligence. The underwriter's potential liability in connection with a public offering is clearly established. The standard of reasonableness by which an underwriter's activities will be judged is also generally acknowledged. Each offering is, however, unique and requires the exercise of the underwriter's judgment, particularly in determining what constitutes a reasonable investigation in a given set of circumstances.

Selected Questions and Answers on Legal Aspects of Due Diligence

QUESTION: Much of the discussion of legal aspects presumed that the issuer and issuer's counsel would draft the registration statement. Often, however, the issuer and its counsel are inexperienced in such matters and it may be easier for the underwriter to draft the registration statement. Should the underwriter avoid assuming such a role?

ANSWER: As a practical matter, the registration statement is a description of the issuer's business and financial condition. As a legal matter, the 1933 Act places almost absolute responsibility on the issuer for the truthfulness of the registration statement. The underwriter's obligation is in a sense derivative and contemplates a verification process. It is highly desirable, from both a practical and a legal point of view, that the issuer and its counsel prepare the registration statement. This may require, on occasion, that the issuer retain special counsel with particular expertise in the registration process. It is also desirable that the issuer's regular counsel be involved as an important part of the process. That counsel is typically most familiar with the legal affairs of the issuer and usually has the confidence of the issuer's management. Bringing in of special counsel must be handled with sensitivity. Some firms handle this situation by suggesting that issuer's counsel select the special counsel.

QUESTION: How much reliance can another underwriter place on the due diligence of the managing underwriter?

ANSWER: Members of the underwriting syndicate should be entitled to rely on the due diligence efforts of the managing underwriter. Accordingly, if the manager has met its statutory responsibilities, the participating underwriters will be immune from liability. Similarly, if the managing underwriter has not satisfactorily effected its inquiry, the other underwriters are likely to be liable.

QUESTION: Should a participating underwriter be hesitant to rely on due diligence performed by a managing underwriter affiliated with the issuer?

ANSWER: If the managing underwriter is affiliated with the issuer, the participating underwriter's concern might well be heightened. There is not necessarily any impropriety in such an arrangement, but the nature of the relationship and the close identity of interest between the issuer and the underwriter should stimulate inquiry by any potential participating underwriter.

QUESTION: The Securities and Exchange Commission has taken actions intended to facilitate smaller offerings through the use of simplified registration statements on Form S-18 or under Regulation A. Frequently, however, the "standard of the street" and years of evolving practice lead attorneys to require the inclusion of extensive disclosure even in simplified registration forms. How does one prepare a truly simplified registration document?

ANSWER: There are conflicting regulatory concerns involved in seeking to facilitate capital raising by small business through simplified registration while meeting statutory requirements for investor protection. This conflict must be addressed by both securities attorneys and underwriters. While it is the attorney's job to help the underwriter avoid liability and be aware of risk, in the final analysis, it is the underwriter's decision whether or not to bear those risks. One way of avoiding a Regulation A or S-18 registration document that contains everything that would have been in a Form S-1 is for the underwriter to have an understanding with its attorney that the goal is not necessarily the absolute maximum diligence possible, but a reasonable level of diligence.

PART THREE

PRACTICAL ASPECTS OF DUE DILIGENCE

Peter A. Bernard

Mr. Bernard graduated from Dartmouth College in 1956, then attended Amos Tuck School of Business and received his MBA in 1957. He served in the U.S. Navy from 1957 to 1959 as a Lieutenant Junior Grade. In 1959 he joined the firm of Bache Halsey Stuart Shields Incorporated and is currently their Executive Vice President. He is head of their investment banking and trading group which covers all corporate trading desks, corporate financing and corporate syndicate. He is a former Governor of the National Association of Securities Dealers and is on various committees of the securities industry. He is also presently a member of the New York Stock Exchange Allocation Committee.

Arnold H. Kroll

Mr. Kroll attended Dartmouth College and Harvard Law School and is a member of the New York Bar, although he has never practiced law. His first job was at Lehman Brothers and he left there as a senior associate to join Dean Witter & Company as a First Vice President and stockholder. In 1972, he joined C.E. Unterberg, Towbin Company (the predecessor of L.F. Rothschild, Unterberg, Towbin) as a partner and he remains a partner of L.F.R.U.T. His business experience has been in the corporate finance area. Currently he is a trustee of the Lexington School for the deaf and a trustee of the Hewitt School in New York City.

Craig L. Johnson

Mr. Johnson is a Vice President of Investment Banking for Dean Witter Reynolds Inc. with whom he has been associated for the past eight years. He is active in providing all phases of corporate finance services to the firm's clients in the western states. He holds a M.B.A. degree from Stanford Graduate School of Business and a B.A. from Harvard College.

Lewis M. Weston

Mr. Weston was a General Partner of Goldman, Sachs & Company until 1978. In his 27 years with the firm, he was involved in all aspects of its operations and specialized in underwriting and securities analysis. He has been a Governor of the National Association of Securities Dealers, Chairman of the Association's Corporate Financing Committee, Chairman of the District No. 12 Committee in the New York area and a panelist at NASD Consultation meetings with NASDAQ companies. Mr. Weston has been an Adjunct Professor of Finance at both the Polytechnical Institute of New York and Hofstra University, and has lectured widely on securities matters in the United States and Europe.

Peter J. Eichler

Mr. Eichler received his B.A. Degree from Claremont Men's College in 1950, then worked for one year for the Union Securities Corporation of New York. He served as a First Lieutenant in the Finance Corps in the U.S. Army from 1951 to 1953. In 1953 he joined Bateman Eichler where he became Vice President in 1960 and President and Chief Executive Officer in 1978.

He is a past president of the Los Angeles Bond Club; was a member of the Board of Governors of the Pacific Stock Exchange in 1973-75; Chairman of the NASD Information Committee in 1976; member of the NASD Finance Committee in 1975-76; member of the NASD Board of Governors in 1973-76. He is currently serving as Vice Chairman of California District 10 for the SIA, where he has also served on the Regional Firms Committee, the Executive Committee California Group and as a member of the Board of Directors.

William R. Harman

Mr. Harman is a principal, secretary and general counsel of Morgan, Stanley and Company, Inc. He graduated from Princeton University in 1963 and received his J.D. from the University of Michigan Law School in 1966. He was engaged in private practice with Mudge, Rose, Alexander & Guthrie until 1972, when he joined Morgan, Stanley and Company, Inc.

He is a former member of the NASD Corporate Financing Committee, the Committee on Securities Regulation of the Association of the Bar of the City of New York, the SIA Federal Regulation Committee and the Executive Committee of the SIA Legal and Compliance Division. He has lectured at Yale Law School and New York University Law School, participated in the PLI Annual Institute on Securities Regulation and written an article entitled, "The Evolution of the National Market System — An Overview."

John T. McGuire

After having received a master's degree from Columbia University in International Affairs, Mr. McGuire became associated with the Bank of America in their International Banking division in New York. In 1968, he joined the corporate finance department of Kuhn Loeb & Company. In 1972 he moved to Texas and was associated with Eppler, Guerin & Turner where he was Vice President in their corporate finance department for two years. Until 1980 Mr. McGuire was Vice President in the corporate finance department of Rauscher Pierce Refsnes, Inc. and for three years headed the corporate finance activities of that firm. In June of 1980, he established and became President of The Dallas Financial Corporation which is a wholly-owned subsidiary of May, Cullum, Ragland & Brittain, Inc., (a member of the NASD).

PRACTICAL ASPECTS OF DUE DILIGENCE:

PROGRAM

The preceding presentation by securities lawyers has dealt with the legal aspects of due diligence, giving consideration to statutory provisions and some general principles which attorneys see as guidelines for underwriters. The next perspective on due diligence will be provided by underwriters themselves, discussing practical steps taken in conducting due diligence investigations.

This discussion will be divided into three parts. First, consideration will be given to some general principles and specific procedures, items, and sources of information which many underwriters believe should be utilized in the conduct of a typical due diligence examination. This discussion is of general applicability. The second and third parts deal with more specific concerns: special considerations for participating dealers and smaller underwriters and special problems relating to short-form registrations.

This discussion is a composite of views of representatives of different underwriting firms of varying size, type, and location. These views are those of certain individuals and do not represent the unanimous views of all underwriters. The opinions expressed here also in no respect reflect any official position of the National Association of Securities Dealers, Inc. The inclusion of any particular views or suggestions should not be seen as indicating the Association's approval of such suggestions or views nor to constitute any requirements by the NASD to adhere to the recommended procedures. As of the time of this writing, the Association does not have any rules in effect which affirmatively require underwriters to take any particular steps in conducting due diligence investigations. It is very important to keep this fact in mind throughout the following discussion.

The Due Diligence Investigation

General Concerns

A primary purpose of due diligence, of course, is the legal protection which it provides to the underwriter against potential liability. This purpose of due diligence should be borne in mind at all times. From an underwriter's point of view, however, due diligence is also a good business practice. Many underwriters believe that they are in a much better position to decide whether to proceed with an underwriting from a business point of view after performing a thorough investigation of the potential issuer. They also believe that thorough due diligence enables an underwriter to do a better job of marketing the securities. Effective marketing is the product of a thorough understanding of the company's business, its strengths and weaknesses.

From another viewpoint, the essence of due diligence can be seen as a combination of two basic principles which govern the securities industry: the requirement to be fully familiar with one's client and the requirement for full disclosure. If an underwriter thoroughly knows his investment banking client and makes full disclosure of the information known, he will have exercised due diligence in the best sense of the word.

In performing due diligence, most underwriters feel that it is necessary to thoroughly know the company, to verify all material facts and, more importantly perhaps, to understand the significance of those facts. You have to know the dynamics of the business which you are financing. An underwriter should know enough about the issuer's business to be able to convince customers that the issuer is worthy of the financing.

Underwriters have a responsibility to raise capital in the marketplace for issuers. This does not mean, however, that every entrepreneur has an absolute right to demand that an underwriter handle his offering. An underwriter's principal responsibility is to protect his customers who purchase the issues which he brings to market. In other words, the underwriter should believe that the offerings which he underwrites are an appropriate investment for his clients.

In conducting due diligence investigations, the underwriter should be comfortable with all of the aspects of the offering, and be prepared to live with the prospectus as a disclosure document, recognizing that potential liability may continue after the offering is completed. The underwriter should also recognize that even with thorough due diligence, it is virtually impossible to create a registration statement which will provide absolute certainty against litigation and potential liability.

The nature of the due diligence investigation will vary considerably from one issuer to another because of the nature of the company, the underwriter's involvement over time, and the kind of security to be issued. One extreme might involve a highly rated debt offering by an issuer with which the underwriter has worked frequently on a number of offerings and which has a stable financial record. In such a situation, the time spent on due diligence is going to be considerably less than otherwise. In this situation, the underwriter would ordinarily maintain familiarity with the issuer's business and be in contact throughout the year. In this instance, the most effective due diligence is a continuing investment banking relationship.

At the opposite extreme is an initial public offering by a company with a very volatile earnings record in an industry where advances in technology can quickly outdate the issuer's products and where the issuer was unknown to the underwriter prior to beginning work on the offering. Here most underwriters feel they have an obligation to check a number of areas in greater detail.

A third situation occurs in a public offering for which there may be excessive demand which can lead to a greater potential for customer disappointment.

In conducting due diligence investigations, many underwriters believe they should exercise simple common sense. The statutory test of reasonableness is the standard of a prudent man in the management of his own affairs. If adverse information surfaces during an investigation which brings the viability of the offering into question, the underwriter must decide whether to proceed. If he has misgivings, he should back out of the offering or determine the source of those misgivings and correct the situation.

In some cases, by the time the due diligence investigation reaches the point where the underwriter is able to determine whether to proceed with the offering, forces are at work which make it difficult not to proceed. Various parties representing the issuer have committed time in preparing for the offering and may be urging that the firm proceed. Underwriters should be particularly cautious in such situations.

In undertaking a due diligence investigation, some suggest that the underwriter ask himself, "What do I need to find out? What are the key areas of inquiry?" Then he should ask himself, "How do I go about getting the answers to those questions?"

Although each offering is unique and requires special attention, some underwriters rely on internal checklists to assure that important issues are not overlooked in the conduct of due diligence investigations. Underwriters must realize that the use of a checklist does not provide an absolute defense and, some argue, may increase potential liability. Those using checklists maintain that the existence of the list indicates that the firm is attempting to elicit the proper type of information as part of its investigation.

Other underwriters argue that the use of checklists discourages a full understanding of the dynamics of the issuer's business. They are also concerned that failure to perform a step on the list, though not necessary for a particular offering, might be the basis for a finding of liability. If lists are used, it should be clearly understood that their applicability to any particular fact situation may vary.[1]

The underwriter should look upon due diligence primarily as an attempt to find "red flags" which indicate potential danger. To assist in his search, he should not hesitate to utilize experts whenever he feels that neither the corporate finance department nor the firm at large has the expertise necessary to analyze a fundamentally important aspect of a company's business. The underwriter should be prepared to pay whatever is reasonably necessary for such expert advice, recognizing that in the final analysis it may well save money.

Many underwriters believe that, if a few problems are found in the course of a due diligence investigation, the underwriter should not necessarily abandon the offering. Successful businesses are not necessarily without some problems and being a successful manager is in many ways the result of being good at solving problems. The underwriter should try to understand weaknesses in the company, however, as well as strengths. In the final analysis, the weaknesses may prove to be more important.

The underwriter's internal procedures used to decide on new financings should be well thought out. Many underwriters utilize a committee of senior officers who make the final decision as to whether the firm will underwrite a proposed transaction. Many firms also have internal guidelines as to the size and type of offerings which they will handle. Some firms also have specific requirements which an issuer must meet before the underwriter will undertake the offering.

As part of the process of due diligence, it is critical for the underwriter to be thoughtful in his choice of underwriter's counsel. It is important that the underwriter retain counsel that is experienced in performing due diligence investigations and preparing registration statements. Some underwriters work exclusively with one or two law firms while others utilize a variety of firms.

Underwriters vary in the internal recordkeeping procedures utilized for due diligence investigations. In the earlier discussion on legal aspects of due diligence, it was noted that there is a divergence of opinion among securities lawyers as to the advisability of maintaining detailed records of all steps taken in the course of the investigation. There is a similar difference of opinion among underwriters. An underwriter will probably want to consult with counsel before deciding upon recordkeeping procedures.

Specific Steps

With this background, let us now consider some specific steps some underwriters follow in conducting a due diligence investigation. It should be remembered that the NASD does not currently require any particular steps to be followed and that the conclusion of any particular procedures or views in this discussion does not necessarily reflect NASD approval. For purposes of this discussion, we will begin

[1]For a more complete discussion of checklists, see the preceding section of this book.

at the time at which the potential underwriter first learns of the possibility of a public offering of securities.

In those instances in which the underwriter and potential issuer do not have an existing relationship, the underwriter is likely to begin the due diligence investigation by conducting a general background check into the reputation of the issuer and its management. If checks with others in the industry, with competitors (if possible), and with experts on the industry as to the business ethics of the issuer, key shareholders, and senior management cause the underwriter to have concern, it may be advisable to proceed no further with the transaction.

Many believe that the earlier the underwriter gets to know his client, to see how management reacts under pressure, to get a reading of the depth of management, and a reading as to where responsibilities lie, the better it is for the underwriter. This will normally entail meeting with management to become familiar with the individuals involved, their capabilities, their business judgement, and their experience to carry the proposed financing, and whatever project may lie behind it, into completion.

If initial inquiries into the reputation and ethical standing of the issuer and its management are positive, the underwriter will then proceed with the due diligence investigation. The investigation itself is usually divided into two parts: first, an investigation of the industry in which the issuer operates and, second, a detailed investigation of the issuer itself.

Investigating the Issuer's Industry — In conducting a review of the industry in which the issuer functions, the underwriter should seek to obtain an understanding of that industry which puts the issuer into perspective vis-a-vis its competition and the overall industry structure. He should look at the industry over a reasonable period of time, five years or more, so that trends can be detected and judgements made as to the general direction of the industry. Where the issuer is involved in multiple lines of business, appropriate attention should be paid to each material component and each respective industry should be considered.

The examination of the industry should provide an understanding of the industry's potential and the key problems facing the industry. Many underwriters begin with a consideration of the general economic factors. For example, what is the impact upon this industry of the significant increases in interest rates which have been seen lately? If the issuer and its industry rely on borrowing, overall earnings will probably be affected by rising interest rates. Other examples of general economic factors to be considered include the availability of energy to a high energy consuming industry, and the impact of inflation or recession on this particular industry.

The underwriter will want to examine industry characteristics relating to markets (both domestic and foreign), principal competitors, and the nature of competition (such as pricing, brand identification, or superior service). In other words, the underwriter should understand the markets and the ways in which the various industry participants compete in those markets.

Most underwriters believe that attention should also be given to the financial results for companies in the industry. Underwriters review such financial measures as the revenue growth of the proposed issuer compared to its competitors for a five-year period, return on revenue, pre-tax margins, and return on capital. Focusing on measures of financial efficiency and growth should provide an overview of how well the industry is doing compared to how well the issuer is doing within a relevant universe.

Underwriters performing due diligence on a private company seeking a public marketplace, usually attempt to identify comparable companies that are already public, looking at those companies' financial ratios, growth patterns, research reports, recent public pronouncements and other relevant information.

The importance of technology, patents, licenses, trademarks and trade names to companies in the industry should be determined. The underwriter should also focus upon the impact on the industry of taxation and governmental regulation, not only existing policy but pending or likely changes.

The underwriter should focus on the principal raw materials for the industry and determine their availability. In recent years, we have been through periods where there has been a variety of broadly-based shortages of raw materials. Without critical raw materials, the issuer may be forced out of business.

Labor relations in the industry should be examined. Are strikes expected? Can the industry expect, because of union pressure, substantial increases in pay in an industry that is labor intensive?

The principal accounting conventions in the industry should be examined. Is this an industry where there are choices as to accounting principles which may make it difficult to compare companies and may require adjustments to make the proper comparison? "LIFO" versus "FIFO" inventory accounting is a good example.

In conducting this examination, the underwriter often utilizes a variety of sources of information. These include prospectuses of companies in the industry, trade association materials, reports from investment advisory services, governmental statistics, trade journals, and articles in general business publications. These materials, and others, will provide information about the industry and provoke additional relevant questions which the underwriter will want to pursue.

Investigating the Issuer — The underwriter would now undertake the most substantive part of the due diligence investigation, the investigation of the issuer itself. Different underwriters naturally address this problem differently and, as discussed before, each investigation must be tailored to the particular situation of each issuer and offering. Following the procedure used by some underwriters, we will divide our consideration of the investigation of the issuer into three components: first, an examination of the company generally and of its management; second, an analysis of the company's business; and third, an analysis of the company's financials. Bear in mind that these thoughts on the scope of a due diligence investigation represent the views of some underwriters and do not reflect any specific NASD requirements.

The Company and Its Management — Many underwriters believe that their initial investigation should focus on the reputation of the issuer and its principals. While some general inquiry will have already been made before the underwriter reaches even this point, the examination should now be much more detailed. The investment banker should thoroughly know his investment banking client.

The underwriter should consider making credit checks on the company and checks on the reputation and experience of its officers. He should contact the issuer's principal banks and review Dun & Bradstreet reports.

The underwriter is presumably beyond the point where he is concerned about the ethics of management and their general ability to manage the business. He should now review their experience level, their technical expertise, and their ages. The underwriter should inquire as to the rate of turnover in management. High turnover in management or labor may be an indicator of problems, particularly if you can get comparable measures from other companies in the industry.

When considering management, the underwriter should also include directors. Directors have become increasingly important to publicly-held companies. In assessing management, many believe that the underwriter can draw comfort from a strong outside board that is clearly exercising its responsibility of overseeing the direction of the company.

Most underwriters agree that an underwriter should meet with management of the issuer, and he should not limit his meeting to the chairman of the board or the president. Some underwriters like to have senior management from the issuer make a presentation, with the respective attorneys present, prior to beginning to write the prospectus. This enables the underwriter to judge management and means that everyone involved in the process of writing the registration statement has a similar frame of reference and is able to ask questions and approach the task from a consistent point of view.

In evaluating management, the underwriter should look not only at management skills, qualifications, and experience. He should also be sure that the experience and abilities of management are relevant to the jobs which they hold. The fact that someone has been in the oil business does not mean that he is necessarily going to be a good manager of a drilling program or that he can select properties that are good prospects.

Some underwriters, particularly in starting out with a new client, get a grasp of the overall company by reviewing annual reports, proxy statements, any previous offerings, and annual reports filed with the SEC on Form 10-K. The underwriter's counsel also reviews the issuer's charter and by-laws and corporate minutes. Then, a representative of the underwriter sits down with a principal officer of the issuer to learn how the company was started, who started it, where, when, and what kind of business the company was in. The underwriter inquires as to how the company has changed over the years. The underwriter then proceeds with the interview into the details of the business as it presently exists.

In investigating the company and its management, underwriters often contact third parties to verify information. For example, the underwriter may check principal suppliers and customers, banks, research reports from its own research department or from other broker/dealers, filings made by the issuer with the SEC, stock exchanges or the NASDAQ System, previous registration statements, proxy statements, Form 10-K's, annual and quarterly reports to stockholders, company histories, and engineering reports.

An example of the need to contact outside parties may be found in the experience of one major underwriter several years ago. The underwriter undertook a first public offering for a company in a consumer field and very carefully conducted a due diligence investigation according to its usual procedure. On the day the registration statement was filed, however, a senior officer of the firm received a telephone call from a relative who worked in a business related to that of the issuer expressing dismay that the underwriter would actually proceed with the offering. He informed the underwriter's officer that a few telephone calls to the right customers would have shown that their loyalty to the product was very weak. The offering proceeded. A year or so later, the issuer misjudged its product line and was in serious financial trouble. The underwriter had performed due diligence but had missed an important aspect of the issuer's business.

In investigating the overall status of the company, most underwriters believe it is important to give particular attention to those items emphasized in the earlier discussion on legal aspects of due diligence. The underwriter should be certain that the organizational documents of the issuer are reviewed for completeness and correctness and that all minutes of stockholder meetings, directors' meetings, and executive committee meetings for a reasonable period of time (commonly, the preceding five years) are read. The importance of this aspect of due diligence was emphasized in the *BarChris* case. Minutes of material subsidiaries should also be reviewed.

Some underwriters consider the area of insider transactions to be an important area for scrutiny. Insider transactions and other intra-company relationships and activities can be very enlightening and should be pursued as a means of evaluating management. Some underwriters deal with the problem of insider transactions by requiring that any such relationship be eliminated prior to the underwriter's participation of the offering.

The Company's Business — The next general aspect of the issuer to be considered is an analysis of the issuer's business.

Some underwriters start this process with a consideration of the issuer's competitive position. How does the company measure up against its competitors? What are the methods of competition? The underwriter should determine whether the issuer is competing increasingly on price, while others are enjoying a higher margin because of superior technology or better marketing. The underwriter should inquire about pricing, advertising, and customer financing, all with the intent of seeking out historical or potential problems in any of these areas. The underwriter should determine the size of the market for the issuer's products and services. This may be defined in many different ways depending on the kind of business the company is in. What the underwriter should be seeking here is to determine if the company's growth is going to be affected by the size of the market and an inability to progress without a drastic change in its business.

Many underwriters believe that relative financial performance should be considered. How do the results of the issuer compare with those of its competitors? Are there any financial ratios that indicate problems? The underwriter should then follow up on problems identified with respect to financial performance and refine his investigation.

The underwriter should seek information on the distribution system used by the issuer for its products or its services. Does the issuer use independent representatives over which it has no control or with whom it has no contractual arrangements? An independent representative may be marketing similar or directly competitive products. Is the issuer distributing over a very long pipeline where the products may be obsolete by the time they get to the buyer?

Most underwriters consider production facilities. Production facilities are particularly important to a manufacturing company. Here the underwriter can address concerns about the issuer's capacity. Is it going to take a significant increase in capital expenditures to continue sales growth? Have company facilities kept up with the times? The underwriter should visit the principal plants, determine the percent of utilization, the number of shifts, the production problems, and understand the manufacturing processes. He should look at additions to, and retirements of, plants over a period of time and consider the adequacy of equipment. Some underwriters have found situations in which warehouses or inventory claimed by the issuer in fact did not exist.

Visiting the issuer on its "home turf" can have a number of advantages. Underwriters should not restrict their investigation to simply determining whether the production lines are operating, but should use the occasion to get a sense of the operation and learn about the general attitude of management. If much of the building is poorly maintained or not kept clean, an underwriter can gain a sense of the way in which the company is run. Such a sense may prove to be relevant in an overall understanding of the company and, more important perhaps, in later deliberations.

The underwriter should give consideration to the issuer's source of raw materials. If the issuer is dependent on particular materials and particular suppliers, the underwriter should determine the nature of those relationships and investigate alternatives available to the issuer if those supplies are cut off. Is the issuer locked into a long-term relationship with a particular supplier? If so, the underwriter should talk with that supplier.

What about the company's labor force? The underwriter should find out whether there has been a particular problem with strikes and whether there are any major contracts coming up that should be disclosed in the prospectus. Employee pensions and other benefit plans should be considered.

Another area of inquiry is research and development. Are expenditures by the issuer for this activity in line with industry trends? Is the company devoting a sufficient portion of its revenues to research and development?

The underwriter may want to research the scope and cost of new products that the company is working on, and determine how those products are accounted for. Patents and patent licenses, both granted by and to the issuer, should be investigated. In important cases, the underwriter should check with the issuer's patent counsel. Where trademarks are important to the issuer, inquiry may be appropriate.

A more general area of questioning which many underwriters pursue relates to recent and prospective events. They determine whether there are any pending mergers, plant closings, plant openings, acquisitions, new product lines, discontinuance of services, or other matters that could have a material effect on the business. The investigation here should be directed to identify those events which, at the worst, the company would be unable to survive, and, at a minimum, should be considered for disclosure.

Inquiry should be made about management compensation policy, the existence of loans to or from officers and directors, stock option programs, retirement plans, and miscellaneous perquisites provided to management. The underwriter should note employment contracts. He should also give particular attention to securities holdings and transactions which may have required reporting to the SEC. The underwriter may also wish to inquire about general remuneration policies for officers and directors and compensation policies for younger people in the company. Some find it beneficial to ask for a list of any salary increases in the past year amounting to more than ten percent.

A further item of inquiry is one of the most important of all: verify the intended use of proceeds. This is an area on which the SEC has been focusing lately and one which most underwriters believe should be an area of careful questioning. It is often difficult to get the issuer's management to pin down what they will use the proceeds for. Many prefer to say, "We will use the money for general corporate purposes." The underwriter should verify intended uses carefully, the expenditures intended, cash or capital requirements, short-term borrowing, and sources and amounts of funds needed and available.

Many believe that, to the extent possible, the underwriter should obtain the cash requirements and cash flow projections. The underwriter should know exactly how much money the company needs before underwriting the offering. This bears on determining the accuracy of the proposed use of proceeds. The underwriter should determine not only how the money is going to be spent, but he should also determine whether enough is being raised.

Part of this process calls for the underwriter to identify cost. It is necessary to identify cost in line with the company's operations or projected operations and be certain that enough money is being raised to get the job done. Many well thought out prospects relying upon publicly-raised funds have failed, not because they were poorly designed, but because they were under-capitalized.

In conducting the analysis of the issuer's business, underwriters frequently interview top officers and operating officers and employees of the company, giving consideration to the different lines of business. The underwriter must exercise his discretion as to how far down the organizational chart he should go.

The underwriter should analyze the business and its problems by material lines of business over a reasonable period of time, commonly five years. He should include such items as products, percentage in dollar breakdown of sales and profits, brand names, market and distribution, dealer agreements, and typical sales agreements.

The underwriter should investigate the pattern of sales and determine whether sales are "spot" sales or under contract. The pricing of products, pricing trends, and the cost of products should also be examined.

The company's production cycles should be investigated, and it should be determined whether products are produced for inventory or against specific orders. Any backlogs of orders should be investigated. In view of the *BarChris* case, underwriters should be particularly aware of the need to verify the accuracy of a backlog.

Underwriters often inquire as to the composition and the age of inventory and the rate at which new orders are received. Many underwriters believe that one should determine whether the issuer does business with the government, and, if so, the significance of that business and any renegotiation experience in that area. Similarly, the underwriter should explore the nature and extent of any foreign business and related currency problems and political risks.

Natural resource companies present special cases. The underwriter should be aware of possible problems in accounting for reserves and should determine the scope of natural resource regulation applicable in the most significant jurisdiction.

Most underwriters review the status of pending and threatened litigation. The underwriter should consult with his counsel to determine how to proceed in this area. The underwriter should also determine any pattern of past litigation and past complaints against the company.

The underwriter or his counsel should normally investigate all debt instruments, major leases, all bank credit agreements, and principal contracts. The terms should be analyzed, with particular attention being given to restrictive covenants. Again, the underwriter should consult with counsel in determining how to proceed in reviewing these items.

The underwriter should investigate the overall regulatory climate affecting the issuer's operations, particularly relating to environmental considerations.

Most underwriters take the position that, in conducting the investigation of the issuer, the underwriter should seek to become intimately familiar with the workings of the company. Some lead underwriters develop specialized questionnaires for various industries. In interviewing a retailer, for example, one underwriter inquires about a breakdown of sales and profits as between principal products for the past ten years; a breakdown of sales by stores, by regions, by fiscal units; a breakdown as between high and low margin items, and an explanation as to why each of these is handled. They inquire as to the price range of the merchandise, its quality, the breadth of the line, and the style. The underwriter then cross checks this information with suppliers.

Such an inquiry also goes into such detail as the amount of retail store space which the company leases to others on concession and the percentage of sales which that amounts to. They inquire about the breakdown of sales between private brands and national brands, the types of stores utilized, and the types of promotions which the company sponsors. They ask about installment sales, what percentage of total sales they are, whether the company finances them, who does the company banking. They inquire about policymaking, asking who decides when products are added or dropped and who controls pricing. They ask what the company's policy is with regard to slow lines, mark-downs, returns, and damages. They inquire as to what "side lines" the company handles. This underwriter also asks for information on controls of merchandise passing in and out of warehouses. Again, the underwriter cross checks with suppliers.

This underwriter uses a similarly detailed series of questions for other issuers in other types of business.

As an offering nears effectiveness, the underwriter should be certain that all information on the company's business remains accurate. Things can change very rapidly and it is important to have information on the current operations of the company. The underwriter should be careful to bring all of his due diligence activities down to the time at which the registration statement becomes effective.

The Company's Financials — The last component of the underwriter's investigation of the issuer relates to the analysis of the issuer's financial statements. As emphasized earlier, it is critical for the underwriter to fully analyze the issuer's financial statements and the financial condition of the company. In analyzing that condition, the underwriter will want to work closely with the company's auditors.

In conducting this phase of the due diligence investigation, most underwriters state that one should look at financial statements and other financial data to determine, among other things, profit margins and trends, and should obtain from management working capital requirements, cash flow, and sales and earnings projections. He should develop the appropriate ratios for analytical purposes and study interim operating reports as well as comparisons with prior periods. He should note any seasonal periods from a financial standpoint.

The underwriter should analyze accounting principles utilized by the company, giving separate consideration to separate lines, subsidiaries, or divisions where appropriate.

The underwriter should review recent directors' financial reports, if possible, and, of course, look to the report of the accountants. He should focus particularly on any applicable effect of audited versus unaudited financials.

If acquistions have been made or are contemplated, the underwriter should consider the methods of accounting for such acquisitions (whether "purchase" or "pooling").

Also, if relevant, the underwriter should review the tax status of the company, particularly with respect to any open tax years.

The underwriter should evaluate the level of inventories, including inventory turnover and possible obsolescence. He should review inventories of affiliates, especially if sales to or from affiliates are not consolidated.

The underwriter should give consideration to the company's pattern of turnover in its accounts receivable as well as its bad debt experience.

Part of the underwriter's investigation of the company's financial standing should include an analysis of the company's budget, the preparation of the budget (by whom and when), and future plans to raise capital. If the company has cash projections, those should be obtained. Commitments to issue new securities should also be considered.

Often the underwriter will review the audited financials with the company's auditors. There then ensues discussions on the nature of "comfort" which the auditor is going to provide to the underwriter on the items which are not audited. The underwriter may seek assurances from the auditor on every possible figure, but in the final analysis, there are usually compromises. In the process of the discussion, however, the underwriter often gains valuable information regarding the issuer.

As with other aspects of the due diligence investigation, the exact extent of the analysis of the issuer's financial status will vary depending on the particular circumstances.

Sources of Information — Having considered the types of information which underwriters believe should be obtained in the conduct of a due diligence investigation, we will now review sources and procedures underwriters utilize in obtaining such information. The sources of information may be divided into those within the proposed issuer and those outside the issuer.

Sources Within the Issuer — With respect to information received from the issuer, some underwriters organize their inquiries with legal counsel prior to approaching the company. With counsel, the underwriter draws up a list of questions for the company to answer before the underwriter meets with the company to initiate the due diligence exercise. The list asks for basic corporate documents that are generally reviewed by underwriter's counsel. These include articles of incorporation, by-laws, major contracts, loans to or from officers and directors, and similar documents. In addition, the underwriter requests lists of products or services, principal competitors, principal suppliers, principal customers, and copies of catalogs and other customer marketing literature, business plan documents, and other relevant documents which will permit the underwriter to thoroughly understand the business of the issuer.

Included in the underwriter's list could also be other source documents such as annual and quarterly reports to stockholders, reports to the SEC on Form 10-K, proxy statements, previous registration statements, company histories, relevant engineering reports, reports to any regulatory agencies, speeches to securities analysts by officers, material prepared for rating agencies, answers to anti-trust questionnaires, and any documents or SEC filings relating to insider transactions or other problems caused by sales of securities.

By requesting this documentation prior to the first due diligence meeting with the issuer, the underwriter has the opportunity to review thoroughly the material so as to make proper preparation for a series of interviews with management.

Much of the information obtained from the issuer is obtained in the course of interviews with management and key personnel. These interviews should generally be conducted on a one-on-one basis. One does not want the chief executive officer around, for example, while talking to the marketing manager. That could seriously dilute the value of talking to the marketing manager, who is likely to be more guarded in his comments if his boss is monitoring his remarks.

Some underwriters supplement interviews by asking each functional officer to review the portion of the prospectus that covers his or her area of operation. Such persons have a better insight into their area and often can correct small factual errors.

Some underwriters request the participation of the company's auditors at meetings to review the prospectus. Auditors should be expected to explain and defend, if necessary, various aspects of the audited statements.

While it is helpful to have the auditors present or available at some meetings between the underwriter and the management, the underwriter should consider having at least one meeting with the auditors without management present. The underwriter should inquire as to any reports which the auditors have made to management or the directors, such as internal reports about potential problems they have found. It is rather common now for auditors to write special management letters. The underwriter should make sure that the auditors are satisfied with their relationship with management and with the cooperation which they receive from management. The underwriter's inquiry of the auditors will probably also include questions concerning the adequacy of internal accounting controls.

Interviews with the auditors are important not only to understand fully the financial statements and to get comfort that they have been prepared properly, but because understanding the financial statements provides real help in understanding the company's business. The footnotes, for example, will provide a wealth of information and clues to areas which the underwriter may want to pursue.

Sources Outside the Issuer — The underwriter will also utilize sources outside the company in obtaining information as part of its due diligence inquiry. Documents which are obtainable from outside sources which should be considered include research reports from the underwriter's firm and other broker/dealers, Dun & Bradstreet reports, Moody's and other services, reports of investment advisory services, material from rating agencies such as Standard & Poor's, Moody's, and Duff & Phelps, trade journals and general business publications.

The other source of outside information is interviews with third parties. After obtaining information from the company, most underwriters go to third parties to verify that information.

The underwriter should seek people who know the principals of the company and something about the business. Many underwriters insist on interviews with the suppliers, customers, and competitors, if possible. Interviews with competitors may be more difficult to arrange, but the competitors are often the most candid about the issuer. Customers and suppliers may be biased because they want to continue doing business with the company. Competitors, however, may be willing to make unflattering remarks. Interviews with competitors can sometimes come about through pre-existing relationships of persons associated with the underwriter or the underwriter's counsel. Caution should be taken, however, not to give the impression that the issuer's confidential information will be made available to the competitor.

Commercial banks should also be utilized as a source of information about the company, particularly if there are outstanding lending relationships. Many underwriters find principal long-term lenders to be particularly good sources of information.

Lastly, underwriters should consider utilizing experts to verify specialized information. Some lead underwriters have retained outside consultants as experts in connection with particular high technology offerings, maintaining the relationship for two or three years as the issuer matures after the public offering. While the value of experts may vary from case to case, some underwriters have found that going the extra mile to obtain an outside study of the issuer by, for example, an engineering firm, can prove to be very valuable if problems surface after the fact and the adequacy of the underwriter's due diligence is called into question.

Special Considerations

Having considered general guidelines and procedures utilized by many underwriters in a typical due diligence investigation, the remainder of this section will be devoted to two specific areas of concern, those affecting the smaller underwriter and those affecting the underwriter performing due diligence on short-form registration statements. In each instance, you are reminded that the views set forth are those of some underwriters but do not necessarily reflect any official policy of the NASD and do not constitute formal regulatory requirements of the Association. The review of special considerations for smaller underwriters will be divided into two aspects: the role of the participating underwriter and the role of the smaller firm originating offerings.

Participating Underwriters

Broker/dealers participating in an underwriting syndicate generally do not perform extensive due diligence directly with the issuer, but rely upon the managing underwriter to perform such investigations on behalf of the syndicate members.

The crucial thing for participating underwriters, therefore, is a determination of the reliability of the managing underwriter and its counsel.

Many emphasize that the participating underwriter should be very cautious of those with whom he is doing business, and should bear in mind that in agreeing to become an underwriter, one assumes his proportionate share of the liability for the offering. The participating underwriter should therefore have confidence in the managing underwriter and in those persons charged with the preparation of the registration statement. He must be able to reliably assume that they are performing a proper due diligence investigation. Many participating underwriters rely heavily upon the reputation of the attorneys and accountants involved in the registration statements.

If a participating underwriter has questions concerning the issuer, the prospectus, or the adequacy of due diligence, he may raise them directly with the corporate finance department of the managing underwriter. Opinions as to the value of due diligence meetings vary widely. Some participating underwriters view the meetings as valuable and some managing underwriters believe the meetings perform a significant function in permitting an explanation of the detail of the offering. Other underwriters seriously question the value of the meetings.

Smaller Firms Acting As Managing Underwriters

Let us now look at some of the special aspects of due diligence from the viewpoint of the smaller or regional firm which is acting as managing underwriter. Many aspects of due diligence are not significantly different for these firms from those discussed generally above. Some distinctions may be drawn between larger, national underwriters and regional firms. Whereas national firms generally focus most of their attention on larger, more mature issuers, regional firms are more likely to be involved with younger, less seasoned companies which are coming to market for perhaps the first time and have not enjoyed a great deal of public exposure. This tends to increase the due diligence responsibility of the smaller underwriter.

In recent years, many larger underwriters have developed specialized corporate finance functions to the degree that one group in a department may be responsible for procuring and maintaining business relationships while another group is involved with processing transactions. This results in a greater degree of specialization than is usually found in smaller firms. Larger firms may also have industry experts within the firm, in the research department perhaps, which are not likely to be available in regional firms.

While personnel of larger firms may handle only specific parts of an overall financing, corporate finance personnel of smaller firms will handle the entire transaction from beginning to end and will be involved in a wide spectrum of activities. This may make their job more difficult, because they must exercise more discipline in performing due diligence.

The smaller underwriter may have an advantage, however, in that it may be more familiar with the principals of the issuer because of its geographic proximity.

Special Considerations for Short-Form Registrations

The last topic which will be considered involves special concerns of firms underwriting offerings on Form S-16 and other short-form registration statements.

Beginning in the 1970's, the SEC began to implement a change in the disclosure process with greater emphasis on continuous disclosure of material information and events and the 1934 Act filing requirements. With emphasis being placed upon improved accounting disclosure and periodic reporting, issuers have become much more attuned to providing the investment community and the investing public with current and meaningful information relating to the conduct of their businesses.

The process today is quite different from a decade ago. Ten years ago, the disclosure of information to the investing public generally focused on the event of a public financing and the preparation of a Form S-1 or S-7. The preparation of the registration statement was surrounded by an intensely detailed discussion at drafting sessions among the issuer's management, its counsel and auditors as well as the underwriter and its counsel. In many cases, the periodic disclosures were not adequate for investment decisionmaking and the registration process provided the fulcrum for placing current information about the company in the marketplace. The entire registration process took place over a period of three to four weeks or longer and involved a mutual attempt to prepare a registration statement which would adequately describe the financial and business condition of the issuer.

Beginning in 1974 with the use of Form S-16 for "shelf" registrations by selling shareholders, the expanded use of the S-16 for debt and equity offerings of issuers meeting certain requirements has resulted in an explosion of its use by most major corporate issuers.

Because the Form S-16 incorporates by reference all 1934 Act filings and because an S-16 can be declared effective on extremely short notice, the breadth of its appeal as a registration document is understandable. On the other hand, however, one can argue with the point that the S-16 and documents incorporated by reference provide the same quality of disclosure as the Form S-1 or S-7. Because of the telescoped timetable and the relative ease of registration today, underwriters must ask themselves how to perfect their due diligence defense under Section 11 of the 1933 Act. At the time the SEC proposed to expand the use of Form S-16 to primary offerings, a number of underwriting firms expressed a growing concern with the extension of S-16 without a clear limitation on the scope of underwriters' liability. Notwithstanding the urging of a more realistic standard, the SEC has been reluctant to adopt such a standard.

Although the SEC has not adopted the suggested standard, many believe that a court should consider whether an underwriter had an opportunity to perform a reasonable investigation. Because businesses can not be run on assumptions of what courts might hold, however, underwriters have been faced with the dilemma of how to perform a level of due diligence which will provide protection for the investing public as well as themselves.

In spite of the compressed timetable that Form S-16 affords, an underwriter should make every attempt to perform the same quality of investigation as before. The change in emphasis in the disclosure process requires underwriters to use their time more efficiently and to anticipate their clients' needs.

A couple of things have happened over the past several years that facilitate this process. One is the development of guidelines for financial disclosure for specific industries and to meet specific accounting needs. By issuing guides for disclosure, the SEC eliminated some of the effort in dealing with the disclosure of certain issues in a registration statement. Time spent in the preparation of an S-16 can now focus more on matters such as specific trends within the industry or the individual issuer.

In equity offerings, the "road show," involving presentations in several cities to prospective institutional buyers, provides the occasion to work closely with the management of the client to focus on the major issues facing the company.

As mentioned earlier, underwriters should endeavor to perform the same quality of due diligence for an S-16 although within a shorter time frame. Naturally, this places a premium on the use of highly-qualified people who keep in close touch with clients during the course of the year so that they are able to use their time effectively when a financing occurs.

Performing due diligence should, where possible, mirror the disclosure process itself. Just as the 1934 Act documents have become the primary focus in the disclosure process, so too should underwriters maintain close contact with their clients during the course of the year. When a client would like to finance rapidly, the underwriter should be up to date because he does not have the luxury of spending three to four weeks as he did some years ago. Being up to date can be accomplished by participating where possible with the client in the preparation of the Form 10-K.

In the case of clients who come to market frequently as a matter of course, the investment banker becomes more involved in the disclosure process. For example, in the case of public utility clients, some underwriters maintain very close involvement with the client's contacts in the investment community and often assist in the preparation of the Form 10-K.

* * * * *

Specific steps which an underwriter should take in performing due diligence investigations have been reviewed and it has been noted that these vary according to the facts of any situation. In the final analysis, the underwriter and his counsel must exercise judgment in determining the nature of inquiry called for in a particular instance. Underwriters agree, however, that the due diligence investigation should lead an underwriter to know thoroughly his investment banking client so that he can assure that all material information about the client and the offering is disclosed to the investing public.

Selected Questions and Answers on Practical Aspects of Due Diligence

QUESTION: The importance of doing thorough due diligence prior to filing an offering has been emphasized. How should an underwriter proceed when negative information is uncovered prior to filing and, perhaps more difficult, what action does an underwriter take when negative information is discovered after filing of the offering but before the effective date?

ANSWER: If the deficiencies discovered are such that the underwriter is uncomfortable with the offering, he should withdraw from the offering. The underwriter should cover all points of its due diligence prior to filing. If negative information is found, a determination should be made as to appropriate action, which may involve requesting that the issuer make certain changes. If the issuer declines to make changes, the underwriter may find that it is necessary to decline to underwrite the offering. If problems surface after filing and before the effective date, the underwriter will want to utilize common sense in deciding an appropriate course of action. If the problem is material, however, the underwriter should not hesitate to withdraw.

QUESTION: Corporate planning has become much more widespread over the past several years. How can an underwriter utilize the planning process and planning documents in conducting due diligence?

ANSWER: It is important for the underwriter to know its client, the issuer. An effective and efficient way to obtain a good insight into the issuer and the interrelationship of all parts of its business is to study the issuer's planning documents. On the other hand, the absence of any planning process should be seen as a significant indication which may lead the underwriter to probe further into the capabilities of management.

QUESTION: In studying the type of due diligence which constitutes good business practice, it becomes obvious that the process can be costly. How can a small underwriter handling a small issue perform adequate due diligence within reasonable limitations of cost?

ANSWER: This situation presents a very difficult dilemma, one which has led numerous underwriters to rule out smaller offerings. In the final analysis, the underwriter must make certain cost-benefit analyses and determine the extent to which it wishes to bear certain risks.

PART FOUR

SPECIAL CONSIDERATIONS FOR LIMITED PARTNERSHIP OFFERINGS AND PRIVATE PLACEMENTS

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Mr. Fein is a member of the law firm of Jones, Day, Reavis & Pogue. From 1975 to 1978, Mr. Fein was Chief Deputy Commissioner of the State of California Department of Corporations. He was admitted to the California State Bar in 1970.

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SPECIAL CONSIDERATIONS FOR LIMITED PARTNERSHIP OFFERINGS AND PRIVATE PLACEMENTS:

PROGRAM

Earlier sections have dealt with legal and practical aspects of a due diligence investigation in the overall sense. Those discussions were presented in terms applicable to corporate offerings, although most of the principles discussed could equally apply to a public offering by either a corporation or a limited partnership. While those overall principles are important as a framework for any due diligence investigation, other more specific principles come into play in the case of a public offering by a limited partnership or any other non-corporate issuer or a private offering by any type of issuer.

This section can be divided into two subsections. The first subsection deals with special considerations applicable to due diligence investigations of limited partnership offerings which are unique to such offerings because of the partnership structure and which apply to both public and private offerings of limited partnerships. The second subsection (which constitutes the bulk of this section) deals with special factors to be considered in investigating a private offering of securities, i.e., an offering made pursuant to a claimed exemption from the securities registration requirements of the Securities Act of 1933 ("1933 Act"). Most of the discussion in the second subsection relates to private offerings of partnership securities.

Other concerns relate to the nature of the partnership vehicle itself. Securities attorneys emphasize that, when dealing with a non-corporate vehicle, one must bear in mind that such a security differs in important respects from corporate securities. A partnership is created solely by contract among the partners (which includes the limited partners) and the state is not a party to that contract. The contract may be oral for some purposes including tax purposes and need be written only if a limited partnership is created, and then only to a limited extent. Attorneys urge that the contract creating a partnership be reviewed carefully to assure that a limited partnership has in fact been created which assures the investors of limited liability. Documents should be reviewed and state laws researched to determine whether the partnership will be treated as a limited partnership in all states where the partnership may be organized, selling interests, or otherwise "doing business" and whether it is necessary to form another partnership for other states.

Partnerships do not have perpetual existence and the partnership agreement should be studied to assure that the partnership will not dissolve prior to the proper point in time, especially if adverse tax consequence would result.

It is also important to determine the nature of the general partners. In some cases, general partners may themselves be general or limited partnerships. One should assure that such general partnerships are created properly and that all relationships and potential for liability are ascertained.

The creation of a general partnership is one of the few areas of the law where it is possible to have a functioning legal entity without any evidence of its existence in writing. Although written agreements may not be required by law, they should be written for the protection of investors. If one of the proposed general partners is an oral partnership, for example, it may be necessary to execute a written partnership document to clarify responsibilities and proportionate liability among the various partners.

Special Considerations for Limited Partnership Offerings

Certain considerations of a legal and practical nature come into play whenever limited partnership interests are sold in either a public or private offering. First, there are differences between partnership interests and corporate securities which should not be overlooked. Chief among these is the fact that there is not now an active secondary market for partnership interests. This means there is virtually no liquidity for investors who purchase such interests and they may not be able to sell their holdings if it becomes obvious that the investment is not succeeding. The fact that there is no secondary trading market in partnership interests also means that there is no group of broker/dealers actively following the security for purposes of satisfying their obligations in connection with secondary trades and thus no continuing disclosure mechanism provided by the marketplace.

By the very definition of a "limited partnership," the limited partners are restricted in their control of the business. The general partner is given very broad discretion, making it that much more important that the broker/dealer selling interests in the partnership be thoroughly familiar with the general partner.

Other problems are presented in dealing with a non-corporate entity. It is reasonably simple to determine whether articles of incorporation have been filed with the state and to read and understand corporate by-laws. Most attorneys believe, however, that a sophisticated attorney or representative of a broker/dealer is required to thoroughly understand the organizational documents involved in the creation of a partnership. It is important that a broker/dealer understand how the terms of a partnership agreement relates to the description of a program provided by the sponsor.

Many believe that the nature of the partnership structure calls for a different emphasis in the due diligence investigation. In a partnership offering, for example an examination of legal opinions is frequently important and should be performed by professionals who are expert in understanding all of the implications of such an opinion. In corporate offerings, legal opinions may be more perfunctory and contain "boiler plate" language which may be familiar. In partnership offerings, legal opinions may more often than not affect the whole essence of the transaction.

Another difference between corporate and partnership offerings relates to the rights of limited partners. In corporate offerings, the process of shareholder voting is well established and does not require a great deal of special attention. In a limited partnership offering, wide discretion may be left to the general partner and decisions must be made in each instance as to those types of approval which should be reserved to the limited partners.

Another distinction between the two types of offerings relates to the way in which management is judged. In a corporate offering, the primary concern of investors and broker/dealers acting on their behalf is the ability of management to operate the business in a profitable manner. In a partnership offering, many broker/dealers believe that importance should be placed on the competency and reliability of the general partner to function as a fiduciary in handling investors' money because of the lack of control by investors over the operation of the partnership.

One difference which some broker/dealers perceive between corporate and partnership offerings relates to the nature of some persons who become involved in the creation and sponsorship of partnerships. Some persons functioning as general partners and counsel to general partners may be less experienced than is typical in corporate offerings. Such persons may demonstrate less understanding of the need for proper due diligence and of the securities laws. This problem is complicated by a pattern whereby broker/dealers are presented with completed offering documents instead of being afforded an opportunity to negotiate over the content of such documents.

This listing of special considerations for partnership offerings is not intended to be all-inclusive nor to present any "official" NASD list of concerns. This discussion does demonstrate, however, that there are unique considerations present whenever a partnership offering is being sold to investors whether as a public distribution or a private placement and a unique and more extensive due diligence effort may be appropriate.

Special Considerations for Private Offerings

As discussed in earlier sections of this book, due diligence investigations for publicly registered offerings are, in the narrowest sense, undertaken to assure an adequate defense under Section 11 of the 1933 Act.

While the practices which have evolved under Section 11 provide some guidance for public offerings, broker/dealers frequently express concern regarding their responsibilities in private placements. These concerns do not relate to due diligence in the strict traditional sense of those words since Section 11 of the 1933 Act is not applicable to private offerings. On the other hand, persons making private offerings must assure themselves that the claimed exemption from registration is valid. While large dollar amounts of corporate offerings are sold through private placements, the concern of most broker/dealers involves private placements of limited partnerships. It is on that basis, therefore, that most of the discussion here will focus. As with the earlier discussions, both legal and practical aspects of issues will be considered.

Legal Considerations in Investigating Private Offerings

Let us first analyze those legal concerns which come into play whenever securities of corporations or partnerships are sold in a private offering. While these legal concerns generally apply equally to corporate and partnership private offerings, the focus here will be more on partnership offerings. This analysis will deal first with the statutory and regulatory framework within which private offerings are made and secondly with ways to better assure the validity of a claimed private offering exemption.

Legal Framework

Earlier discussions have dealt with the statutory and regulatory provisions applicable to public offerings of securities. It may be helpful to review here the overall structure of the federal and state securities laws and the status of private offerings in that structure.

Basically, the 1933 Act and the Securities Exchange Act of 1934 ("1934 Act") are structured in the following manner. The core provision of the 1933 Act is Section 5 which provides that all securities must be registered unless there exists an exemption either for the securities to be issued or for the transaction in which the securities are to be sold. If no such exemption is available, the 1933 Act provides that securities may not be offered unless a registration statement is filed and may not be sold unless a registration statement is effective. The 1934 Act goes on to provide that, if there is no available exemption for the person selling the securities, those persons must register as broker/dealers under the 1934 Act.

In order to avoid registration of securities under the 1933 Act, reliance must be placed upon one of the available exemptions from registration. With regard to promoters or sellers of limited partnership interests, reliance must be placed upon either the private placement exemption provided by Section 4(2) of the 1933 Act and Rule 146 thereunder, the intrastate offering exemption provided by Section 3(a)(11) and Rule 147 thereunder, Section 4(6) of the 1933 Act or Rule 240 adopted under Section 3(b) of the 1933 Act, or Regulation A, also adopted under Section 3(b).

Even though securities are sold pursuant to a private offering exemption, the federal securities laws still apply. Assuming there exists a security, various anti-fraud and civil liability provisions of the 1933 Act and the 1934 Act apply, whether or not the securities or the persons selling those securities are exempt from registration.

Earlier discussions described Section 11 of the 1933 Act (which concerns misstatements or omissions in a registration statement and which only applies with respect to public offerings) and Section 12(2) of the 1933 Act (which is the general anti-fraud provision). Those discussions also included statements to the effect that due diligence is, in effect, an affirmative defense available to underwriters[1] with respect to litigation under Section 11 (and, to a certain extent, under Section 12(2) of the 1933 Act).

With respect to violations of the registration requirements of the 1933 Act, another provision is of paramount import. That provision, Section 12(1) of the 1933 Act, relates to actions by purchasers of unregistered securities and provides absolute civil liability for violations of the registration requirements of the 1933 Act. "Absolute liability" means that due diligence or the exercise of reasonable care is not a legal defense to violations of the 1933 Act registration requirements.

Much of the activity of a broker/dealer in the nature of due diligence investigations with respect to private offerings is taken to insure compliance with the claimed exemption and much of the later discussion will deal with procedures to secure those exemptions. There also exists, however, the question of the nature of the more traditional due diligence investigation which the broker/dealer should adopt. Many securities attorneys believe that there is an obligation for some kind of an investigation, that once a broker/dealer is involved in an offering, as a professional in the securities business he has some degree of responsibility. Many attorneys believe that it is unlikely that a broker/dealer would be found totally free of liability where he has not performed some type of investigation.

With that as a general background, what about due diligence in private offerings? In the case of public offerings, concerns over compliance with the securities laws is generally limited to assuring that there are no material misrepresentations or omissions in the registration document. When dealing with an exemption from registration, the broker/dealer has an obligation to assure the availability of the claimed exemptions.

There is also a concern about compliance with the anti-fraud provisions. In the opinion of many, there is at least an implicit duty of the broker/dealer to investigate the proposed transaction, even if the only concern is potential liability pursuant to Rule 10b-5 under the 1934 Act and state law.

In the case of a private offering, there is also concern for compliance with Section 12(2) of the 1933 Act, which provides that one cannot make material misstatements or omissions of material facts in connection with the sale of securities, whether or not such sale is pursuant to a registration statement.

In summary, the due diligence to be performed by a broker/dealer participating in a private offering may be seen as a combination of the type of due diligence performed for a public offering, additional due diligence performed to assure satisfaction of claimed exemptions from registration, and special due diligence required in those instances where the issuer is not a corporation.

Rule 146 — Rule 146 under the 1933 Act is often relied upon by persons making private offerings. Rule 146 is a "safe harbor" for complying with the provisions of Section 4(2) of the 1933 Act, the federal private placement exemption. The SEC has repeatedly stated that an issuer may proceed in reliance upon the criteria set forth in relevant judicial and administrative interpretations of Section 4(2) in effect at the time of the transaction in making a private offering without reliance upon Rule 146. The SEC has stated that attempted compliance with Rule 146 does not serve as an election of that rule as the exclusive exemption from registration nor a waiver of the statutory private placement exemption. The Commission has further stated that failure to comply with one or more technicalities of Rule 146 does not necessarily result in a violation of the registration requirements of the 1933 Act.

All of these assurances aside, however, because some attorneys believe that Rule 146 generally liberalizes the private placement standards set forth in

[1]From a technical legal viewpoint, there may be some question as to whether a broker/dealer participating in a private offering is a statutory "underwriter" as defined in the 1933 Act.

relevant case law, especially with regard to the qualification and number of offerees, losing the benefit of Rule 146 through non-compliance with its terms may mean losing the benefit of the private placement exemption which would otherwise be available outside of the rule. For this reason, persons making private offerings pursuant to Rule 146 frequently take extreme care to assure compliance with the rule's terms. (Procedures which may be followed to better assure compliance with the rule are discussed below.)

Other rules under the 1933 Act (e.g. Rules 240 and 242) also provide exemptions for private offerings, but these are not generally utilized for partnership offerings at the present time due to restrictions on their availability.

State Law — It is important to also focus on the status of private offerings at the state level. Compliance with Section 4(2) of the 1933 Act or Rule 146 under that Act may provide an exemption from the federal securities registration requirements, but such compliance in no way assures that state securities registration requirements are met. In the view of many, the difficulty in satisfying state requirements for private offerings is much greater than that of satisfying federal requirements, and the obligation for thorough investigation is therefore that much greater.

State regulatory frameworks generally correspond to the framework of federal regulation. Most states require the registration of securities unless a specific exemption is available. Virtually all states require the registration of brokers or dealers, absent a specific exemption. All jurisdictions proscribe fraud in the sale of securities, and most state securities laws authorize a private right of action by a defrauded purchaser of securities.

Although it differs from the federal exemptive pattern, there is also a discernible pattern to state exemptions from securities registration. Most states, for example, have some variation of the federal private placement exemption, although individual provisions differ widely. In some states, the exemptions pertain only to offerings within the state to no more than a specified number of offerees (usually ten to twenty-five) within a twelve-month period, if purchasers take for investment. In some of those states, like Massachusetts or Pennsylvania, a claim of exemption must be made by filing with the appropriate authorities a specified number of days prior to the time any offer may be made. In other states, like Texas, the limitation, rather than being expressed in terms of the number of offerees, is expressed in terms of the number of purchasers or security holders. With respect to some states, an affirmative claim of exemption must be made prior to the time reliance may be placed upon it. Still other states have no private placement exemption. Finally, most states' statutes contain a provision for the state securities commissioners to withdraw or further condition exemptions afforded by their state statutes and waive any conditions contained therein.

In essence, this means that it is critical for a broker/dealer to verify the law of each and every state in which any offer of a security is to be made prior to making such offer in or from that state or to any residents of that state. The states' private offering exemptions are not uniform, and the statutes of most states provide for absolute civil liability for sales of securities in violation of the states' registration requirements. If a private exemption is not available in a particular state, the offering must be registered in that state just like a public offering. In many states, the administrator will have the power to determine whether the offering is "fair, just, and equitable."

Whether or not the offering is filed, or required to be filed, state statutes contain civil liability provisions and provisions which parallel the federal anti-fraud statutes. The courts have in some instances adopted aiding and abetting and conspiracy theories similar to those under the federal securities acts at the state level as well. State statutes often by their terms apply to any "broker/dealer" instead of "underwriter," thereby making their application much more expansive than the federal statutes.

In sum, state requirements may be even more difficult and restrictive than federal requirements and should be given close attention by any person seeking to offer securities pursuant to a private exemption.

Case Law — The availability of the federal private placement exemption depends in large part upon the administrative and judicial law derived from over 46 years of interpretation and there are a number of very important lessons to be derived from case law and administrative law.

Perhaps the most significant lesson is that virtually all of the cases turned on a simple procedural matter, the failure of the issuer and any party acting on its behalf to introduce sufficient evidence to prove the availability of the exemption. In short, the cases are illustrative of the consequences of a failure to maintain an adequate burden of proof file. In this area, many believe that leaving a paper trail is critical.

A few other pertinent lessons derived from the case law deserve mentioning. First, it is clear that the issuer claiming the benefit of an exemption from the registration requirements of the 1933 Act, and anyone acting on behalf of the issuer, has the burden of proving entitlement to the claimed exemption.

Another lesson is that, according to the case law, the nature of offerees is absolutely critical, and the focus is upon their number, whether they all had access to the kind of information which a registration statement would provide, and whether they were all sophisticated investors. Lastly, it is important to note that the number of offerees, in and of itself, is not conclusive, nor is the number of purchasers, in determining the availability of the private offering exemption.

Potential Liability for Loss of Exemption — Having studied the federal and state provisions for private offering exemptions, and the case law derived therefrom, let us consider the consequences of failing to satisfy requirements for such an exemption. If an unregistered offer or sale of a security is not exempt from registration, the consequences may be drastic. Those consequences involve liability to any suing purchaser for the full amount paid for the securities, plus interest. Most attorneys agree that, in selling a partnership interest pursuant to the private placement exemption, a chief objective of the broker/dealer should be to structure the sales effort, and indeed the entire transaction, so as to make the exemption, generally Rule 146, available.

To reiterate, among the severe disadvantages of any violation of Rule 146, apart from whatever action the SEC might take, is the right which all purchasers in such a transaction would have to rescind and recover their purchase price, even though such purchasers may have received complete and accurate information and the sale may have been in all other respects proper. This is so, even though the suing purchasers may be undisputably sophisticated and rich. One "bad" offering under Section 4(2) or one "bad" sale under Rule 146 can result in rescission rights for all purchasers. Accordingly, the issuer and broker/dealer may, at the option of purchasers, be required to return all of the funds received in a private placement, with interest. Since exercise of rescission rights alone would result in severe financial consequences, the importance of complying with all of the technicalities of Rule 146 or other claimed exemptions, cannot be overemphasized.

While the results in any fact situation will, of course, vary, failure to comply with the technical requirements of Rule 146 may result in the unavailability of the exemption provided by that safe harbor. The question then becomes whether the offering satisfies the requirements of Section 4(2) of the 1933 Act. The danger is always present that the offering will be found to be not in compliance with Section 4(2). The offering may be found to constitute a "distribution." Any broker/dealer engaged in a distribution to the public is potentially an "underwriter" as defined in Section 2(11) of the 1933 Act subject to underwriter's liability as provided in the 1933 Act.

Preserving the Private Offering Exemption: Procedures for Complying with Rule 146

As noted earlier, the regulatory provisions relating to private offerings discussed here are equally applicable to offerings by corporations or partnerships. Most of the questions which arise in this area, however, relate to the sale of limited partnership interests. Such interests are more frequently marketed to individual investors than privately placed corporate offerings. Because of the apparent greater concern over the status of partnership offerings under private offering exemptions, the discussion here will presume a private offering of a limited partnership.

Most partnership offerings made pursuant to private exemptions today appear to be made on the basis of Rule 146. It is impossible to comply inadvertently with Rule 146; very specific steps are necessary to assure compliance with the rule's numerous specific requirements.

The requirements of Rule 146 are detailed and most broker/dealers are probably familiar with a listing of those requirements.[2] For those who are not familiar with the specific requirements of the rule, there are some excellent articles and books available on the subject. Any broker/dealer who intends to sell securities in reliance upon Rule 146 should become familiar with all of its conditions and provisions.

Rather than review specific requirements of Rule 146, this analysis will approach the rule from another angle. Assume that a broker/dealer sold millions of dollars of partnership interests in an oil and gas offering and that now, almost a year later, when no oil was found, he is drawn into litigation by one of the "sophisticated" investors in that program and charged with, among other things, selling securities in violation of the registration requirements of the 1933 Act. Not so bad, he concludes, scanning the list of investors. All of them are qualified, all of them are rich, all of them are sophisticated and the broker/dealer has offeree questionnaires delivered with the private placement memorandum and executed by each of the purchasers which substantiate all of these factors. Can the broker/dealer breathe a sigh of relief? Many securities attorneys would say "absolutely not." They would state that, if that is the extent of what will be introduced into evidence, the firm cannot possibly sustain the burden of proving the availability of the exemptions, whether within or outside of Rule 146.

What would one have to show, assuming that the offering was made in reliance upon Rule 146? The NASD does not, of course, issue legal advice on such subjects. Securities attorneys state, however, that the critical requirements would be the following:

1. One would have to prove that all offerees, as well as all purchasers, were qualified. In order to do that, first he would have to introduce evidence showing that, prior to the time he made each and every offer, the issuer or, in most cases, the broker/dealer, since this will be his area of responsibility, believed — with reasonable grounds — either that the offeree had (a) investment sophistication (meaning such knowledge and experience in financial and business matters that he is capable of evaluating the merits

[2]For reference purposes, a copy of the text of Rule 146 is included as Exhibit D to this book.

and risks of the proposed investment) or (b) risk-bearing ability (meaning the ability to bear the economic risk of the investment).

Additionally, the defendant broker/dealer would have to introduce proof showing that, immediately prior to making any sale, the issuer and the broker/dealer believed — with reasonable grounds, after reasonable investigation — that each purchaser-to-be either had investment sophistication or had risk-bearing ability and an advisor (known as an offeree representative) who had such investment sophistication.

2. One would have to prove that he had reasonable grounds to believe that the number of purchasers fell within the numerical limit of Rule 146.

3. One would have to introduce proof showing that the offering was made in such a manner as not to involve general advertising or general solicitation. If there were any seminars, he would be required to prove that only qualified offerees (or the broker/dealer's own sales representatives) were in attendance.

4. With few exceptions, one would have to prove that he furnished to every offeree the information that would be required to be furnished if the offering were registered.

Now, of course, there are other areas as to which evidence must be introduced, such as proof of filing Form 146, which are the responsibility of the issuer. At the state level, one might also be required to prove such things as the fact that an exemption was obtained prior to any offers being made or that every purchaser in that state was apprised of certain limited rescission rights.

Is it now becoming obvious that, if the only things one could introduce into evidence in the earlier hypothetical example were a list of qualified investors, with executed investor questionnaires for each one, he would have satisfied only one of the requirements securities attorneys enumerate? He would simply have shown that there was reasonable inquiry between the time of offer and the time of sale to substantiate his reasonable basis for believing that purchasers-to-be were qualified. Important, certainly, but not even a remotely adequate burden of proof file.

The Burden of Proof File

Several times, the term "burden of proof file" has been used here. This is a file which, at the conclusion of an offering, contains all written material relating to the offering, especially compliance material. Attorneys suggest that it should show the offers made, the basis of reasonable belief, all actions taken by the issuer and anyone acting on its behalf and all other facts needed to establish availability of an exemption. It is this package of information which should be packed away at the end of an offering, ready to be dragged out and presented into evidence should availability of the exemption at any time be challenged. The essential question is whether the issuer and anyone acting on its behalf, at the completion of the offering, will have a sufficient record of the offers made and facts used to make various determinations so as to sustain the exemption.

Need for a Unified System

As stated above, almost all of the court cases defending claimed exemptions were lost because of the inability of the issuer or the underwriter to prove compliance with the requirements of the private placement exemption. Some sophisticated securities attorneys urge that any broker/dealer involved in selling partnership offerings through private placements have a unified compliance system in place, and that this system be faithfully followed. Forms should be designed for utilization in connection with all possible offerings under the provisions of Rule 146 and should provide for compliance with the rule from inception to completion of every offering.

Installing a Compliance System

Let us consider one attorney's views about putting a unified compliance system into place and what such a system should contain.

It has been observed that many departments of large broker/dealers which originate partnership offerings operate somewhat independently of the firm's corporate compliance officers. Where this situation exists, a compliance officer should be appointed within that department or the firm's regular compliance officer should supervise Rule 146 compliance procedures. In any event, there should be a specific compliance officer within the firm who should have direct participation program compliance responsibilities.

If a firm does not have specific Rule 146 offering procedures in place, then the firm should have such a system prepared, tailored for its needs and installed as quickly as possible. The cost of creation of such a system is not too great and could if necessary be amortized over several placements. Once the overall system is approved, then some effort should be made to train branch managers and individual sales representatives in the new offering procedures. In any event, once the system is in place, the firm should insist on internal conformity.

Components of a Minimal System

One attorney describes the mechanics of a minimal, integrated Rule 146 compliance system as follows:

1. *Master Schedule:* There should be some kind of master schedule or overall flow chart. This record serves as the central coordination point for the entire private placement process. Provision should be made on it for the notation of all significant events that must occur throughout the offering period in terms of

each offeree and/or offeree representative in order to satisfy the many constraints of the rule. On it, for example, should be noted such things as the name of all offerees, their states of residence, the basis upon which they were evaluated and qualified as offerees, transmittal of memoranda to them, their offeree representatives' names, questionnaires and other documents, final evaluation, receipt of offeree questionnaires, and so forth. Both during and at the end of an offering, the broker/dealer should be in a position to track every offer made, either to termination or to purchase, as the case may be. The larger the offering, the longer the flow chart, but the process remains the same. It is important to note, however, that this and all other records in the system cannot be partially completed but must be completed in total. The more detailed the records system, however, the greater the danger that the information obtained may be incomplete and therefore potentially used against the broker/dealer to prove a lack of reasonable grounds or investigation on which to conclude that the private offering exemption was sustained.

2. *Private Placement Memoranda Distribution Record:* A second important record is a private placement memoranda distribution record. This record form should be designed to allow maintenance of a continuous check on the location and status of all private placement memoranda, whether such memoranda are being used internally or have been distributed to offerees. Careful control of and accounting for private placement memoranda is a necessary requirement of nonpublic distributions under both federal and state securities laws.

3. *Forms:* As for forms, there are several which attorneys consider. There are a number of additional forms which some attorneys think ought to be placed into the compliance system, but which are not necessarily used with regard to every offering. As for the basic forms, one attorney believes they should consist generally of the following:

a. *Potential Offeree Identification Form.* This form, which is completed internally, serves as a preliminary mechanism to target and gather information on individuals who may qualify as potential offerees. The form can be partly keyed to previously completed offeree questionnaires if an offeree has invested in a previous deal, or can be utilized where dealing with a new offeree. This form should not give the appearance of being part of the selling mechanism, however, so as to avoid the possibility of a subsequent claim that all individuals were the subject of a general solicitation.

b. *Potential Offeree Evaluation Form.* This serves as a fundamental evaluation document, again completed by internal managerial personnel. It was mentioned earlier that the broker/dealer will be required to prove that the issuer and any person acting on its behalf believed, with reasonable grounds, immediately prior to making each offer that every potential offeree met one of the standards of an offeree set forth in the rule. The potential offeree evaluation form triggers the analysis process and provides evidence that, prior to an offer having been made to an individual, the required reasonable grounds to believe and belief were present. Taken together with the potential offeree identification form (or a recently completed offeree questionnaire form from a prior transaction), the broker/dealer should have sufficient proof regarding qualification of offerees.

c. *Offeree Questionnaire.* Another basic form which should comprise part of the compliance system is the offeree questionnaire. It is this questionnaire that is often included as part of the subscription package in the private placement memorandum and is the questionnaire which is to be completed by the potential investor himself. It is designed to elicit information, provide the broker/dealer with reasonable grounds to believe that a potential investor qualifies for inclusion in the offering and satisfy in large part his duty of reasonable investigation between offer and sale.

d. *Offeree Representative Documents.* Where an offeree representative is utilized, there are a number of additional forms and steps which are required to be taken by Rule 146, and attorneys advise that these basic forms also be included in the compliance system. For example, since the broker/dealer will have to make a determination as to the offeree representative's investment sophistication, it will be necessary to obtain an offeree representative questionnaire from that representative. This form should elicit sufficient information to enable the broker/dealer to establish such person's qualification as an offeree representative and to reveal certain material relationships between the offeree representative and the issuer, as required by Rule 146. As also required by Rule 146, prior to purchase, the offeree must acknowledge receipt of the material relationship disclosure and must acknowledge with respect to each particular investment that the offeree representative is acting in that capacity for him. In addition, since it is necessary for the issuer and anyone acting on its behalf, prior to sale, also to disclose to the individual offeree any material relationship between them and that individual's offeree representative, it is also necessary to include a form for that purpose.

e. *Final Evaluation Form.* The last basic form in this attorney's system is a final evaluation form. This is the concluding evaluation document and is completed internally prior to sale. The form is designed to provide for review of the documents previously collected as to each offeree and offeree representative in order to provide evidence that reasonable grounds exist as to each offeree's qualification to purchase the security.

4. *Additional Forms:* So much for the basic system. There are additional documents and samples which some attorneys believe might also be included in an integrated compliance system. A few of those are as follows:

a. *Additional Offeree Questionnaires.* The offeree questionnaire usually included in the private placement memorandum is a questionnaire designed for use by individuals. Often, the purchasers of direct participation program interests are either partnerships, corporations, or trusts, and one should have alternate forms of offeree questionnaires to be utilized as needed by each of such entities.

b. *Meeting Records.* Additionally, since there are often informational meetings for individuals involved in an offering and since Rule 146 is very clear on precisely who may and, by negative inference, who may not, attend such meetings, forms of notification letters for meetings, as well as a record form for the meeting itself should be included. Remember, the broker/dealer would be required to prove who was there and what was said.

c. *Forms of Transmittal Letters.* The third category of additional forms suggested for this attorney's system consists of various transmittal letters. Although the broker/dealer may wish to vary these letters from time to time, samples of accompanying letters for the various material being transmitted to offerees should be included in the compliance program.

This particular system may appear to involve a lot of paperwork, especially the first time through an offering. After that, the procedure should become simpler, provided that it is done continuously and consistently, provided that the flow charts are kept from the inception of the offering, and provided that the gaps in paperwork are noted and corrected throughout the offering.

In most offerings, at least where sophisticated issuers and equally sophisticated counsel are involved, the broker/dealer will be undertaking in the selling agreement the responsibility of maintaining adequate records evidencing his compliance with the many requirements of Rule 146. Having undertaken the responsibility of maintaining the burden of proof file to preserve the exemption, it is incumbent upon the broker/dealer to do so, especially since he has probably indemnified the issuer against liability arising out of his failure to do so. Remember again what was said about how all the court cases were lost?

Special Areas

Before turning to the selling agreement which some attorneys believe is critical to the due diligence responsibilities of the broker/dealer, let us look at a few special areas. The first concerns multiple firms in the same offering. Many securities attorneys maintain that nowhere is there a greater need for control than in this kind of situation. These attorneys believe that, just as in a corporate offering, it is critical that one firm be designated as principal selling agent. It is then the responsibility of that principal selling agent, among other things, to approve or control the compliance procedures to be utilized by the entire selling group. If another member of the selling group does not have adequate Rule 146 procedures in place, then, for purposes of that offering, the principal selling agent should take the responsibility of designating the procedures to be used and should control distributing of memoranda.

The second special problem, although one welcomed by broker/dealers, has to do with repeat offerees and investors. At least some attorneys take the position that offeree questionnaires and evaluations completed within a relatively recent time period should be sufficient for repeat offers. For this reason, it may be useful to have a master file of all investors with, in each file, a copy of offeree questionnaires executed by such investor, offeree representative information and questionnaires, and notations of all investments. If possible, it is useful to computerize the information generated by these documents, especially the net worth information, state of residence and previous investment details. In this regard, the broker/dealer should determine, for internal purposes, a reasonable period, absent additional information on an offeree, for which an offeree's previous questionnaire should be good, at least for purposes of qualifying offerees. Where there is a previous questionnaire filled out by an offeree in the files, there should not be any need to justify an offer based upon internally generated information from a sales representative. One must make sure, however, that the information maintained does not constitute a "credit report" within the scope of regulations applicable to such reports.

Importance of the Selling Agreement

The other main vehicle utilized for due diligence with respect to partnership offerings in preserving the exempt status of a private placement is the same document utilized for such purposes in corporate offerings — the selling agreement. Knowledgeable securities attorneys point out that one of the most critical functions of the selling agreement is to focus attention on the various areas of responsibility, liability, and undertakings of the parties to that agreement.

Some attorneys are surprised by the number of broker/dealers who enter into selling agreements which carefully delineate their responsibility for complying with various aspects of Rule 146 and which then give the broker/dealer some modicum of indemnification against omissions and material misrepresentations in the offering documents, but which give them nothing more than that. Let us consider some of the basic provisions of selling agreements relating to direct participation program offerings which attorneys believe can assist broker/dealers in carrying out their due diligence obligations.

Representations and Warranties — Attorneys maintain that the general partner, issuer and/or sponsor, among other things, should be willing to represent and warrant, *i.e.*, to assure the broker/dealer of, the following that:

1. they have prepared and furnished to the broker/dealer a private placement memorandum which furnishes the information essentially required to be furnished under Rule 146 and that that document does not include any untrue statements, omissions, or misrepresentations (except, of course, for information concerning the broker/dealer);

2. assuming the offering and sale of units is made in compliance with the terms of the memorandum and the selling agreement, that they have complied with the private placement exemption of the 1933 Act, with all of the provisions of Rule 146 applicable to them, and with all other securities laws and regulations applicable to them;

3. the partnership in fact has been duly organized and is validly existing as a limited partnership and that it is qualified to do business in the various jurisdictions where it may be required to be so qualified in order to protect the limited liability of the limited partners; and

4. as in a corporate offering, the general partner, if it is a corporation, is duly organized and existing, the securities conform to the statements relating to them contained in the memorandum, there are no violations of certificates of incorporation or bylaws, no breaches of contracts, no material litigation, no defaults in material obligations, and so forth.

All the representations and warranties given to the principal selling agent should expressly run to all members of the selling group.

Covenants — Among the covenants which attorneys believe the partnership, the general partners, and promoters should give the broker/dealer are those expressly dealing with such things as filing Form 146 with the Commission and necessary state securities administrators, and causing the general partner, if it is a sole corporate general partner, to meet whatever net worth or other requirements for tax purposes that have been agreed upon.

Opinions — Attorneys advise broker/dealers that they should also receive opinions of counsel to the partnership, the general partner, and the promoter with respect to such things as the organization of the partnership, its qualification in foreign jurisdictions, and various aspects of compliance with the private placement exemption. The precise nature of those opinions may be left to negotiation between the various counsel involved. The broker/dealer should be assured, however, that such counsel has expressly focused upon these matters.

Many securities attorneys and broker/dealers believe that it is advisable to seek the opinion of counsel on the status of a particular offering under the claimed private offering exemption. There is general agreement among securities attorneys that, provided with the necessary factual information, as well as his own investigation and perhaps some reasonable assumptions, a competent attorney should be able to render an opinion as to the availability of a claimed exemption under Section 4(2) of the 1933 Act.

When an offering is made upon the basis of Rule 146, however, the question of the availability of an opinion will become more controversial. Many attorneys will not render an opinion that a given offering is in compliance with Rule 146 because of the technical complications and conditions involving subjective determinations that are involved in the rule. An attorney may simply enumerate the documents executed in an attempt to comply with Rule 146 and state that these are the documents normally prepared for such an offering.

Some broker/dealers maintain that much is gained by requesting an attorney to render an opinion on the validity of the private offering exemption, and some require such an opinion of counsel, to the effect that a valid private placement under either Section 4(2) or Rule 146 is available. Some broker/dealers believe that this exercise results in a more thorough analysis of the claimed exemption and the disclosure in the private offering circular.

Another very important area to be focused upon concerns integration of the partnership offering with other offerings and sales of securities by the general partner or any of its affiliates so as to render the exemption provided by Rule 146 unavailable. If there are problems with other offerings which make rendering this opinion difficult, the broker/dealer might agree that specific other offerings may be excluded from any opinion he may be receiving. Some attorneys suggest, however, that unless language is included in the selling agreement concerning this opinion requirement, counsel may not focus upon the impact of other partnership offerings by the same promoters.

Closing Certificates — Prior to closing, the broker/dealer should be receiving certificates which bring down the representations, warranties, covenants, and agreements to that point in time.

Indemnification — Finally, the selling agreement should contain comprehensive indemnification and contribution provisions.

There are, of course, other provisions of the selling agreement which have not been reviewed here, simply because they do not pertain to due diligence. To reiterate, those stated here do not necessarily constitute a complete listing and do not constitute an official statement of NASD position on this issue. They are, instead, a compilation of the views of some knowledgeable securities attorneys.

Practical Considerations in Performing Due Diligence Limited Partnership Offerings and Private Placements

Just as there are unique legal concerns which come into play whenever one attempts to sell securities, particularly limited partnership interests, via a private offering exemption, so there are unique practical concerns. The remainder of this discussion will deal with the unique aspects of partnership offerings, particularly private partnership offerings, which dictate special practical considerations. Practical steps as followed by some broker/dealers will be reviewed. Lastly, certain areas which are the subject of frequent questions will be studied.

Guiding Principles

Before considering specific practical procedures which are followed in conducting a due diligence investigation of a limited partnership offering, let us consider a few guiding principles which some broker/dealers follow in the conduct of such an investigation. As in other areas, it should be borne in mind that these principles are not necessarily sanctioned by the NASD and represent instead the views of certain members of the brokerage community. It should also be noted that many of the principles of due diligence which have been discussed in the context of corporate offerings are equally applicable to limited partnership offerings, including privately offered partnerships. Due diligence is always important, but many broker/ dealers believe it is more important in initial offerings or "promotional" type of offerings, especially those with a tax orientation.

Some broker/dealers reduce due diligence principles to two primary considerations: first, whether the investment should be sold to clients at all, and, if so, second, how the broker/dealer will prove the steps he took in analyzing the offering several years after the fact when he is called to task.

These broker/dealers see the first part of this formula as simply one of fulfilling a fiduciary responsibility placed on the broker/dealer by a customer to select investments. These broker/dealers believe that, especially in private placements and partnership offerings, customers rely upon their broker/dealer to exercise his expertise and judgment in determining the kind of offering that will be made to the customer.

The second guiding principle here is simply one of avoiding potential liability. This concern in turn may be seen as composed of two factors, one for the potential legal liability itself and, the second for the broker/dealer's potential loss of reputation.

With respect to legal liability, some programs are, of course, more difficult to defend than others. Programs which are structured with heavy emphasis on tax benefits, and with more marginal economic merit, are viewed by many broker/dealers as very difficult to defend. The cost of defending even the best of programs, however, is a factor which should be borne in mind. The cost of any litigation can quickly consume all of the profits which a broker/dealer realized from the offering.

Performing proper due diligence on partnership offerings helps the broker/dealers better understand the important aspects of such programs. The information obtained in the review process can be helpful in the sales process and help to justify the confidence that clients place in their broker/dealer. If the broker/dealer does not understand the projects he is selling, he cannot sell them well and, many believe, he should not attempt to do so.

There is no one way to perform due diligence and, in many ways, the due diligence process is really the application of common sense. One good approach, according to many broker/dealers is simply to do "good" deals. If the economics of the offering appear to be good, the problems which will arise because of shortcomings in the due diligence or disclosure process are likely to be reduced. Common sense should also be brought to bear, according to many broker/dealers, when pressure mounts to abbreviate the due diligence process and get on with completing an offering. Under those circumstances, there is a tendency to minimize any reservations which appear about the offering.

Another principle followed by many, although not all, broker/dealers distributing partnership offerings is to maintain an extensive written record of the due diligence investigation performed. Virtually all broker/dealers engaged in this process agree that the intent behind the 1933 Act is that a reasonable investigation be conducted and that all material facts be disclosed in the offering memorandum, and that it is important to maintain a written record indicating what steps toward fulfillment of that intent were taken.

In performing due diligence, some broker/dealers begin with an overview of the offering, applying the "big fact" approach. They ask themselves "what are the big facts which I should know about this offering? What is going to go wrong with this program which will subject me to liability?" While most view attention to detail as important, a broker/dealer should not ignore the big factors while concentrating on details.

Many smaller broker/dealers are cognizant of the need to undertake only programs of a size commensurate with the firm's capabilities and programs located in the firm's region. Dealing with programs sponsored by general partners which are located relatively nearby makes initial due diligence investigations easier and permits the broker/dealer to monitor the ongoing activities of the program after the distribution.

Many broker/dealers believe that there is much more to conducting a due diligence investigation for a private offering than for a registered offering. In dealing with private offerings, most broker/dealers follow the general principle of due diligence for public offerings, and then seek to assure themselves of the validity of the claimed exemption from registration. The validity of such claim is often not easily determined and compliance with some of the requirements, especially Rule 146, is often difficult. Smaller firms often find the requirements particularly difficult. For all of these reasons, many smaller broker/dealers rely heavily upon their own experienced securities counsel to determine the availability of the claimed exemptions. If any reasonable doubt exists as to the validity of an exemption, however, a broker/dealer should not participate in the offering.

Lastly, it should be noted that broker/dealers vary in their use of outside consultants. Some have suggested that it is ironic for firms which would routinely retain outside consultants when underwriting a corporate offering in a widely understood industry to attempt a partnership offering in a highly technical industry without any consultants. Some broker/dealers, however, spend significant amounts of funds on outside consultants. These firms may maintain smaller internal staffs and readily acknowledge their need for outside expertise in particular types of direct participation program offerings. Besides the limitations of staff size, some firms find natural limitations of their location. Firms located in major northeastern cities, for example, may retain outside consultants to provide expertise in agriculture. Many broker/dealers believe that it is advisable to fully utilize consultants in any due diligence investigation.

Steps in Conducting Due Diligence Investigations

From earlier discussions of transactions in partnerships and private offerings, it is obvious that most broker/dealers believe it is prudent to perform an investigation in the traditional due diligence sense as well as, in the case of private offerings, an investigation to assure that the private offering exemption is available and protected. Most broker/dealers agree that there is no one specific way to perform such an investigation, and that, in many respects, one's common sense must be used for guidance.

This discussion will set out the practical approach to the due diligence investigation followed by various broker/dealers. Generally speaking, the suggested approach of these broker/dealers is to look at the overall transaction, then at the persons involved in managing the prospective general partner, and at the properties, and other particular aspects.

It is important to note that the procedures discussed here are not intended to be all-inclusive or to present specific requirements for any particular offering. As noted throughout this book, these procedures are not intended to reflect any policy or specific requirements of the NASD or any other regulatory body but rather, are presented as practices which are viewed by various broker/dealers as appropriate in performing due diligence investigations. The requirements for adequate due diligence in any particular offering will vary, and each broker/dealer should consult with his own counsel in determining the nature of investigation which is called for in that particular transaction.

Offering Materials

Many broker/dealers begin the investigation with a thorough review of all of the offering materials. This review will vary, of course, depending upon the particular offering and the point in time at which the broker/dealer becomes involved. Unlike traditional corporate offerings where the prospective underwriter is involved in the preparation of all of the offering documents, partnership offerings are often presented to a broker/dealer with much of the documentation in final, or virtually final, form. The status of the offering documents should not, of course, deter a broker/dealer from conducting a thorough investigation and requesting that changes be made or, in the alternative, deciding not to participate in the offering. If the broker/dealer does not participate in the preparation of the offering materials but intends to sell a significant portion of the offering, he should closely review the documents and interview those persons responsible for drafting them.

In considering the offering materials, many broker/dealers first review the overall structure of the transaction. One of the most important questions to be addressed at this point is whether the transaction as structured has economic merit. The broker/dealer must determine whether there is a real likelihood that the results as described will actually be achieved. This is one of the most important determinations which will be made in the course of the investigation.

In analyzing the transaction, the broker/dealer should seek to determine whether investors will benefit from their participation in the program. In many "exotic" partnerships, broker/dealers may find that it is highly problematical that investors will ever realize any profit. Certain other areas, such as subsidized housing, may appear questionable in terms of economic merit but present other considerations. In the latter case, Internal Revenue Service policies, if satisfied, may provide a favorable result to investors. In any event, the economic losses of the program should be readily apparent. Some attorneys advise their clients to beware of any explanations cloaked in terms of complex or intertwined relationships.

Broker/dealers seek to determine whether there is any rationale to the sponsor's claims and projections when evaluating the overall transaction. In addition, there are many other factors, some of which are dealt with in greater detail below, relating both to business judgment and the legal considerations of due diligence investigations, which must be considered. These include arrangements for compensation, offering expenses and sales incentives, assessments and other staged payments, and the overall mechanics of the offering.

In the course of reviewing the transaction, broker/dealers usually give careful consideration to the underlying documents. Partnership agreements should be reviewed to determine if they are in proper form and it should be ascertained that titles and leases are properly executed and in fact have been or will be transferred to the partnership. Broker/dealers' own counsel are often utilized in assuring that these documents are sufficient.

The next area for investigation is the proposed sponsor and its management. This step involves a consideration of the quality of the character and experience of the people who will serve as general partners or management of the sponsor. Many broker/dealers consider this to be the most important aspect of the due diligence investigation. Many believe that the quality of individuals is more important in partnership offerings than in corporate offerings in view of the limited control which may be exercised over their activities in the management of the business once the offering is completed.

Most broker/dealers believe it is important to meet with and interview management for the purpose of forming an opinion as to each person's knowledge, ability, and forthrightness. Broker/dealers seek to determine the management team's overall depth of experience and the ability to manage the proposed project. Consideration of each person's forthrightness and credibility are important not only for decisions with respect to the offering initially, but also to demonstrate a reasonable basis for accepting their statements of intent with respect to actions to be performed after completion of the offering.

As part of this process, broker/dealers give particular attention to the experience of management to assure that they have expertise in areas relevant to the proposed program. It is important in this regard to assure that the management has expertise for each of the areas necessary to successfully operate the program. Some broker/dealers follow a policy of requiring a minimum of five years' experience. If the management does not possess the requisite experience, the broker/dealer should determine whether such experience is available to management on a contractual basis. In the latter instance, many believe it is better if there has been a history of a relationship with the "expert" retained by management unless the "expert" has a widespread reputation.

As a further step in evaluating the management, most broker/dealers review programs which the parties have managed in the past. While management's track record should not be seen as controlling, experience in the specific area of projected activity is important. Many programs are "blind pools" and in those offerings the investor is purchasing exclusively management expertise, without any specific properties or prospects designated.

In reviewing past programs, broker/dealers often talk to investors in those programs to determine the manner in which they have been managed.

One issue to be addressed in reviewing past programs is the ability of the prospective sponsor to handle investors' funds. While a particular person may be a very capable geologist who finds abundant quantities of oil, if he cannot account for investors' money, investors will lose out. Some broker/ dealers hire accountants to investigate the sponsor's handling of funds in past offerings, the allocation between limited partners and the general partner, and the overall effectiveness of the sponsor's accounting systems and general business practices. While such a review may cost from $2,000 to $12,000, some broker/dealers believe the investment is worthwhile.

In the case of oil and gas offerings, some broker/dealers retain petroleum engineers to analyze the track record and the inventory of prospects of the proposed general partner. In analyzing such a track record, however, it is important to study the success of the general partner in the geographic area where the proposed program will operate.

One aspect of reviewing past programs to determine the overall ability of management is simply to review problems which the general partner has faced to determine how those problems were solved.

Another aspect of broker/dealers' investigation of management is a determination of the depth of the organization. Broker/dealers seek to determine whether the success of the proposed program is dependent on a single person. If so, broker/dealers may seek "key man" life insurance policies payable to the partnership.

In evaluating management, some broker/dealers focus particularly on the amount of turnover in management, particularly among persons charged with supervision of the program's day-to-day operations.

An item often considered in the course of interviews with management is their overall attitude toward their responsibilities to investors and their responsibilities under the securities laws.

Many broker/dealers take steps to investigate the background and business reputation of individual general partners and officers and directors of corporate sponsors. Several broker/dealers obtain a background check on each such person with whom they are doing business for the first time. Such investigations are not credit checks but investigate each person's prior employment, reputation, and involvement in litigation. The cost for such investigations ranges from $400 to $600 but some broker/dealers believe that the expenditure is worthwhile. Broker/dealers have found relevant information, including data on felony convictions and bankruptcies, in the course of such investigations.

If the overall impression of the general partner as well as any background investigation prove satisfactory, these broker/dealers proceed to check other sources. Banks used by prospective sponsors may be a good source of information, although some broker/dealers have found that it is important to determine the standing of any bank providing data.

Broker/dealers sometimes contact suppliers to the proposed sponsor to determine whether the sponsor is in good standing and apparent sound financial condition. In the real estate industry, such a check may include contractors and property managers to determine the reputation of the general partner and opinions as to his performance in other partnerships.

Broker/dealers also find that a sponsor's competitors and trade associations are useful in providing information as to overall reputation and standing within the sponsor's industry.

One aspect of any investigation into a sponsor's stature is a thorough investigation of net worth. Broker/dealers often obtain "comfort" letters from a sponsor's accountants for this purpose. However, the reliability of the accountants should be assured.

While state securities authorities and the Internal Revenue Services may impose certain minimum net worth criteria on sponsors, many believe that the real question with respect to any partnership is whether the sponsor's net worth is adequate to perform its functions for the offering proposed.

Properties

The next step in conducting a due diligence investigation is the inspection of properties. While the value of an inspection may vary from program to program, many broker/dealers believe it is important to visit physical properties to gain an understanding of their quality, location, general market environment, competition, and special risks.

A visit to relevant properties is especially important in real estate offerings in the view of many broker/dealers. In specified property offerings, broker/dealers will inspect the property to be acquired. In "blind pools," broker/dealers visit properties of partnerships which the general partner has managed in the past. Some broker/dealers favor making such visits on an unannounced basis.

Other Factors

In addition to the general procedures for due diligence investigations discussed above, broker/dealers will give special attention to other factors as dictated by the particular facts of an offering. The remainder of the discussion in this section will be devoted to those factors.

Conflicts of interest present in the proposed program structure is one of the factors given particular attention by many broker/dealers. By the nature of general partners' typical business activities, many partnerships contain conflicts of interest in varying degrees. Some broker/dealers believe that the presence of some conflict of interest is not necessarily bad. A general partner who has no conflicts of interest may be a general partner who has no experience in the business of the partnership. Given the choice between an inexperienced general partner with absolutely no conflicts of interest and a well-experienced one with some potential conflicts, many broker/dealers argue that it is in the better interest of investors to elect to do business with the experienced general partner, taking steps to avoid potential abuse of any conflicts.

It is important, however, to determine the extent of any conflicts of interest. Broker/dealers take steps to determine exactly the relationships between the proposed sponsor and its affiliates. Broker/dealers should beware of transactions among affiliates and determine whether assets in such transactions are transferred at cost or at market price, and, if the latter, who determines market price. Similarly, they should determine when it is possible for assets to be transferred back.

The same concerns should be present with respect to services provided by affiliates of the sponsor. Broker/dealers may obtain a commitment from the sponsor as to the amount which will be charged for services. This permits the broker/dealer to determine whether the proposed charges are comparable to those for similar services.

Lastly, in investigating conflicts of interest, broker/dealers should be cognizant of any affiliation or potential conflict between the sponsor and attorneys or accountants who are performing services in connection with the offering.

Special tax considerations are a second factor which many broker/dealers see as important in investigating partnership offerings, both private and public. They see tax considerations as having greater import in partnership offerings than in corporate offerings. Assumptions underlying projected tax results should be reviewed. Broker/dealers typically determine whether claimed tax results are based upon IRS rulings or on an opinion of counsel.

If the projected tax results rely on an opinion of counsel, most broker/dealers believe it is important to carefully review that opinion to determine whether it adequately addresses all relevant factors and reaches a firm conclusion. Broker/dealers should determine whether the purported opinion in fact opines upon questions of tax law or merely presents a discussion with no conclusion. Many securities attorneys and broker/dealers believe that attorneys should be willing to express an opinion with respect to the treatment of the proposed entity as a partnership for tax purposes. Opinions which purport to opine on the deductibility of specific expenses, however, are questioned by some. Broker/dealers should determine whether the opinion considers important negative aspects such as possible recapture.

Broker/dealers are also typically concerned about the adequacy of disclosure regarding tax aspects and may request additional disclosure. Some broker/dealers require a restructuring of the overall transaction utilizing more conservative tax assumptions as a condition to their participation in the proposed offering.

Compensation arrangements for the proposed partnership are viewed as a third important factor by most broker/dealers. Broker/dealers often analyze the transaction to determine the relative flow of compensation to the various parties. Many broker/dealers look for a "mutuality of interest" between the sponsor and the investors in the structure of the offering which assures that the sponsor obtains compensation only when investors are also realizing a return.

A consideration of risk factors involved in the proposed offering is another element of many broker/dealers' due diligence. Their concern is whether such factors are properly disclosed, especially the risk of failure. Broker/dealers must also determine whether the risks involved are reasonable for investors to undertake. The analysis of risk factors for partnership offerings, in the view of many, must be more extensive than for corporate offerings.

The mechanics of the proposed offering itself are often the subject of review by broker/dealers. As noted earlier, broker/dealers typically review partnership and other documents, utilizing their own attorneys to determine the propriety of those documents. Other agreements, however, come into play in looking at the mechanics of the offering. For example, if the offering provides for an escrow of proceeds, the escrow agreement should be carefully studied to assure that of investors' funds are being protected in an account held by an independent financial institution.

The means proposed to assure compliance with regulatory requirements should be included in this review as well. Included here are concerns over the mechanics of assuring that private offering exemptions are not violated or that improper sales literature does not fall into the hands of public customers.

Most broker/dealers give particular attention to projections which are utilized in the sale of partnership interests. Broker/dealers review such projections and the underlying assumptions to determine their reasonableness. Some broker/dealers retain independent accounting firms to review projections while other broker/dealers rely upon their own research departments or other analytical personnel. Whichever approach is followed, a careful investigation should be conducted of any projections or assumptions which claim that the sponsor is better or more efficient in performing its activities than others in the industry.

In addition to the above factors, many broker/dealers believe it is important to give attention to the proposed use of proceeds, the rights of limited partners to remove the general partner, and any guarantees made by the general partner. As noted earlier, the emphasis to be placed upon any of the factors discussed here will vary depending upon the nature of the particular offering.

As a summary of the procedures utilized in conducting due diligence investigations of partnership offerings, some broker/dealers utilize checklists. While most securities attorneys and broker/dealers agree that checklists should never be utilized as the sole basis for a due diligence investigation because each offering is unique, some believe that checklists may be beneficial if used as general guidelines. In summarizing its procedures in conducting due diligence investigations, one broker/dealer has devised a list of steps which it often takes. This list is presented here solely for purposes of illustration and not as an indication of any minimum or maximum amount of effort which may be called for in any particular offering and not as any statement of NASD requirements. The steps are as follows:

1. Investigate whether the basic economic merits of the proposed undertaking and the results of prior activity have been adequately and meaningfully disclosed.
2. Review applicable partnership agreements for legal adequacy and tax consequences.
3. Perform a physical inspection of properties, plant and equipment of the sponsor.
4. Review the financial stability, reputation within the industry, and other available information on the sponsor's background, qualifications, and experience.
5. Examine the program for conflicts, risk factors, proposed activities, and financial status.
6. Examine the material records submitted by appraisers, engineers, and financial consultants.
7. Examine the items of compensation, with an emphasis on disclosure of all forms of compensation.
8. Conduct a study by qualified legal counsel of all tax aspects of the program to determine whether there is a reasonable basis for assuming the benefits are likely to occur.
9. Examine the experience of management and technical staff in operations and in the handling of funds, as well as the management of projects or services offered to the program.

Special Considerations for Smaller Participations

Many of the due diligence considerations discussed thus far are equally applicable to large and small, public and private partnership offerings. Certain practical considerations of the due diligence investigation may vary, however, depending on the size of the offering and the nature of each broker/dealer's participation. Different considerations come into play, for example, where one broker/dealer is offering and selling an entire large issue and where several broker/dealers are each handling small participations in a smaller offering. The special considerations inherent in the second situation are discussed here.[3]

Earlier discussions have repeatedly noted that, although the NASD does not currently have an affirmative requirement in this area, most broker/dealers perform some form of due diligence investigation prior to participating in either a public or private partnership offering. The earlier discussions have also reiterated that broker/dealers cannot rely solely on the sponsor or its affiliates to conduct such an investigation.

In seeking to achieve the ideal of an effective due diligence investigation in each offering, however, problems arise. The cost of conducting a due diligence investigation becomes a real factor and may have a significant impact on the approach many broker/dealers take to such an investigation. Cost becomes a particularly troublesome problem for the smaller broker/dealer. Often, the participation of such a firm in offerings is too small to justify the cost of performing a due diligence investigation of the nature which appears warranted. Such firms also often lack the technical expertise which may be called for by the offering.

The situation of the smaller firm seeking to balance considerations of costs and effective due diligence is a very difficult one. A number of practices have evolved, however, which are often of interest to smaller broker/dealers.

Smaller firms handling small participations in public or private partnership offerings often find it advantageous to pool their resources for the performance of due diligence investigations. This "joint due diligence" is particularly common on large offerings. Such a pooling may be achieved informally or through a formal agreement.

Often, five or six broker/dealers may informally contact each other on the basis of knowledge that they are each participating in a particular offering. Each broker/dealer agrees to contribute toward a due diligence budget. Initial contacts may arise when one or more of the broker/dealers becomes uncomfortable with the quality of due diligence which the firm is able to perform within the cost constraints of his particular participation.

Under an informal pooling, the broker/dealers may decide to pool their resources and retain an outside consultant to investigate the sponsor. The broker/dealers come to an agreement as to the particular consultant, the consultant performs an investigation and prepares a report. The broker/dealers may then meet with the consultant to review the report and ask questions concerning its findings. If additional areas appear relevant to one or more of the broker/dealers, these may be pursued by the consultant.

Broker/dealers under an informal arrangement do not typically pool their internal employees, although there is frequently an informal sharing of information among the participating broker/dealers.

A much more formal arrangement has been utilized by some groups of broker/dealers to help achieve cost-effective due diligence investigations. Some groups of regional broker/dealers have created formal organizations for the purpose of conducting due diligence investigations. These groups usually retain an attorney or employ other staff experts to conduct the investigation along lines directed by the member broker/dealers. Such investigations usually entail a visit to the sponsor and may involve interviews in a group session by representatives from each broker/dealer. Such formal arrangements normally call for the sponsor to pay a fee in order to have the group conduct an investigation.[4] The resulting reports are available to all members of the group, but each member makes its own decision as to participation in the offering. Such groups may vary in their expertise as to the types of offerings which they handle, but some broker/dealers which are members of such groups maintain that the group participation not only enables them to benefit from a more thorough investigation but makes them aware of more programs which are being offered.

Questions arise as to whether participation in a pooled due diligence effort is adequate to satisfy a broker/dealer's full responsibilities. Many broker/dealers believe that participation in the process goes a long way toward fulfilling those obligations, but that direct interviews with general partners or management of the sponsor may be called for in some circumstances.

A second procedure utilized by some broker/dealers to overcome the cost of due diligence is akin to a procedure which is common in corporate underwritings. Some broker/dealers request and ob-

[3] The considerations of a larger broker/dealer handling a small participation in an offering may be similar to those of a smaller broker/dealer in that situation, but it is the smaller firm which more frequently appears in need of guidance. Most of the discussion here will therefore focus on the smaller broker/dealer.

[4] The amount of any such fee normally would be viewed by the NASD as underwriting compensation subject to the requirement that total compensation for an offering be fair and reasonable.

tain an expense allowance from the sponsor for the conduct of the investigation.[5] While the sponsor's willingness to provide such an allowance will vary depending upon the amount of participation, some broker/dealers have found sponsors receptive to the concept. Broker/dealers have also found that, if the sponsor is not willing to provide an allowance for a single broker/dealer, an allowance may be forthcoming for a group of broker/dealers who pool their due diligence efforts.

Some firms rely on research services or consultants to reduce the cost of due diligence. In some cases, research service firms are paid by sponsors to prepare a due diligence report on the sponsor. The report is therefore not prepared by the sponsor per se although there may be a question of control by the sponsor. In other instances, subscription services paid by broker/dealers produce periodic reports on particular sponsors.

In each of these instances, most broker/dealers view the resulting reports as good starting points for the conduct by the broker/dealer of its own due diligence investigation. Some broker/dealers believe that consultants or research service firms also provide a good way of screening questionable offerings. These firms follow a procedure of requiring that any sponsor submit its product to such a process before the firm will consider participating in the distribution.

A fourth means utilized by some broker/dealers calls for placing limited reliance upon affiliates of the sponsor, including the captive broker/dealer. Broker/dealers and securities attorneys agree, however, that a broker/dealer should not rely upon an affiliate of the sponsor to satisfy the broker/ dealer's complete due diligence responsibilities. Reports prepared by affiliates are not prepared on an arm's-length basis and therefore are of only questionable objectivity. Some broker/dealers believe, however, that the reports prepared by affiliates of the sponsor provide a good starting point to begin their own investigation. By having such a document to work from, these firms find that they realize some cost savings.

A fifth practice which is utilized by some broker/dealers is sometimes referred to as "coattailing." If the amount of a firm's participation in an offering is particularly low, *e.g.*, $10,000 or $25,000, some firms may choose to rely primarily upon the due diligence investigation conducted by other broker/dealers who are handling a larger participation in the offering if the firm has great confidence in the broker/dealer which conducted the investigation. This reflects the fact that some broker/dealers may find it unrealistic to perform perform extensive due diligence from a cost/benefit standpoint. Some firms simply make the business decision to take the businss risk to the extent of their partcipation and rely on due diligence performed by others.

Some broker/dealers limit their use of "coattailing" to those situations in which the customer transaction is a bona fide unsolicited trade. Perhaps the most troublesome situation occurs when a customer approaches his broker/dealer with a request to purchase one unit in a partnership which the customer has learned about from other sources. While many broker/dealers are reluctant to refuse such a request, the cost of performing a full due diligence investigation under such circumstances may be difficult for the firm to justify. Some firms request that the customer attest in writing that the transaction was initiated by the customer and was not solicited by the broker/dealer before the firm will handle the transaction in reliance upon a due diligence investigation conducted by others. Some broker/dealers also limit this procedure to public offerings, on the theory that it is unwise to participate in a private offering in which the firm has not conducted thorough due diligence in view of the potential for full rescission of the transaction if the claimed private offering exemption is found to be unavailable.

The last alternative procedure for dealing with offerings in which a firm's participation does not justify costly due diligence is simply not to handle the offering. While such a decision usually involves business as well as regulatory and legal considerations, the potentially adverse consequences of handling a transaction without an adequate investigation may be so grave as to be controlling.

The dilemma faced by a firm handling a small participation is a serious one and realistic solutions are needed. Most attorneys agree, however, that broker/dealers should be extremely cautious in participating in any offering for which no adequate investigation has been conducted. In seeking to utilize any of the procedures discussed here, broker/ dealers should work closely with their own knowledgeable securities counsel.

* * * * *

It can be seen, therefore, that most securities attorneys and broker/dealers agree that general principles of due diligence apply to limited partnership offerings and to private placements. They also agree, however, that other, more extensive requirements may apply to those offerings. Broker/dealers are cautioned to enter into such transactions only after thoroughly familiarizing themselves with these requirements with the assistance of competent counsel.

[5] As in the case of fees paid to groups of broker/dealers, expense allowances flowing from sponsors to broker/dealers are subject to NASD guidelines on underwriting compensation.

Selected Questions and Answers on Limited Partnership Offerings and Private Placements

QUESTION: A few years ago the SEC proposed to amend Rule 146 so as to prohibit registered representatives from acting as offeree representatives. That proposal was never adopted because of a storm of protest, but the role of a registered representative acting as an offeree representative continues to raise questions in some people's minds. What types of potential problems may a firm encounter in permitting a registered representative to act as an offeree representative?

ANSWER: The duty of an offeree representative is not set forth in Rule 146. His duty is presumably to analyze the offering on behalf of the offeree, to inform the offeree of the good and bad aspects of the offering, and generally to sophisticate him by proxy. There is no requirement in the rule itself that the offeree representative recommend one way or the other that the offeree purchase.

Several securities attorneys believe that those broker/dealers which prohibit their registered representatives from acting as offeree representatives are taking the preferable approach simply because of the obvious conflict. They believe it is unrealistic to think that a registered representative may not be affected by the possibility of receiving a commission on the potential sale. The same attorneys note, however, that nothing legally prohibits a firm from utilizing offeree representatives and they note that there are a number of broker/dealers which do so.

QUESTION: Most of the discussion of the burden of proof file focused on the obligation of the broker/dealer engaged in the sales effort. What role does the issuer have in maintaining the file?

ANSWER: Most securities attorneys find that, when an issuer is relying upon a broker/dealer to do the selling effort, the issuer does not maintain a separate burden of proof file. They note that maintaining the burden of proof file in that situation is the responsibility of the broker/dealer except for certain things specified in Rule 146 as being the obligation of the issuer.

QUESTION: Is it ever appropriate to prepare a summary of an offering of a private placement and distribute the summary with the offering memorandum or even without the offering memorandum?

ANSWER: Most broker/dealers and securities attorneys would be very reluctant to use such a summary primarily because of the potential liability from persons who may have received only the summary and not the complete private placement memorandum. Securities attorneys caution that the use of such a summary could lead to a finding that the securities were being offered and sold on the basis of a document which has material omissions. If a summary were to be used, attorneys stress that it should very prominently state that the entire summary is qualified by reference to the private placement memorandum of which it is deemed to be a part and that records should be maintained to assure that everyone who receives the summary also receives the actual private placement memorandum prior to the time of purchase.

Exhibit A

NOTICE TO MEMBERS: 73-17

March 14, 1973

NOTICE

TO: All NASD Members and Interested Persons

RE: 1. Proposed New Article III, Section 35 of the Rules of Fair Practice Concerning Underwriter Inquiry Standards Respecting Distributions of Issues of Securities to the Public;

2. Proposed Amendment to Article III, Section 2 of the Rules of Fair Practice Concerning Suitability of Recommendations to Customers; and

3. Proposed Amendment to Schedule "C" of Article I, Section 2(d) of the By-Laws Embodying the Concept of and Requirements for a Qualified Underwriter Principal.

The Board of Governors of the Association has proposed a new Rule of Fair Practice, an amendment to an existing Rule of Fair Practice and an amendment to the Association's By-Laws which have as their purpose the establishment of a system of regulation in the areas of underwriter inquiry and investigation respecting distributions of issues of securities to the public, customer suitability standards for certain new issues, and the creation of a new category of registration, "qualified underwriter principal," with specified requirements to qualify for such. These proposals are being published by the Board at this time to enable all interested persons an opportunity to comment thereon. Other proposals bearing on the bona fides of certain public offerings of securities are part of an overall package and shall be published for comment in the near future. Comments on the proposals submitted herewith must be submitted in writing and be received by the Association by April 13, 1973, in order to receive consideration. After the comment period has expired, the proposals must again be reviewed by the Board. Thereafter, the proposed rule and rule amendment must be submitted to the membership for a vote. If approved, they and the proposed By-Law amendment must be submitted to and not disapproved by the Securities and Exchange Commission prior to becoming effective.

Explanation of Proposals

These proposals have resulted from the Securities and Exchange Commission's request of July 26, 1972, to the Association that it consider the establishment of appropriate standards in the areas of underwriter inquiry standards and customer suitability rules respecting first-time public offerings, among other things.

As a result of its Public Investigation in the Matter of the Hot Issues Securities Markets, the Commission determined that two significant problems relating to due diligence procedures of managing underwriters existed. First, the Commission noted that there was a diversity in due diligence practices among underwriters. Further, there appeared to be some disagreement among underwriters as to which statements in a registration statement must be verified, the extent to which such verification should be carried, and the methods and means by which such verification should be conducted. Secondly, the Commission also found that in some cases the due diligence practices of underwriters were inadequate to satisfy the reasonable investigation requirement of Section 11 of the Securities Act of 1933. That section is the basis of underwriters' so-called due diligence obligation in connection with its investigation of a company for which it is offering to the public an issue of securities. In light of the Commission's findings, it requested the Association to consider formulating minimum standards for underwriters to follow in connection with their due diligence investigations.

The Association's Board of Governors established an Ad Hoc Committee to Study New Issue Rules to review the Commission's requests. After several meetings, that Committee made certain recommendations to the Board which are the basis for the proposals here being made. In respect to underwriters' inquiry standards, the Board determined that the best approach would be to require that underwriters establish their own inquiry or "due diligence standards" for the investigation of an issuer prior to a public offering of securities and that they be required to follow the procedures they have thus established. These requirements are contained in a proposed Rule of Fair Practice, Article III, Section 35, attched hereto. The details of that proposed rule are delineated below. This approach follows the concept adopted in the past by the Association of requiring members to establish written supervisory procedures and to follow the procedures established, i.e., Article III, Section 27 of the Rules of Fair Practice.

The Board also concluded that important to a consideration of underwriter inquiry standards are the qualification of persons engaged in underwriting activities. Thus, it has proposed a new category of registration, "qualified underwriter principal," and requirements for qualifying as such, for those individuals engaged in the distribution of securities offerings to the public.

Experience in investment banking activities would be required to qualify as would successful passage of a qualification examination measuring competence in at least the three following areas, among others: (1) accounting and financial analysis; (2) regulations of the SEC and NASD pertaining to securities distributions; and (3) preparation of registration statements. These concepts are embodied in a proposed amendment to Schedule "C" to Article I, Section 2(d) of the Association's By-Laws.

In its Public Investigation, the Commission noted that the enormous demand for securities in a hot issue market might create pressures upon broker/dealers to hastily sell securities to their customers regardless of the investment merits of the securities or the customer's individual circumstances. Within that framework, the Commission requested the Association consider the development of suitability standards to guide its membership in selling securities issued by companies engaged in an initial distribution of securities to public investors. In this area, the Board upon recommendation of the Ad Hoc Committee, determined that higher than normal suitability standards should be required in connection with the distribution of securities of companies in the promotional, exploratory or development stage with no history of earnings. These new requirements would not apply to an established private company distributing its securities to the public for the first time. The proposed new suitability requirements are contained in a proposed amendment to Section 2 of the Association's Rules of Fair Practice. The amendment would require a member to maintain in its files the basis for and reasons upon which it made its determination of suitability as to a particular customer's purchase of securities of a promotional-type company in an initial public distribution.

A section-by-section analysis of the three proposals follows:

Proposed Article III, Section 35 of the Rules of Fair Practice

Paragraph (a) of proposed Section 35 would require every member engaged in investment banking activities, as defined, as a managing undewriter, as defined, to establish and maintain written procedures which it would be required to follow in its inquiry and investigation of an issuer for whom it is acting in the planned distribution of an issue of securities to the public. Sixteen areas of inquiry which would be required to be included in a member's procedures are stated in the rule. They are not intended to be exclusive of others which would be required depending upon the nature of a particular member's investment banking activities; rather, they are intended to represent minimum standards of inquiry. Subparagraphs (a)(1) through (15) have particular reference to managing underwriters engaged in the distribution of corporate securities to the public. Subparagraphs (a)(16)-(i) through (iv) require certain additional standards in connection with the distribution of tax-sheltered programs to the public.

The definition of "managing underwriter" in relation to paragraph (a) is important and it should be studied by all members. That term is defined for purposes of the rule in a manner different from the commonly understood meaning of the term so as to insure (when combined with paragraph (b)) that proper inquiry and investigation has been made by a member of the Association of all issues of securities distributed by members regardless of whether there is a managing underwriter in the context of the commonly understood meaning of that term. The term "managing underwriter" is defined for purposes of the rule as the:

> member originating the distribution and/or the primary distributor of the issue in question, or the member who made the required filing with the Association pursuant to the provisions of the Interpretation of the Board of Governors Concerning the Review of Corporate Financing.

Thus, all members who underwrite, act as the primary distributor or file an issue of securities with the Association for review pursuant to the Corporate Financing Interpretation are subject to the obligations of paragraph (a).

Paragraph (b) would cover situations where a corporate issue is "self-underwritten" by the issuer itself or a tax-sheltered program is distributed to the public by the "program issuer" or its affiliate utilizing NASD members. Many times these offerings are filed for review with the Association by the issuer itself which intends, if the review is favorable, to subsequently solicit NASD members for purposes of distribution. This has been permissible conduct but the Association's Board is concerned about the adequacy of disclosure in such situations because of the absence of an independent inquiry and investigation. Henceforth, therefore, pursuant to paragraph (b), members participating in such distributions would be subjected to the same paragraph (a) obligations of proper inquiry and investigation as members falling within the definition of "managing underwriters." If one of several distributors has assumed and met paragraph (a) obligations, the requirements of paragraphs (a) and (b) will be considered to have been met in connection with that offering. While paragraph (b) would appear to impose new requirements upon NASD members participating in the distribution of such corporate self-underwritten or tax-sheltered issues, it should be noted that such standards are applicable to such members since they could possibly already be considered underwriters under the Securities Act of 1933.

Paragraph (c) of Section 35 would require a managing underwriter prior to the effective date of a securities distribution to certify in the agreement among underwriters that it had both established adequate inquiry and investigation procedures as detailed in paragraph (a) of the proposed rule, and had followed such procedures with respect to the underwriting in question. Paragraph (c) would also require the managing underwriter to make such a certification to all selling group members prior to the offering date of a securities distribution in those cases where an agreement among underwriters does not exist. In those cases where neither an agreement among underwriters exists nor a selling group has been established, nor where the required inquiry and investigation is performed by a member subject to the provisions of paragraph (b), the certification must be contained in the prospectus.

Paragraph (d) would require each managing underwriter to maintain, keep and preserve written documentation evidencing compliance with the provisions of proposed Section 35. These records would be required to be maintained for a period of five years, the first two years in an easily accessible place. This retention requirement is similar in scope to the requirement of Securities and Exchange Commission Rule 17a-4 respecting records to be preserved by broker/dealers. This documentation will be reviewed by the Association in the course of its inspection program of members' offices.

Paragraph (e) defines the words "investment banking," "managing underwriter," "prospectus," and "tax-sheltered program," used in Section 35. The term "managing underwriter" has been discussed above. The other definitions are self-explanatory.

Proposed Amendment to Article III, Section 2 of the Rules of Fair Practice

Paragraph (a) of Section 2 would be changed only by a technical amendment made necessary by proposed new paragraph (b). Thus, the Association's existing suitability standards would continue to apply in respect to all transactions (except those regulated by Schedule 'E" to Article IV, Section 2(c) of the By-Laws) not covered by paragraph (b).

Paragraph (b) would impose more stringent suitability requirements in connection with recommendations to customers by members of certain unseasoned securities. That paragraph would require a member who recommends to customers the purchase of a security which is part of initial public offering of a company in the promotional, exploratory or developmental stage, as defined, to maintain written documentation detailing the basis for and the reasons upon which such determination was established. The suitability of the recommendation would be required to be judged by the member based on information furnished by the customer concerning his investment objectives, financial needs and situation, and other pertinent information known to the member.

Paragraph (c) would define the phrase, "promotional, exploratory or developmental stage," as used in paragraph (b) as being a company incorporated or organized within one year prior to the date of the filing of the registration statement for the issue to be distributed and which has not had net income resulting from operations of the character for which the company was formed; or a company incorporated or organized more than one year prior to the date of the filing of the registration statement for the issue to be distributed and has not had net income resulting from operations of the character for which the company was formed in at least one of the two fiscal years immediately preceding the filing of the registration statement or in at least one fiscal year if the company was organized less than two years prior to the filing of the registration statement. These criteria are similar to those contained in Rule 253 under the Securities Act of 1933 dealing with Regulation A offerings.

Proposed Amendment to Part I of Schedule "C" to Article I, Section 2(d) of the Association's By-Laws

Subparagraph (a)(1) of proposed Section (4) of Schedule "C" to Article I, Section 2(d) of the Association's By-Laws applies to new members and would in subparagraph (a)(i) require each firm whose membership becomes effective after the adoption of the proposed amendment, and who intends to engage in investment banking activities, to designate with the Association at least one person as a "Qualified Underwriter Principal." The duties of such individual would include the organization and/or supervision of any participation in the origination or distribution of offerings of securities by a member whether as an underwriter or selling group member.

Subparagraph (a)(ii) would require, prior to the time the new member could engage in investment banking activities, as defined, the individual designated by the firm as a "Qualified Underwriter Principal" to pass both a Qualification Examination for Principals and the new Qualification Examination for Qualified Underwriter Principals. If such individual is not required to pass the Qualification Examination for Principals as per the provisions of subparagraph 1(c) of Schedule "C," because he had previously passed that examination or was "grandfathered," he would be required nonetheless to pass the examination for Qualified Underwriter Principal.

Subparagraph (a)(iii) would establish an experience requirement which would have to be met before a person could be designated by a member as a Qualified Underwriter Principal. Thus, the person so designated would have to have been associated with a member actively engaged in the distribution of offerings of securities for a period of at least three years prior to such designation and he must demonstrate that his duties during such employment entailed involvement by him with the member's investment banking activities. Subparagraph (a)(iii) also provides for a waiver of the experience requirement in exceptional cases upon written application to the President of the Association. The burden of jusification of all waivers would be upon the applicant.

Paragraph (b) to proposed Section (4) applies to existing members of the Association. Subparagraph (b)(1) thereof would require each such member engaged in investment banking activities whose membership became effective prior to the adoption of the proposed amendment to designate with the Association at least one Qualified Underwriter Principal. Such member would not be permitted to engage in investment banking unless such designation had been made and approved by the Association. Subparagraph (b)(1) would also require, with certain exemptions contained in subparagraph (b)(iv), such designated person to pass both a Qualification Examination for Principals (unless such were previously taken) and a Qualification Examination for Qualified Underwriter Principals.

Subparagraph (b)(ii) would require every person becoming registered as a principal of a member after the effective date of the rule whose duties do or will involve the organization and/or supervision of any participation in the origination or distribution of offerings of securities by the member whether as an underwriter or selling group member to be designated as a Qualified Underwriter Principal. These individuals would be required to pass both the Qualification Examination for Principals (if it had not already been passed) and the Qualification Examination for Qualified Underwriter Principals. It should be noted that a selling group member is defined as a member engaged in a distribution whose participation exceeds 10% or more of the entire securities offering.

Subparagraph (b)(iii) would require any registered principal whose duties are changed after the adoption of this proposed amendment to Schedule "C" to involve the organization and/or supervision of any participation in the origination or distribution of offerings of securities by the member whether as an underwriter or selling group member to pass the Association's Qualification Examination for Qualified Underwriter Principals.

Subparagraph (b)(iv) would permit those principals who were actively engaged in the distribution or underwriting of issues of securities and had been employed by a member or a series of members for a period of at least three years prior to the effective date of the proposed amendment to be qualified with the Association as a "Qualified Underwriter Principal" without taking the Qualification Examination for Underwriter Principals. Principals unable to qualify under this exemptive provision would be required to pass the Qualified Underwriter Principals examination testing a person's investment banking knowledge.

Subparagraph (b)(v) would require any individual whose status as a registered principal with the Association has been terminated for a period of at least two years immediately preceding his application as a "Qualified Underwriter Principal" to pass the Qualification Examination for Underwriter Principals prior to his assumption of duties relating to the organization and/or supervision of any member's investment banking activities notwithstanding the length of his previous experience in investment banking.

Paragraph (c) would prohibit any officer, director, general partner, owner of ten percentum or more of the voting securities or a controlling person of any Association member for whom a trustee has been or is subsequently appointed pursuant to the Securities Investor Protection Act from engaging in any phase of investment banking activities until such individual has passed the Qualification Examination for Principals and the Qualification Examination for Underwriter Principals. Therefore, after the adoption of this proposed amendment to Schedule "C" of the Association's By-Laws, no person previously or subsequently associated in the enumerated capacities with an Association member which had been or subsequently is placed in a SIPC trusteeship will be permitted to be responsible for the organization and/or supervision of any member's investment banking activities until such individual has qualified for such responsibility through the Association's experience and examination process.

Subparagraph (d) defines the "investment banking" and "selling group member" for purposes of Schedule "C." Those definitions are self-explanatory.

All comments should be addressed to Mr. Donald H. Burns, Secretary, National Association of Securities Dealers, Inc., 1735 K Street, N.W., Washington, D.C. 20006, on or before April 13, 1973. All communication will be considered available for inspection.

Sincerely,

Gordon S. Macklin
President

PROPOSED ARTICLE III, SECTION 35 OF RULES OF FAIR PRACTICE CONCERNING UNDERWRITER INQUIRY AND INVESTIGATION STANDARDS RESPECTING DISTRIBUTIONS OF ISSUES OF SECURITIES TO THE PUBLIC

Obligation to Establish and Maintain Written Procedures

(a) Every member engaged in investment banking activity as a managing underwriter shall establish and maintain written procedures which shall be followed by it in its inquiry and investigation of any issuer for whom it is acting in connection with the distribution of an issue of securities to the public. Such procedures shall include, but not necessarily be limited to, the following:

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

(2) Examination of the audited and unaudited financial statements of the issuer, including footnotes, for the preceding ten year period or for the entire period of the issuer's existence if less than ten years;

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

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

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

(6) Review of internal projects of the issuer, including the intended use of the proceedings of the offering;

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

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

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

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

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

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

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

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

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

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

(i) Investigation to determine that the management of a tax-sheltered investment program has experience and a working knowledge of tax-sheltered investments sufficient for the proper handling of investment monies and the maintenance of the tax-sheltered program.

(ii) Physical inspection of all properties described in the prospectus as being acquired by the tax-sheltered program, a review of all documents pertaining to such acquisitions and an examination of the facilities of any servicing function performed by the tax-sheltered management, if any.

(iii) Examination of applicable partnership agreements.

(iv) Review of available information with respect to the issuer's position within its industry including:

(i) Examination for proper disclosure of all conflicts of interest of the sponsor of the tax-sheltered program; and

(ii) Examination of all records submitted by appraisers, engineers, financial consultants, and other independent consultants with emphasis respecting the procedures utilized in the formulation of their analysis of the tax-sheltered investment, and study of all tax aspects of the tax-sheltered program to insure that the described or anticipated tax benefits will, in fact, accrue to the investor.

Obligation of Inquiry and Investigations in Issuer Distributed Offerings of Tax-Sheltered Programs

(b) At least one member participating in the distribution to the public of an issue of securities for which there is no managing underwriter must assume the obligation of establishing, maintaining and following written procedures concerning inquiry and investigation of the issuer as delineated in paragraph (a) hereof and those obligations of certification and record keeping contained in paragraphs (c) and (d) hereof.

Certification as to Adequate Inquiry

(c) On or prior to the effective date of the distribution of an issue of securities to the public, the managing underwriter shall certify in the agreement among underwriters that it had established adequate inquiry procedures in accordance with the provisions of subsection (a) hereof, and that in respect to the underwriting which is the subject of the agreement, it had followed procedures thus established. In the event there is no agreement among underwriters, the said certification shall be made to all selling group members. If there is no selling group, or if the required inquiry and investigation is performed by a member subject to the provisions of paragraph (b), the certification shall be made in the prospectus.

Maintenance and Retention of Written Documentation

(d) Every member subject to the provisions of paragraph (a) or (b) hereof shall keep and preserve appropriate written documentation demonstrating compliance with paragraphs (a) and (c) hereof. These records shall be preserved for a period of not less than five years, the first two years in an easily accessible place.

Definitions

(i) "Investment Banking Activity" — shall mean the business carried on by a member of underwriting or distributing issues of securities for which documents and other information are required to be filed with the Association pursuant to the provisions of the Interpretation of the Board of Governors Concerning the Review of Corporate Financing.

(ii) "Managing Underwriter" — for purposes of this Section 35 shall, where necessary in view of the context within which it is used, mean that the member originating the distribution and/or the primary distributor of the issue in question, or the member who made the required filing with the Association pursuant to the provisions of the Interpretation of the Board of Governors Concerning the Review of Corporate Financing.

(iii) "Prospectus" — shall have the meaning given to that term by Section 2(10) of the Securities Act of 1933; provided, however, that such term as used herein shall also include an offering circular filed with the Securities and Exchange Commission pursuant to Rule 256 of the General Rules and Regulations under the Securities Act of 1933 and, in the case of an intrastate offering, any document, by whatever name known, filed and/or distributed as part of the registration or similar process by whatever name known for an issue of securities pursuant to the laws or regulations of any state.

(iv) "Tax Sheltered Program" — a program which provides for flow-through tax benefits regardless of the structure of the legal entity or vehicle for distribution including, but not limited to, oil and gas programs, real estate syndications (except real estate investment trusts), citrus grove developments, cattle programs and all other programs of a similar nature, regardless of the industry represented by the program, or any combination thereof.

PROPOSED AMENDMENT TO ARTICLE III, SECTION 2 OF THE RULES OF FAIR PRACTICE

(New Material Italicized)

Section 2

(a) *Except as provided in paragraph (b) hereof,* in recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and to his financial situation and needs.

(b) *In recommending to a customer the purchase, sale or exchange of any security which is part of the initial public offering of a company in the promotional, exploratory or developmental stage, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of information furnished by the customer concerning the customer's investment objectives, financial situation and needs, and any other information known by the member. In connection with all such determinations, the member must maintain in its files the basis for and the reasons upon which it reached its determination.*

(c) *Definitions*

(i) *Promotional, Exploratory, Developmental Stage — shall mean a company incorporated or organized within one year prior to the filing of the registration statement for the offering to be distributed and which has not had a net income from operations of the character for which the company was formed; or a company which was incorporated or organized more than one year prior to the filing of the registration statement for the issue to be distributed and has* not had a net income from operations of the character for which the company was formed for at least one of the two fiscal years immediately preceding the filing of the registration statement.

PROPOSED AMENDMENT TO SCHEDULE "C" OF ARTICLE I, SECTION 2(d) OF THE ASSOCIATION'S BY-LAWS

(4) *Registration of Qualified Underwriter Principal*

(a) *New Members*

(i) *Effective every applicant for membership who intends to engage in investment banking activity shall designate with the corporation at least one person as a Qualified Underwriter Principal, the duties of whom shall include, but not necessarily be limited to, the organization and/or supervision of any participation in the organization or distribution of offerings of securities by a member whether as an underwriter or selling group member.*

(ii) *Before a member may engage in investment banking activity, the designated Qualified Underwriter Principal shall successfully complete Parts I and III of a three-part Qualification Examination for Principals. If a person is qualified to be registered as a principal pursuant to Part I hereof, such individual shall be required to pass only Part III of the Qualification Examination for Principals.*

(iii) *Only those persons who have three years of experience with a member actively engaged in the origination of the underwriting of offerings of securities and who can demonstrate that a significant part of their individual business experience with the member entailed involvement with investment banking activities may be designated and qualified as a Qualified Underwriter Principal. In an exceptional case, when the business background and experience of the designated individual justifies such, the experience requirement imposed herein may be waived by the President of the corporation upon written request of the designated Qualified Underwriter Principal. In all such cases the burden of justification for such waiver shall be upon the applicant.*

(b) *Existing Members*

(i) *Every member of the corporation engaged in investment banking activity shall as of designate at least one person as a Qualified Underwriter Principal whose duties shall include, but not necessarily be limited to, the organization and/or supervision of any participation in the origination and distribution of offerings of securities by a member whether as an underwriter or selling group member. Except as otherwise provided in subparagraph (iv) herein, such person shall be required to take and successfully pass Parts I and III of the three-part Qualification Examination for Principals.*

(ii) *Every person becoming registered as a principal after , whose duties do or will involve the organization and/or supervision of any participation in the origination or distribution of offerings of securities by a member whether as an underwriter or selling group member shall be designated a Qualified Underwriter Principal. All persons so designated shall be required to pass Parts I and III of the three-part Qualification Examination for Principals.*

(iii) *Any registered principal whose duties with a member are changed after to involve the organization and/or supervision of any participation in the origination or distribution of offerings of securities by a member whether as an underwriter or selling group member, shall be designated a Qualified Underwriter Principal and shall be required to pass Part III of a three-part Qualification Examination for Principals unless such individual is exempt from such requirement in accordance with the provision of subsection (iv) herein.*

(iv) *Any person designated as a Qualified Underwriter Principal who has been registered with a member or members as a principal for a period of at least three years prior to and who was actively engaged in the origination of underwriting issues of securities shall not be required to take Part III of the three-part Qualification Examination for Principals. A registered principal who does not meet the stated experience requirement may be registered with the corporation as a Qualified Underwriter Principal upon passing Part III of the Qualification Examination for Principals.*

(v) *A principal whose registration has been terminated for a period of two years or more immediately preceding the filing of an application for Qualified Underwriter Principal may not engage in the organization and/or supervision of any participation in the origination or distribution of an offering of securities until he has passed Part III of the Qualification Examination for Principals notwithstanding the length of his previous experience in investment banking activity.*

(c) *Prohibition*

(i) *Notwithstanding the provisions of paragraphs (a) and (b) hereof, any officer, director, general partner, owner of 10 percentum or more of the voting securities, or controlling person of any broker or dealer for whom a trustee has been or is hereafter appointed pursuant to the provisions of the Securities Investor Protection Act of 1970 may not engage in the organization and/or supervision of any participation in the origination or distribution of an offering of securities after unless such individual subsequent to the appointment of the trustee takes and successfully completes Part III of the Qualification Examination for Principals.*

(d) *Definitions — for the purpose of Section 4, the following words shall have the stated meanings:*

(i) *"Investment Banking Activity" — shall mean the business carried on by a member of under-*

writing or distributing issues of securities for which documents and other information are required to be filed with the Association pursuant to the provisions of the Interpretation of the Board of Governors Concerning the Review of Corporate Financing.

(ii) *"Selling Group Member" — shall mean a member of the Association engaged in a distribution of an offering of securities which distribution amounts to 10 percentum or more of the entire securities offering.*

Exhibit B

NOTICE TO MEMBERS: 75-33

April 25, 1975

IMPORTANT
NEW REGULATORY PROPOSALS FOR COMMENT

TO: All NASD Members and Interested Persons

RE: (1) Proposed Statement of Policy of the Board of Governors Concerning Due Diligence Requirements For Public Offerings of Securities

(2) Proposed Amendment to the Statement of Policy of the Board of Governors Concerning Fair Dealing With Customers

(3) Proposed Amendment to Article III, Section 15 of the Rules of Fair Practice Concerning Discretionary Accounts

(4) Proposed Amendment to "Review of Corporate Financing" Interpretation of the Board of Governors Concerning Issuer Reserved or Directed Securities

(5) Proposed New Article III, Section 34 of the Rules of Fair Practice Concerning Best Efforts Offerings of Securities

The Board of Governors of the Association has made certain regulatory proposals which have as their purpose the recommendation of procedures for the establishment of a system of regulation in the areas of underwriter inquiry and investigation (due diligence) respecting distributions of new issues of securities to the public, recommendations to customers regarding the purchase of securities in a public offering of a new issue, the purchase or resale of securities which are or were part of a public offering of a new issue by means of discretionary power, the reserving or directing by an issuer of shares in a public offering of securities and the distribution of "best efforts offerings" to the public.

These proposals are being published by the Board at this time to enable all members and other interested persons an opportunity to comment thereon. Comments on the proposals contained herein must be in writing and received by the Association by May 26, 1975 in order to receive consideration. After the comment period has expired the proposals must again be reviewed by the Board taking into consideration the comments received. If the proposals, or an amended revision thereof, are at that time approved by the Board, the Statements of Policy must be submitted to the Securities and Exchange Commission for nondisapproval while the new and amended rules must be submitted to the membership for vote and subsequently filed with the Securities and Exchange Commission for nondisapproval.

All comments should be directed to Mr. Donald H. Burns, Secretary, National Association of Securities Dealers, Inc., 1735 K Street, N.W., Washington, D.C. 20006. All communications will be considered available for inspection. Any questions concerning this notice should be directed to George E. Warner or S. William Broka at (202) 833-7240.

Sincerely,

Frank J. Wilson
Senior Vice President
Regulation

Background and Explanation of Proposals

These proposals resulted largely from the Securities and Exchange Commission's written requests on July 26, 1972 of the Association that it consider the establishment of underwriter inquiry standards and customer suitability rules respecting first time public offerings and examine the question of what constitutes a bona fide public distribution in such offerings. Subsequent to those requests, the Association's Board of Governors established the Ad Hoc Committee to Study New Issue Rules. The Committee made several recommendations to the Board some of which were formalized into proposed rules and submitted to the membership and other interested persons for comment on March 14, 1973 (1973 proposals). That release, Notice to Members 73-17, presented proposals dealing with due diligence, suitability and the concept of a qualified underwriter principal. The proposals regarding due diligence and suitability received extensive adverse comment and were subsequently returned to the Committee which made major modifications. They were thereafter resubmitted to the Board of Governors and approved by it in the form here submitted. The proposals contained herein represent a major departure from the 1973 proposals and also present some new proposals not included in any prior release. The originally proposed section dealing with the establishment of a qualified underwriter principal included in the 1973 proposals received no adverse comment and was subsequently approved by the Board. It therefore will not be reconsidered for further comment here although some reference is made thereto throughout these proposals. This special category is not yet effective, however, since the provisions thereof will become, with certain amendments, part of Schedule C which is currently in the process of being completely rewritten. Amendments in respect thereto are currently before the membership for comment (see Notice to Members 75-25). The appropriate qualifications examination is also being developed for "underwriter principals."

In response to the comments received on the due diligence proposal, the Committee recommended, and the Board concurred, that in lieu of requiring by rule that underwriters establish their own inquiry or "due diligence standards" as envisioned in the 1973 proposals, the Board of Governors should promulgate a Statement of Policy concerning the subject. This approach is reflected in the proposed Statement of Policy Concerning Due Diligence Requirements For Public Offerings of Securities. The proposed Statement of Policy stresses an underwriter's responsibilities and liabilities for compliance with the anti-fraud provisions of the federal securities acts and emphasizes the need for each member firm to insure that an adequate due diligence investigation has been performed prior to particpating in the distribution of an issue of securities to the public. In addition, the proposal cites specific examples of generally acceptable industry practice in the investigation of direct participation programs which in some respects go beyond the traditional concept of due diligence in corporate offerings. Delineation of these examples resulted from comments received from the membership on the 1973 proposals as well as from the recommendations of a Subcommittee of the Committee on Direct Participation Programs which is composed of experts in that area of securities industry activity.

The amendment to Article III, Section 2 of the Rules of Fair Practice concerning Suitability of Recommendations to Customers as proposed in the 1973 proposals has, consistent with the comments received, been significantly modified and is now in the form of an addition to the Statement of Policy of the Board of Governors Concerning Fair Dealing With Customers. The addition describes guidelines for members to use in connection with their recommendations to customers of purchases of securities which are part of the public distribution of new issues. The guidelines would be especially applicable if the securities were being issued by a company going public for the first time. Adoption of a statement of policy approach in this area rather than an amendment to an existing rule as proposed in 1973 leaves the judgment of determining the suitability of a given offering for a particular investor in the hands of the broker/dealer, as in the case of any security, but emphasizes his responsibility to see that an investment is indeed suitable for each customer making a purchase. In short, the Board believes the existing suitability rule is adequate for implementation in respect to new issues and that a new rule, embodying the new suitability concepts specified in the 1973 proposals, is not necessary.

After presenting the 1973 proposals to the membership, the Board of Governors and the Ad Hoc Committee continued their efforts in pursuit of a response to the Commission on the question of establishing standards for new issues regarding the components of a bona fide public distribution. No suggestions in this respect were made in the 1973 proposals. The Commission initially asked that the Association "establish guidelines particularizing what constitutes a bona fide public offering" and recommended that such guidelines take into consideration the total number of securities to be offered, the price of the securities to be offered, the number of persons to whom the securities would be distributed and the "float" in the hands of the public as opposed to that in the hands of affiliates of the issuer, among other things. The Ad Hoc Committee rejected recommending to the Board requirements along those lines believing that such would infringe on the management prerogatives of the issuer. As an alternative, however, it recommended to the Board, which agreed, a proposed amendment to Article III, Section 15 of the Rules of Fair Practice, an amendment to the Interpretation of the Board of Governors With Respect to "Review of Corporate Financing" and an expanded version of a rule pertaining to best efforts offerings proposed in 1971 but which was subsequently set aside. The Board believes that the combination of these proposals and other changes in the Association's regulations relating to new issues would help to combat abuses evident in some areas dealing with new issues as revealed by the Securities and Exchange Commission's special study covering hot issues and by the Association's own investigations. Each of these proposals is designed to attack elements which have been identified as being components of market manipulation schemes. It is hoped that in the aggregate they will make manipulation in connection with initial distributions more difficult to perpetrate.

The proposed amendment to Article III, Section 15 would prohibit the use of discretionary power in effecting for any customer's account the purchase or resale of a security which is or was part of the initial public distribution of an issuer's securities. Discretionary power has been improperly used by manipulators by allocating shares to accounts to decrease public float, thereby creating false demand and establishing artificial markets to aid in the perpetration of their schemes.

The amendment to the "Review of Corporate Financing" Interpretation of the Board of Governors would prohibit a member from soliciting or accepting instructions from an issuer to reserve or direct securities to a specified person or class of persons, including persons related to the issuer's business. The

Board believes such an amendment is necessary to assist in preventing artificial stimulation of the price of an initial offering, so-called "free rides," by some company related investors, and to insure that there will be more shares of an initial public offering of securities available for purchase by the public rather than a compressed and potentially small percentage of the amount stated in the prospectus as comprising the offering.

The proposed rule concerning best efforts offerings is embodied in proposed new Rule of Fair Practice, Article III, Section 34. The Board proposed a similar rule in 1971 as a result of a study made by the Association of what appeared to be improper activity in connection with the distribution of certain best efforts underwritings and secondary market trading in them. The proposed rule was submitted to the membership for comment in February 1972. In March 1972, following a review of the comments received, a mail vote on the proposed rule was requested. The proposal was approved by the membership but nondisapproval by the Commission was never received due to technical opposition to certain provisions thereof.

The best efforts proposal being made here represents a revision of the earlier rule. Reconsideration of the rule was prompted by the Commission's July 1972 request of the Association to examine the components of the bona fide public distribution of an issue of securities, partially as a result of some of the flagrant practices evidenced in certain offerings that surfaced as a result of the Commission's hearings, and by practices the Association has seen in its own investigations. Indications were that in certain situations, primarily involving small, low-priced, speculative best efforts distributions, some underwriters maintained strict control over the supply of shares in the market by refusing to deliver to purchasers in the offering or by discouraging or refusing to accept sell orders entered by their own customers. Thus, the underwriter was able to have an aftermarket price established and maintained at a predetermined or continuously increasing level. This type of activity while the distribution was still in process assisted the underwriter in disposing of unsold securities of the offering. In some cases, the inflated price of the securities of the offering was used by the underwriter as evidence of a "track record" for inducing sales in future offerings. Essential to the successful consummation of this scheme was the unavailability of certificates of the securities sold in the offering. In many cases certificates were not made available for several months after the offering had been completed. By not making them available, the securities could not be disposed of by the purchasers through other broker/dealers due to certain regulatory restrictions previously imposed upon the membership but which have since been modified. The purchasers were, therefore, effectively prevented from taking advantage of the aftermarket prices thereby enabling those prices to remain or increase to artifically inflated levels. The new proposed rule is taken largely from the earlier proposal but does contain some new and broadened definitions which will be discussed below. The new proposal would also require the establishment of an escrow account into which a member or issuer would be required to place all funds received in connection with a best efforts distribution until the distribution of the issue had been legally terminated.

A section-by-section analysis of each of the proposals follows:

Proposed Statement of Policy of the Board of Governors Concerning Due Diligence Requirements For Public Offerings of Securities

This proposed policy statement is self-explanatory and no elaboration is needed here. It should be noted, however, that adequate due diligence in respect to a particular offering can be determined only by reference to the peculiar facts relative thereto and the issue involved. Thus, greater or lesser emphasis could and should be placed upon the various factors discussed in the Statement of Policy, or other areas of inquiry, depending upon the facts surrounding the issue and the issuer itself. The determination of adequacy of the inquiry is, in the first instance, always a subjective judgment on the part of the underwriter. This determination should always be made with full recognition of the legal requirements and potential liabilities in mind. The Board hopes that the proposed policy statement will assist in causing members to focus more clearly on such.

Proposed Amendment to the Statement of Policy of the Board of Governors Concerning Fair Dealing With Customers

A technical amendment would be made to the language in the last sentence of the introductory paragraph of the existing Statement of Policy deleting the word "and" and inserting the word "or" in its place.

A new paragraph 6 would be added to existing paragraphs 1-5 to serve as a guide for members regarding fair dealing with their customers when recommending the purchase of securities which are part of a distribution of an initial issue to the public. This paragraph would remind members of their responsibility to insure that any such purchase recommendations are not violative of the Association's suitability rule.

Proposed Amendment to Article III Section 15 of the Rules of Fair Practice

This existing rule under Section 15 would be amended by redesignating existing paragraphs (b), (c) and (d) as (c), (d) and (e) and by adding a new paragraph (b) thereto. The new paragraph (b) would prohibit the use of discretionary accounts for purposes of purchasing or reselling shares in initial issues of securities. Under this prohibition no member would be able to effect for any customer's account in which it or its agents had been vested with discretionary power any transaction of purchase or resale of a security which is part of the initial distribution. The Board believes that the use of discretionary accounts in the distribution of new issues of securities can, and in a number of instances has, contributed to the artificial inflation of market prices by limiting the number of securities available. It further believes because of the very speculative nature of many initial distributions discretionary power should not be available to the member or its agent but the decision of whether to buy or sell in these situations should rest entirely with the customer.

Proposed Amendment to Interpretation of the Board of Governors With Respect to "Review of Corporate Financing" Concerning Issuer Reserved or Directed Securities

The present paragraph of the Interpretation of the Board of Governors With Respect to "Review of Corporate Financing" entitled "Issuer Reserved or Directed Securities," contained in Paragraph 2151, pages 2030 and 2031 of the NASD Manual, would be deleted and the new proposal inserted in lieu thereof. The existing Interpretation allows a reasonable number of securities (interpreted as being no greater than 10%) of a public offering to be reserved or directed by an issuer to persons who are directly related to the conduct of the issuer's business provided that contractual purchase commitments are made by such recipients by the close of business on the business day following the effective date of the offering and provided further that payment for such securities is made in accordance with established requirements. The proposed Interpretation would *prohibit* a member, in an initial public offering, from soliciting or accepting *any* instructions from an issuer to reserve or direct securities to any specified person or class of persons, including persons related to the issuer's business. Such persons would not be prohibited from purchasing securities in the public offering, but they would have to do so through the normal channels available to the investing public at large and in accordance with all applicable rules and regulations respecting the purchase of securities. The Board does not believe the use of this procedure, which recognizes that other means are available by which employees can acquire securities of its employer, such as an employee stock option plan, will inhibit the flow of securities to employees. It does believe, however, that it will contribute to a more orderly after-market since it appears that recipients of directed shares often immediately resell them in the after-market if there is an increase in price rather than hold them for long-term investment.

Proposed Section 34 of the Rules of Fair Practice Concerning Best Efforts Offerings of Securities

Subparagraph (a)(1) would define the term "best efforts offering" for purposes of the Rule as being any public distribution of an initial issue of securities wherein any portion of such, excluding overallotment options of no more than ten percent of the distribution, is not the subject of a firm commitment by a member or nonmember underwriter. Excluded from the definition would be any public distribution of an investment company registered pursuant to the provisions of the Investment Company Act of 1940, as amended; units of a separate account as defined in Section 2(a)(37) of the Investment Company Act of 1940, as amended; a Direct Participation Program; an exchange offer by a nontraded company for the outstanding securities of a publicly traded company; or any offering of which there is not intended to be free transferability of the securities which are the subject thereof. The latter category would for example include offerings of limited partnership interests, joint ventures, and other investment contracts for which there would commonly not be a public trading market.

Subparagraphs (a)(2) and (a)(3) define the terms "prospectus" and "direct participation program" consistent with the manner in which those terms appear in other rules or proposed rules of the Association.

Paragraph (b) would prohibit a member or person associated with a member from engaging in the distribution of a best efforts offering as an underwriter, a selling group participant or otherwise, unless the prospectus clearly states that the terms of the offering require that the funds received from the distribution be placed in an escrow account until the issue has been legally terminated and other provisions of the Rule have been complied with. This would insure protection of investor funds, and the return of such to them, if the terms of the offering had not been achieved and it had to be cancelled.

Paragraph (c) would require the managing underwriter to file a "Notice of Termination and Release of Issue for Trading" (Notice) with the District Committee in the District where its main office is located with a copy to the Corporate Financing Department in the Association's Executive Office, prior to trading in the secondary market securities of any offering subject to the provisions of the Rule and/or prior to publishing any quotation or bid for any security which is or has been part of such an offering. The notice would be required to specify the following: (1) that the offering has been terminated as of the time of the filing of the notice; (2) the date and time of release of the issue for trading; and (3) the total number of shares, units or other appropriate designation of certificates representing the completed offering. Such notification would also be accompanied by a copy of the prospectus relating to the offering. This paragraph also provides that the size of the offering would be limited to and fixed at no more than the number of shares specified in the notification to the Association, regardless of the number of shares registered as part of the offering. Aftermarket trading would be prohibited until the notice had been filed. Additional sales of shares from the issue would be prohibited after it has been filed. A copy of the proposed Notice form is attached to the proposed Rule.

Paragraph (d) outlines conditions for effecting settlement and delivering certificates to original purchasers of the issue, requiring that settlement be effected and certificates placed in the mails or otherwise delivered in negotiable form at the public offering price within seven business days following the date of the filing of the Notice described in paragraph (c) above. Such delivery would be required to take place unless: (1) the purchaser directed otherwise as provided under paragraph (e) of the Rule or (2) upon written application made to the Association by the underwriter, or by the issuer in the case of a non-underwritten issue, an extension of time for delivery had been granted. Such extension would not be granted unless the applicant was able to clearly demonstrate that delivery within the seven-day period would not be possible because of, for example, the size of the issue, the number of purchasers or some other similar reason. Extensions would not automatically be granted and each request and the reasons therefor would be closely studied before any action would be taken on the request.

Paragraph (e) would require that a member who participates in an offering subject to the provisions of the Rule deliver to each purchaser with each confirmation of sale at the public offering price a notice which advises the purchaser of the number of shares of the offering sold as of that date and include therewith a statement that certificates will be delivered to the purchaser as provided in paragraph (d) above, unless the purchaser, after receipt of such notice, originates written instructions to the contrary identifying the issue and specifying the alternative disposition of the certificates.

Paragraph (f) addresses situations in which the distribution of an issue of securities subject to the provisions of the Rule is being made by a nonmember issuer without the services of an underwriter, or where the underwriter is a nonmember of the Association. In such instances, no member would be permitted to trade such securities in the secondary market and/or publish any quotation or bid for any such security during the life of the prospectus, unless the issuer and/or the nonmember underwriter has undertaken in the prospectus to comply and has complied with all provisions of this Section to the same extent as though he were a member of the Association.

The final paragraph establishes the effectiveness of the provisions and makes the Rule not applicable to offerings which commence distribution prior to (date to be determined) nor to the trading of any new issue which commenced distribution prior to the effective date of the Rule.

PROPOSED STATEMENT OF POLICY OF BOARD OF GOVERNORS CONCERNING DUE DILIGENCE REQUIREMENTS FOR PUBLIC OFFERINGS OF SECURITIES

The Securities and Exchange Commission's Public Investigation in the Matter of the Hot Issues Securities Markets revealed that some underwriters may not be conducting reasonable due diligence investigations so as to enable them to determine whether the disclosures contained in registration statements and offering circulars describe accurately and completely all material facts relating to the business of new high risk ventures. Proper and adequate due diligence inquiry is a mandatory obligation of all underwriter members. The purpose of this Policy, therefore, is to review the responsibilities of members for the investigation of an issuer prior to a public offering of securities.

The Securities Act of 1933 grants certain rights to purchasers of securities. Section 11(a) of that Act provides that if the registration statement of an issuer, when such becomes effective, contains an untrue statement of material fact or fails to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring a security issued pursuant thereto, may sue, among others, *every* underwriter with respect to such security. Section 11(b) of the Securities Act, however, provides shelter from liability for any misstatement or omission of material fact if an underwriter made a reasonable investigation of the issuer's business activities and thereafter had reasonable grounds to believe, and did believe, at the time of effectiveness of the registration statement that the statements contained therein were true and that there was no omission of a material fact required to be stated therein or necessary to make the statements therein not misleading. All underwriters are urged to familiarize themselves with all of the provisions of Section 11, which is complex in nature, and the various judicial determinations made thereunder. Those provisions and decisions, as well as all other provisions of the Securities Act of 1933, should be closely reviewed with knowledgeable securities counsel by underwriters prior to undertaking an underwriting commitment.

Further, the anti-fraud provisions of the federal securities acts make it unlawful, among other things, for any person to employ any device, scheme or artifice to defraud, to obtain money or property by false or misleading statements of material facts or to engage in any transaction, practice or course of business which would operate as a fraud or deceit upon purchasers. Those provisions, therefore, impose liability in instances of misrepresentations or where opinions are unfounded and unsubstantiated. The anti-fraud provisions impose similar responsibilities upon underwriters participating in the distribution of offerings exempt from registration and not subject to Section 11, such as Regulation A offerings and intrastate offerings. The Association believes, therefore, that failure to fulfill the obligation of due diligence described under the Securities Act of 1933, or in a manner inconsistent with the anti-fraud provisions, constitutes conduct inconsistent with high standards of commercial honor and just and equitable principles of trade.

While adequate and reasonable inquiry of an issuer is required prior to the offering of any security of any company to the public, hearings conducted by the Securities and Exchange Commission have demonstrated that an underwriter's due diligence responsibility is most important in initial offerings of speculative or promotional issuers. Thus, a particularly thorough and intensive due diligence investigation is necessary in connection with an offering of a company either in the developmental stage or a promotional company engaged in marketing highly technical products particularly when such distribution is a first time offering.

In an effort to aid members, the Association has reviewed areas of acceptable standards of inquiry performed during the course of due diligence investigations. It is realized that the scope and content of each due diligence investigation must be tailored to such determinants as the nature of the offering, the size of the issuing company, the availability of information, the issuer's operating history, the legal entity under which it is offered, the SEC form under which it is registered, and the speculative nature of the public distribution, among many other things.

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

Regarding the above, underwriters must consider that the intent of the Securities Act of 1933 is to insure that all material information concerning an issuer and its major customers is included in the registration statement and hence, made available to investors. The attention of an underwriter should be directed to a reasonable investigation of each material fact disclosed by the registrant in the registration statement. Disclosure should be based on the various requirements, types and formats appropriate to the different Securities and Exchange Commission forms used, as well as the guides to these forms, such as S-1, S-7 and S-11, among others. For these purposes, many investment banking firms require that underwriter personnel develop a written record of registration work for each situation in which the member assumes underwriting liability. Such documentation could not only assist in defending a lawsuit brought pursuant to Section 11 challenging the adequacy of an underwriter's due diligence investigation but could also serve as a guide for the performance of future underwriting ventures on behalf of the same or other issuers.

In each situation the member assuming the underwriting liability should, for its own protection, maintain a written record of the investigation and where reliance is upon the investigative actions of another person or member, the name of such person or member and an indication of the review which was made of that person's or member's records, if any, should be kept.

As noted previously, every underwriter in a securities distribution is potentially liable under Section 11 of the Securities Act of 1933 for misleading statements and omissions in a registration statement. This should be of major concern to members acting as underwriters in a distribution of securities to the public. As a standard industry practice, participating underwriters defer all or a major portion of due diligence investigation to the managing underwriter. In this regard, it should be noted that court decisions, e.g., *Escott vs. BarChris Construction Company*, 283 F. Supp 697 (S.D., N.Y. 1968), held that participating underwriters who make no independent investigation of their own were bound by the managing underwriter's failure to carry out his investigatory functions. Participating underwriters should therefore be mindful that the delegation of the function does not necessarily obviate the responsibility therefor or potential liability attached thereto. The Association does not desire to suggest any alternative to the apparently satisfactory industry practice of delegation of due diligence performance to the managing underwriter. Nevertheless, it does believe some machinery should be available to participating underwriters to enable them to have ample opportunity for consultation with the managing underwriter. Therefore, the Association believes it appropriate to request that any managing underwriter who utilizes the services of participating underwriters furnish them with the identity of the Underwriter Principal of the manager whose responsibility is the organization and supervision of the due diligence investigation of the subject distribution. This procedure would insure that participating underwriter members have at hand the identity of a person to whom inquiries can be directed regarding the scope of the managing underwriter's due diligence investigations. (NOTE: This presumes the subsequent effectiveness of the proposed requirement that members engaged in underwritings have an underwriter principal. That proposal is in the advanced stages of development and should become effective in the not too distant future.)

Further, in those cases wherein a corporate security is "self-underwritten" by the issuer itself or through an affiliate, all participating dealers, to the extent they are deemed underwriters pursuant to the provisions of Section 2(11) of the Securities Act of 1933, must assure themselves as to the adequacy of disclosure in such situations due to the absence of an independent due diligence investigation. It is, therefore, incumbent upon such dealers to maintain close contact with the distributor to ascertain that proper and adequate due diligence investigations have in fact been conducted. Absent such verification, the participating dealer may find it beneficial and, in fact, necessary to perform part or all of the due diligence investigation itself or alternatively, to not participate in the distribution.

In addition to communication with the managing underwriter afforded by contact with the manager's Underwriter Principal, as discussed above, participating underwriters should utilize the due diligence meeting to interview and discuss with management questions they have relating to material registration statement disclosures of the issuer, among other things.

While the foregoing is representative of the basic investigative actions necessary in most underwritings, there are certain types of offerings which require more than the conventional investigation. Thus, the scope and content of the due diligence investigation must be tailored to the issuer itself. The Association believes, for instance, that due diligence investigations should go beyond the traditional concept of such in many instances in the case of direct participation programs. In view of the emphasis on management, a due diligence investigation requires looking beyond the prospectus in a direct participation program to assess adequate disclosure of the economic realities of the offering itself. This is especially true because these offerings generally involve high risk new ventures where little prior information is available to the public.

The Association believes the following can be used as examples of what may be acceptable industry practice in direct participation offerings. They should, of course, be pursued in conjunction with the more familiar due diligence approaches discussed above but they should not be considered all inclusive:

(1) Investigation of whether the basic economic merit of the proposed undertaking and the results of prior activities have been adequately and meaningfully disclosed;

(2) Review of applicable partnership agreements for basics of legal adequacy and tax advantages;

(3) Random physical inspections of properties, plant and equipment of the sponsor and any affiliates offering services to the program;

(4) Review of the financial stability, reputation within the industry and other available information on the sponsor's background, qualifications and experience;

(5) Examination of the program for conflicts, risk factors, proposed activities and financial status;

(6) Examination of records submitted by appraissers, engineers, and financial consultants;

(7) Examination of items of compensation, having an understanding of true compensation, with emphasis on disclosure of all forms of compensation;

(8) Study of all tax aspects of the program to determine whether there is a reasonable basis for assuming the benefits are likely to occur; and

(9) Examination of experience of management and technical staff in operations and handling of funds. Likewise, examination should be made of the management of projects or services offered to the program.

Further, the Association believes, in view of the lack of traditional underwriting methods used in the distribution of these securities and the need for technical knowledge in the specific areas of business activity which the program relates to, some additional steps may be necessary. In the absence of a managing underwriter or dealer manager, participating members for various reasons such as economics, lack of experience and the time required to fulfill the responsibility may desire to pool their resources. If such is the case, they should not hesitate to do so. Likewise, the lack of expertise in certain areas may require contracting the services of outside consultants or engineers.

The Securities Act makes it clear that reliance on the issuer, its affiliates or its agents for verification of statements or opinions does not constitute a discharge of the underwriter's responsibility to conduct a reasonable due diligence investigation. The Association is of the opinion that reliance on the sponsor of a direct participation program for due diligence also does not satisfy compliance with that obligation.

For purposes of this Statement of Policy, the term "direct participation program" shall have the following meaning which is consistent with the definition of the term as contained in other rules, or proposed rules, of the Association:

Direct participation program — a program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution including, but not limited to, oil and gas programs, real estate programs, agricultural programs, cattle programs, condominium securities, Subchapter S corporate offerings and all other programs of a similar nature, regardless of the industry represented by the program, or any combination thereof. Excluded from this definition are real estate investment trusts, tax qualified pension and profit sharing plans pursuant to Sections 401 and 403(a) of the Internal Revenue Code and individual retirement plans under Section 408 of that Code, tax sheltered annuities pursuant to the provisions of Section 403(b) of the Internal Revenue Code, and any company, including separate accounts, registered pursuant to the Investment Company Act of 1940.

PROPOSED AMENDMENT TO THE STATEMENT OF POLICY OF THE BOARD OF GOVERNORS CONCERNING FAIR DEALING WITH CUSTOMERS

(New material italicized)
(Deleted material indicated by brackets)

Sec. 2. (of Rules of Fair Practice) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.

Policy of the Board of Governors

Fair Dealing With Customers

(Introductory paragraphs omitted)
(Numbers 1-5 indicate existing paragraphs)

Some practices that have resulted in disciplinary action [and] *or* that clearly violate this responsibility for fair dealing are set forth below as a guide to members:

1. Recommending Speculative Low-Priced Securities

* * * * *

2. Excessive Trading Activity

* * * * *

3. Trading in Mutual Fund Shares

* * * * *

4. Fraudulent Activity

* * * * *

5. Recommending Purchases Beyond Customer Capability

* * * * *

6. *Improper Recommending to Customers Purchases of Speculative New Issues of Securities*

Recommending to customers the purchase of securities regardless of the investment merit of such securities, the financial ability of a customer to complete the transaction, or by improper sales practices. Since each customer, regardless of his financial or market sophistication, is entitled to rely on the implied representation made by a member or a person associated therewith that he will be treated fairly, particular care must be taken in recommending to customers the purchase of new issues, especially those securities issued by companies going public for the first time in a speculative market, to insure that such recommendations are not violative of the Association's suitability rule.

PROPOSED AMENDMENT TO ARTICLE III, SECTION 15 OF THE RULES OF FAIR PRACTICE

Section 15 would be amended by redesignating existing paragraphs (b), (c) and (d) as (c), (d) and (e) and by adding a new paragraph (b) thereto as follows:

Prohibition in New Issues

(b) No member shall effect with or for any customer's account in respect to which such member or his agent or employee is vested with discretionary power any transaction of purchase or resale of a security if such security is or was part of the initial distribution of an issuer's securities to the public.

PROPOSED AMENDMENT TO "REVIEW OF CORPORATE FINANCING" INTERPRETATION ISSUER RESERVED OR DIRECTED SECURITIES

The Interpretation of the Board of Governors With Respect to Review of Corporate Financing shall be amended by deleting that section commencing on page 2030 and ending on page 2031 of the Association's manual entitled Issuer Reserved or Directed Securities. The following shall be inserted in lieu thereof:

Issuer Reserved or Directed Securities:

The failure to make a bona fide distribution of an offering of securities to the public can be a factor in artificially stimulating the price of such an offering. Therefore, in order to insure that there will be an adequate number of shares of an initial public offering of securities for purchase by the public customers of a member, the member shall not solicit or accept any instructions from an issuer to reserve or direct securities to any specified person or class of persons, including persons related to the issuer's business. Such persons are not prohibited from purchasing the securities of the registrant, but such must be through the normal channels available to the investing public at large and then only when in accordance with all applicable rules and regulations respecting the purchase of securities in the consummation of securities transactions.

PROPOSED SECTION 34 OF THE RULES OF FAIR PRACTICE BEST EFFORTS OFFERINGS OF SECURITIES

(a) **Definitions.**

For purposes of this section, the following words shall have the stated meanings:

(1) ***Best Efforts Offering*** — Shall mean any distribution of an initial issue of securities to the public wherein any portion of such, excluding overallotment options which shall be limited to ten percent of the distribution, is not the subject of a firm commitment by a member or nonmember underwriter; provided, however, such shall not include any distribution of an investment company registered with the Securities and Exchange Commission pursuant to the provisions of the Investment Company Act of 1940, as amended; units of a separate account as defined in Section 2(a)(37) of the Investment Company Act of 1940, as amended; a Direct Participation Program; an exchange offer for the outstanding securities of a publicly traded company, or any offering of which there is not intended to be free transferability of the securities which are the subject thereof.

(2) ***Prospectus*** — Shall have the meaning given to that term by Section 2(10) of the Securities Act of 1933; provided, however, such term as used herein shall also include an offering circular as required by Rule 256 of the General Rules and Regulations under the Securities Act of 1933 and in the case of an intrastate or foreign offering, any document, by whatever name known, which is required by any state or foreign country in connection with the offering of securities which is being made to the public or which is used in connection with the distribution thereof.

(3) ***Direct Participation Program*** — A program which provides for flow-through tax consequences regardless of the structure of the legal entity or vehicle for distribution including, but not limited to, oil and gas programs, real estate programs, agricultural programs, cattle programs, condominium securities, Subchapter S corporate offerings and all other programs of a similar nature, regardless of the industry represented by the program, or any combination thereof. Excluded from this definition are real estate investment trusts, tax qualified pension and profit sharing plans pursuant to Sections 401 and 403(a) of the Internal Revenue Code and individual retirement plans under Section 408 of that Code, tax sheltered annuities pursuant to the provisions of Section 403(b) of the Internal Revenue Code, and any company, including separate accounts, registered pursuant to the Investment Company Act of 1940.

(b) No member or person associated with a member shall engage in the distribution of a best efforts offering as an underwriter, a selling group participant, or otherwise, unless the terms of the offering, clearly stated in the prospectus, require that funds received from the distribution be placed in an escrow account where they shall remain until the issue has been legally terminated and the provisions of this rule have been complied with.

(c) Before the securities of an offering subject to the provisions hereof may be traded by a member in the secondary market, or before a member may publish any quotation or bid for any security which is or has been part of such an offering, a "Notice of Termination and Release of Issue for Trading" shall be filed by the managing underwriter with the District Committee in the District where its main office is located with a copy to the Corporate Financing Department in the Association's Executive Office. Such notice shall specify that the offering has been terminated as of the time of the filing of the notice, the date and time of release of the issue for trading, and the total number of shares, units or other appropriate designation of certificates representing the completed offering. Such notice shall also be accompanied by a copy of the prospectus relating to the offering. Notwithstanding the number of shares registered as part of the offering, the size of the offering shall be limited to and fixed at no more than the number of shares specified in the notification filed with the Association.

(d) Within seven business days following the date of the filing of the "Notice of Termination and Release of Issue for Trading" settlement shall be effected and certificates shall be placed in the mails or otherwise delivered in negotiable form to all original purchasers of the issue at the public offering price unless:

(1) the purchaser has directed otherwise as provided in paragraph (e) of this section, or

(2) upon written application made to the Association by the underwriter, or by the issuer in the case of a non-underwritten issue, an extension of time for delivery has been granted. Extensions shall not be granted unless the applicant is able to clearly demonstrate that delivery within the stated seven-day period will not be possible because, for example, of the size of the issue, the number of purchasers or some other similar reason. Extensions will not automatically be granted.

(e) A member who participates in an offering subject to the provisions of this section shall deliver to the purchaser with each confirmation of sale at the public offering price a notice which advises the purchaser of the number of shares of the offering sold to date and includes a statement that certificates will be delivered as provided in paragraph (d) hereof unless the customer originates, after receipt of such notice, written instructions to the contrary identifying the issue and specifying the alternative disposition of the certificates.

(f) In those cases where a nonmember issuer is making a distribution of an issue of securities subject to the provisions hereof without the services of an underwriter, or where the underwriter is a nonmember of the Association, no member shall trade such securities in the secondary market during the life of the prospectus, nor shall a member publish any quotation or bid for any such security, unless the issuer and/or the nonmember underwriter has undertaken in the prospectus to comply and has complied with all provisions of this section to the same extent as though he were a member of the Association.

This Rule shall not apply to offerings in which distribution commenced prior to (date to be determined) nor to the trading of any new issue which has commenced distribution prior to the effective date of this Rule.

Exhibit C

Securities Act of 1933
Sections 11 and 12

Sec. 11(a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

(1) every person who signed the registration statement;

(2) every person who was a director of (or person performing similar functions) or partner in, the issuer at the time of the filing of the part of the registration statement with respect to which his liability is asserted;

(3) every person who, with his consent, is named in the registration statement as being or about to become a director, person performing similar functions, or partner;

(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

(5) every underwriter with respect to such security.

If such person acquired the security after the issuer has made generally available to its security holders an earning statement covering a period of at least twelve months beginning after the effective date of the registration statement, then the right of recovery under this subsection shall be conditioned on proof that such person acquired the security relying upon such untrue statement in the registration statement or relying upon the registration statement and not knowing of such omission, but such reliance may be established without proof of the reading of the registration statement by such person.

(b) Notwithstanding the provisions of subsection (a) no person, other than the issuer, shall be liable as provided therein who shall sustain the burden of proof—

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

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

(3) that (A) as regards any part of the registration statement not purporting to be made on the authority of an expert, and not purporting to be a copy of or extract from a report or valuation of an expert, and not purporting to be made on the authority of a public official document or statement, 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; and (B) as regards any part of the registration statement purporting to be a copy of or extract from a report or valuation of himself as an expert, (i) 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, or (ii) such part of the registration statement did not fairly represent his statement as an expert or was not a fair copy of or extract from his report or valuation as an ex-

port; and (C) as regards any part of the registration statement purporting to be made on the authority of an expert (other than himself) or purporting to be a copy of or extract from a report or valuation of an expert (other than himself), he had no reasonable ground to believe, and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement of the expert or was not a fair copy of or extract from the report or valuation of the expert; and (D) as regards any part of the registration statement purporting to be a statement made by an official person or purporting to be a copy of or extract from a public official document, he had no reasonable ground to believe and did not believe, at the time such part of the registration statement became effective, that the statements therein were untrue, or that there was an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, or that such part of the registration statement did not fairly represent the statement made by the official person or was not a fair copy of or extract from the public official document.

(c) In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property.

(d) If any person becomes an underwriter with respect to the security after the part of the registration statement with respect to which his liability is asserted has become effective, then for the purposes of paragraph (3) of subsection (b) of this section such part of the registration statement shall be considered as having become effective with respect to such person as of the time when he became an underwriter.

(e) The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offerred to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought: Provided, That if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable. In no event shall any underwriter (unless such underwriter shall have knowingly received from the issuer for acting as an underwriter some benefit, directly or indirectly, in which all other underwriters similarly situated did not share in proportion to their respective interests in the underwriting) be liable in any suit or as a consequence of suits authorized under subsection (a) for damages in excess of the total price at which the securities underwritten by him and distributed to the public were offered to the public. In any suit under this or any other section of this title the court may, in its discretion, require an undertaking for the payment of the costs of such suit, including reasonable attorney's fees, and if judgment shall be rendered against a party litigant, upon the motion of the other party litigant, such costs may be assessed in favor of such party litigant (whether or not such undertaking has been required) if the court believes the suit or the defense to have been without merit, in an amount sufficient to reimburse him for the reasonable expenses incurred by him, in connection with such suit, such costs to be taxed in the manner usually provided for taxing of costs in the court in which the suit was heard.

(f) All or any one or more of the persons specified in subsection (a) shall be jointly and severally liable, and every person who becomes liable to make any payment under this section may recover contribution as in cases of contract from any person who, if sued separately, would have been liable to make the same payment, unless the person who has become liable was, and the other was not, guilty of fraudulent misrepresentation.

(g) In no case shall the amount recoverable under this section exceed the price at which the security was offered to the public.

Sec. 12. Any person who—

(1) offers or sells a security in violation of section 5, or

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue state-

ment 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 to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

Exhibit D

Securities Act of 1933
Rule 146

§230.146 Transactions by an issuer deemed not to involve any public offering.

PRELIMINARY NOTES

1. The Commission recognizes that no one rule can adequately cover all legitimate private offers and sales of securities. Transactions by an issuer which do not satisfy all of the conditions of this rule shall not raise any presumption that the exemption provided by section 4(2) of the Act is not available for such transactions. Issuers wanting to rely on that exemption may do so by complying with administrative and judicial interpretations in effect at the time of the transactions. Attempted compliance with this rule does not act as an election; the issuer can also claim the availability of section 4(2) outside the rule.

2. Nothing in this rule obviates the need for compliance with any applicable state law relating to the offer and sale of securities.

3. Section 5 of the Act requires that all securities offered by the use of mails or other channels of interstate commerce be registered with the Commission. Congress, however, provided certain exemptions in the Act from such registration provisions where there was no practical need for registration or where the public benefits of registration were too remote. Among these exemptions is that provided by section 4(2) of the Act for transactions by an issuer not involving any public offering. The courts and the Commission have interpreted the section 4(2) exemption to be available for offerings to persons who have access to the same kind of information that registration would provide and who are able to fend for themselves. The indefiniteness of such terms as "public offering," "access" and "fend for themselves" has led to uncertainties with respect to the availability of the section 4(2) exemption. Rule 146 is designed to provide, to the extent feasible, objective standards upon which responsible businessmen may rely in raising capital under claim of the section 4(2) exemption and also to deter reliance on that exemption for offerings of securities to persons who need the protections afforded by the registration process.

In order to obtain the protection of the rule, all its conditions must be satisfied and the issuer claiming the availability of the rule has the burden of establishing, in an appropriate form, that it has satisfied them. The burden of proof applies with respect to each offeree as well as each purchaser. See *Lively v. Hirschfield*, 440 F. 2d 631 (10th Cir. 1971). Broadly speaking, the conditions of the rule relate to limitations on the manner of the offering, the nature of the offerees, access to or furnishing of information, the number of purchasers, and limitations on disposition.

The term "offering" is not defined in the rule. The determination as to whether offers, offers to sell, offers for sale, or sales of securities are part of an offering (i.e., are deemed to be "integrated") depends on the particular facts and circumstances. See Securities Act Release No. 4552 (November 6, 1962) (27 FR 11316). All offers, offers to sell, offers for sale, or sales which are part of an offering must meet all of the conditions of Rule 146 for the rule to be available. Release 33-4552 indicates that in determining whether offers and sales should be regarded as a part of a larger offering and thus should be integrated, the following factors should be considered:

(a) Whether the offerings are part of a single plan of financing;

(b) Whether the offerings involve issuance of the same class of security;

(c) Whether the offerings are made at or about the same time;

(d) Whether the same type of consideration is to be received; and

(e) Whether the offerings are made for the same general purpose.

4. Rule 146 relates to transactions exempted from section 5 by Section 4(2) of the Act. It does not provide an exemption from the anti-fraud provisions of the securities laws or the civil liability provisions of section 12(2) of the Act or other provisions of the securities laws, including the Investment Company Act of 1940.

5. Clients of an investment adviser, customers of a broker or dealer, trusts administered by a bank trust department or persons with similar relationships shall be considered to be the "offerees" or "purchasers" for purposes of the rule regardless of the amount of discretion given to the investment adviser, broker or dealer, bank trust department or other person to act on behalf of the client, customer or trust.

6. The rule is available only to the issuer of the securities and is not available to affiliates or other persons for sales of the issuer's securities.

7. Finally, in view of the objectives of the rule and the purposes and policies underlying the Act, the rule is not available to any issuer with respect to any transactions which, although in technical compliance with the rule, are part of a plan or scheme to evade the registration provisions of the Act. In such cases registration pursuant to the Act is required.

(a) ***Definitions.*** The following definitions shall apply for purposes of this rule.

(1) ***Offeree representative.*** The term "offeree representative" shall mean any person or persons, each of whom the issuer and any person acting on its behalf, after making reasonable inquiry, have reasonable grounds to believe and believe satisfies all of the following conditions:

(i) Is not an affiliate, director, officer or other employee of the issuer, or beneficial owner of 10 percent or more of any class of the equity securities or 10 percent or more of the equity interest in the issuer, except where the offeree is:

(*a*) Related to such person by blood, marriage or adoption, no more remotely than as first cousin;

(*b*) Any trust or estate in which such person or any persons related to him as specified in paragraph (a)(1)(i)(*a*) or (*c*) of this section collectively have 100 percent of the beneficial interest (excluding contingent interests) or of which any such person serves as trustee, executor, or in any similar capacity; or

(*c*) Any corporation or other organization in which such person or any persons related to him as specified in paragraph (a)(1)(i)(*a*) or (*b*) of this section collectively are the beneficial owners of 100 percent of the equity securities (excluding directors' qualifying shares) or equity interest;

(ii) Has such knowledge and experience in financial and business matters that he, either alone, or together with other offeree representatives or the offeree, is capable of evaluating the merits and risks of the prospective investment;

(iii) Is acknowledged by the offeree, in writing, during the course of the transaction, to be his offeree representative in connection with evaluating the merits and risks of the prospective investment; and

(iv) discloses to the offeree, in writing, prior to the acknowledgement specified in paragraph (a)(1)(iii) of this section, any material relationship between such person or its affiliates and the issuer or its affiliates, which then exists or is mutually understood to be contemplated or which has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship.

Note 1: Persons acting as offeree representatives should consider the applicability of the registration and anti-fraud provisions relating to brokers and dealers under the Securities Exchange Act of 1934 and relating to investment advisers under the Investment Advisers Act of 1940.

Note 2: The acknowledgement required by paragraph (a)(1)(iii) of this section and the disclosure required by paragraph (a)(1)(iv) of this section must be made with specific reference to each prospective investment. Advance blanket acknowledgment, such as for "all securities transactions" or "all private placements," is not sufficient.

Note 3: Disclosure of any material relationships between the offeree representative or its affiliates and the issuer or its affiliates does not relieve the offeree representative of its obligation to act in the interest of the offeree.

(2) ***Issuer.*** The definition of the term "issuer" in Section 2(4) of the Act shall apply, provided that notwithstanding that definition, in the case of a proceeding under the Bankruptcy Act, the trustee, receiver, or debtor in possession shall be deemed to be the issuer in an offering for purposes of a plan of reorganization or arrangement, if the securities offered are to be issued pursuant to the plan, whether or not other like securities are offered under the plan in exchange for securities of, or claims against, the debtor.

(3) ***Affiliate.*** The term "affiliate" of a person means a person that directly or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with such person.

(4) ***Material.*** The term "material" when used to modify "relationship" means any relationship that a reasonable investor might consider important in the making of the decision whether to acknowledge a person as his offeree representative.

(b) ***Conditions to be met.*** Transactions by an issuer involving the offer, offer to sell, offer for sale or sale of securities of the issuer that are part of an offering that is made in accordance with all the conditions of this rule shall be deemed to be transactions not involving any public offering within the meaning of Section 4(2) of the Act.

(1) For purposes of this rule only, an offering shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, *Provided,* That there are during neither of said six month periods any offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

(2) Transactions by an issuer which do not satisfy all of the conditions of this rule shall not raise any presumption that the exemption provided by Section 4(2) of the Act is not available for such transactions.

Note: In the event that securities of the same or similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six months prior to or subsequent to any offer, offer for sale or sale pursuant to the rule, see Preliminary Note 3 hereof as to which offers, offers to sell, offers for sale or sales may be deemed to be part of the offering.

(c) ***Limitation of manner of offering.*** Neither the issuer nor any person acting on its behalf shall offer, offer to sell, offer for sale, or sell the securities by means of any form of general solicitation or general advertising, including but not limited to, the following:

(1) Any advertisement, article, notice or other communication published in any newspaper, magazine or similar medium or broadcast over television or radio;

(2) Any seminar or meeting, except that if paragraph (d)(1) of this section is satisfied as to each person invited to or attending such seminar or meeting and, as to persons qualifying only under paragraph (d)(1)(ii) of this section, such persons are accompanied by their offeree representative(s), then such seminar or meeting shall be deemed not to be a form of general solicitation or general advertising; and

(3) Any letter, circular, notice or other written communication, except that if paragraph (d)(1) of this section is satisfied as to each person to whom the communication shall be deemed not to be a form of general solicitation or general advertising.

(d) ***Nature of offerees.*** The issuer and any person acting on its behalf who offer, offer to sell, offer for sale or sell the securities shall have reasonable grounds to believe and shall believe:

(1) Immediately prior to making any offer, either:

(i) That the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) That the offeree is a person who is able to bear the economic risk of the investment; and

(2) Immediately prior to making any sale, after making reasonable inquiry, either:

(i) That the offeree has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or

(ii) That the offeree and his offeree representative(s) together have such knowledge and experience in financial and business matters that they are capable of evaluating the merits and risks of the prospective investment and that the offeree is able to bear the economic risk of the investment.

(e) ***Access to or furnishing of information.***

Note: Access can only exist by reason of the offeree's position with respect to the issuer. Position means an employment or family relationship or economic bargaining power that enables the offeree to obtain information from the issuer in order to evaluate the merits and risks of the prospective investment.

(1) Either:

(i) Each offeree shall have access during the course of the transaction and prior to the sale to the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense; or

(ii) Each offeree or his offeree representative(s), or both, shall have been furnished during the course of the transaction and prior to sale, by the issuer or any person acting on its behalf, the same kind of information that is specified in Schedule A of the Act, to the extent that the issuer possesses such information or can acquire it without unreasonable effort or expense. This condition shall be deemed to be satisfied as to an offeree if the offeree or his offeree representative is furnished with information, either in the form of documents actually filed with the Commission or otherwise, as follows:

(*a*) In the case of an issuer that is subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934;

(*1*) The information contained in the annual report required to be filed under the Exchange Act or a registration statement on Form S-1 under the Act or on Form 10 under the Exchange Act, whichever filing is the most recent required to be filed, and the information contained in any definitive proxy statement required to be filed pursuant to Section 14 of the Exchange Act and in any reports or documents required to be filed by the issuer pursuant to Section 13(a) or 15(d) of the Exchange Act, since the filing of such annual report or registration statement, and

(*2*) A brief description of the securities being offered, the use of the proceeds from the offering, and any material changes in the issuer's affairs which are not disclosed in the documents furnished;

(*b*) In the case of all other issuers, the information that would be required to be included in a registration statement filed under the Act on the form which the issuer would be entitled to use: *Provided, however,* That:

(*1*) The issuer may omit details or employ condensation of information if, under the circumstances, the omitted information is not material or the condensation of information does not render the statements made misleading.

Note: The issuer would have the burden of proof to show that, under the circumstances, the omitted information is not material and that any condensation does not render the statements made misleading.

(*2*) If the issuer does not have the audited financial statements required by such form and cannot obtain them without unreasonable effort or expense, such financial statement may be furnished on an unaudited basis, provided that if such unaudited financial statements are not available and cannot be obtained without unreasonable effort or expense, the financial statements required by Regulation A under the Act may be furnished.

(3) If the financial schedules required by Part II of the registration statement have not been prepared, they need not be furnished.

(*c*) Notwithstanding paragraphs (e)(1)(ii)(*a*) and (*b*) of this section, exhibits required to be filed with the Commission as part of a registration statement or report need not be furnished to each offeree or offeree representative if the contents of the exhibits are identified and such exhibits are available pursuant to paragraph (e)(2) of this section;

(*d*) If the aggregate sales price of all securities offered in reliance upon this rule does not exceed \$1,500,000, the information requirements of paragraph (e)(1)(ii) may be satisfied by furnishing the disclosure required by Schedule I of Regulation A under Section 3(b) of the Act; and

(2) The issuer shall make available, during the course of the transaction and prior to sale, to each offeree or his offeree representative(s) or both, the opportunity to ask questions of, and receive answers from the issuer or any person acting on its behalf concerning the terms and conditions of the offering and to obtain any additional information, to the extent the issuer possesses such information or can acquire it without unreasonable effort or expense, necessary to verify the accuracy of the information obtained pursuant to paragraph (e)(1) of this section; and

(3) The issuer or any person acting on its behalf shall disclose to each offeree, in writing, prior to sale:

(i) Any material relationship between his offeree representative(s) or its affiliates and the issuer or its affiliates, which then exists or mutually is understood to be contemplated or which has existed at any time during the previous two years, and any compensation received or to be received as a result of such relationship;

(ii) That a purchaser of the securities must bear the economic risk of the investment for an indefinite period of time because the securities have not been registered under the Act and, therefore, cannot be sold unless they are subsequently registered under the Act or an exemption from such registration is available; and

(iii) The limitations on disposition of the securities set forth in paragraph (h)(2), (3), and (4) of this section.

Note: Information need not be provided and opportunity to obtain additional information need not be continued to be provided to any offeree or offeree representative who, during the course of the transaction, indicates that he is not interested in purchasing the securities offered, or to whom the issuer or any person acting on its behalf has determined not to sell the securities.

(f) ***Business combinations.*** (1) The term "business combination" shall mean any transaction of the type specified in Paragraph (a) of Rule 145 under the Act and any transaction involving the acquisition by one issuer, in exchange solely for all or a part of its own or its parent's voting stock, of stock of another issuer if, immediately after the acquisition, the acquiring issuer has control of the other issuer (whether or not it had control before the acquisition).

(2) All the conditions of this rule except paragraph (d) and paragraph (h)(4) of this section shall apply to business combinations.

Note: Notwithstanding the absence of a written agreement pursuant to paragraph (h)(4), any securities acquired in an offering pursuant to paragraph (f) are restricted and may not be resold without registration under the Act or an exemption therefrom.

(3) For purposes of paragraph (f) only, the issuer and any person acting on its behalf, after making reasonable inquiry shall have reasonable grounds to believe, and shall believe, at the time that any plan for a business combination is submitted to security holders for their approval, or in the case of an exchange, immediately prior to the sale, that each offeree either alone or with his offeree representative(s) has such knowledge and experience in financial and business matters that he is or they are capable of evaluating the merits and risks of the prospective investment.

(4) In addition to information required by paragraphs (e) and (f)(2) of this section, the issuer shall provide, in writing, to each offeree at the time the plan is submitted to security holders, or in the case of an exchange, during the course of the transaction and prior to the sale, information about any terms or arrangements of the proposed transaction relating to any security holder that are not identical to those relating to all other security holders.

(g) ***Number of purchasers.*** (1) The issuer shall have reasonable grounds to believe, and after making reasonable inquiry, shall believe, that there are no more than thirty-five purchasers of the securities of the issuer from the issuer in any offering pursuant to the Rule.

Note: See paragraph (b)(1) of this section, the note thereto and the Preliminary Notes as to what may or may not constitute an offering pursuant to the rule.

(2) For purposes of computing the number of purchasers for paragraph (g)(1) of this section only:

(i) The following purchasers shall be excluded:

(*a*) Any relative or spouse of a purchaser and any relative of such spouse, who has the same home as such purchaser; and (*b*) Any trust or estate in which a purchaser or any of the persons related to him as specified in paragraph (g)(2)(i)(*a*) or (*c*) of this section collectively have 100 percent of the beneficial interest (excluding contingent interests);

(*c*) Any corporation or other organization of which a purchaser or any of the persons related to him as specified in paragraph (g)(2)(i)(*a*) or (*b*) of this section collectively are the beneficial owners of all the equity securities (excluding directors' qualifying shares) or equity interest; and

(*d*) Any person who purchases or agrees in writing to purchase for cash in a single payment or installments, securities of the issuer in the aggregate amount of $150,000 or more.

Note: The issuer has to satisfy all the provisions of the rule with respect to all purchasers whether or not they are included in computing the number of purchasers under paragraph (g)(2)(i).

(ii) There shall be counted as one purchaser any corporation, partnership, association, joint stock company, trust or unincorporated organization, except that if such entity was organized for the specific purpose of acquiring the securities offered, each beneficial owner of equity interests or equity securities in such entity shall count as a separate purchaser.

Note: See Preliminary Note 5 as to other persons who are considered to be purchasers.

(h) ***Limitations on disposition.*** The issuer and any person acting on its behalf shall exercise reasonable care to assure that the purchasers of the securities in the offering are not underwriters within the meaning of Section 2(11) of the Act. Such reasonable care shall include, but not necessarily be limited to, the following:

(1) Making reasonable inquiry to determine if the purchaser is acquiring the securities for his own account or on behalf of other persons;

(2) Placing a legend on the certificate or other document evidencing the securities stating that the securities have not been registered under the Act and setting forth or referring to the restrictions on transferability and sale of the securities;

(3) Issuing stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, making a notation in the appropriate records of the issuer; and

(4) Obtaining from the purchaser a signed written agreement that the securities will not be sold without registration under the Act or exemption therefrom.

Note: Paragraph (h)(4) of this section does not apply to business combinations as described in paragraph (f) of this section. Notwithstanding the absence of a written agreement, the securities are restricted and may not be resolved without registration under the Act or an exemption therefrom. The issuer for its own protection should consider, however, obtaining such written agreement even in business combinations.

(i) ***Report of offering.*** At the time of the first sale of securities in any offering effected in reliance on this rule, the issuer shall file three copies of a report on Form 146 with the Commission at the Commission's Regional Office for the region in which the issuer's physical business operations are conducted or proposed to be conducted in the United States. The copies of such report with respect to an issuer having or proposing to have its principal business operations outside the United States shall be filed with the Regional Office for the region in which the offering is primarily conducted or proposed to be conducted. No report need be filed for any offering or offerings in reliance on Rule 146 the proceeds of which total, cumulatively, less than $50,000 during any twelve-month period. If any material change occurs in the facts set forth on the report on Form 146 filed with the Commission, the person who filed the statement shall promptly file with the Commission, at the Regional Office of the Commission in which the original report on Form 146 was filed, three copies of an amended Form 146 disclosing such change.

NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

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