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Securities Law--Prospectus Must Reflect Developments Subsequent to Effective Date of Registration Statement To Meet Requirements of Section 10(a) of Securities Act of 1933--*SEC v. Manor Nursing Centers, Inc.**

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RECENT DEVELOPMENTS

SECURITIES LAW—Prospectus Must Reflect Developments Subsequent to Effective Date of Registration Statement To Meet Requirements of Section 10(a) of Securities Act of 1933—*SEC v. Manor Nursing Centers, Inc.**

Manor Nursing Centers, Inc., made a public offering of 450,000 shares of its common stock at a price of ten dollars per share.[1] Under the provisions of the Securities Act of 1933,[2] a registration statement containing a prospectus was filed with the Securities and Exchange Commission. These documents represented that the offering would be on a best efforts, "all-or-nothing" basis—that is, if all the 450,000 shares were not sold by a specified selling deadline, the proceeds of any sales would be returned to subscribers. The prospectus stated that subscribers' funds would be segregated in an escrow account and that arrangements to establish such an account had already been made. Finally, the registration statement represented that the shares would be sold only for cash. Contrary to these representations, no escrow account was ever established, Manor's principals disposed of shares for other than cash consideration, and the offering was closed before complete dispersal of the shares. In addition to these misrepresentations, the registration statement and prospectus failed to reveal that certain individuals and brokers would receive special compensation for their participation in the offering.

The sale of Manor's shares began on December 8, 1969, the effective date of the registration statement. When the underwriter encountered difficulty disposing of the stock, other brokers were induced to participate in the offering by promises of special compensation, including shares of the offered stock. In one case, Manor's controlling shareholder guaranteed a personal loan to a broker and used proceeds of the offering to purchase collateral for the guarantee. After it became clear that not all of the 450,000 shares had been sold, Manor's principals resorted to various transactions designed to "sell" additional shares. Sales commissions of a brokerage firm, some legal fees for the offering, and even outstanding indebtedness to trade creditors were paid in securities, despite the registration statement's provision that the securities would be issued only for cash. In addition, proceeds of sales to public investors were used to purchase over 30,000 of the offered shares on behalf of corporations controlled by a securities lawyer who was the special counsel to Manor for the offering. Through these "bootstrap" transactions and the issuance

* 458 F.2d 1082 (2d Cir. 1972).

1. The various transactions at issue are chronicled by the court at 458 F.2d at 1088-94.

2. 15 U.S.C. §§ 77a-77aa (1970).

of shares for consideration other than cash, "Manor and its principals were able to make it appear that all 450,000 shares had been sold."[3] However, as a result of defaults in payment for 270,000 shares by two brokers and the various "sales" that failed to bring in any additional cash, less than 1.4 million dollars was actually realized from public investors, although a proper "all-or-nothing" sale would have yielded 4.5 million dollars. No one connected with the offering attempted to return any of the proceeds to the public investors.

In an action brought by the SEC in federal district court[4] pursuant to section 22(a) of the Securities Act of 1933[5] and section 27 of the Securities Exchange Act of 1934,[6] the court found that Manor's principals, underwriters, and participating brokers had violated the antifraud provisions of the 1933 and 1934 Acts and the prospectus-delivery requirements of the 1933 Act. Certain defendants were enjoined from further violations of the Acts, all defendants were ordered to disgorge proceeds of the offering as well as income earned on such proceeds, a trustee was appointed to receive such funds for subsequent distribution to the investors, and the assets of the defendants were frozen pending the transfer of such funds to the trustee.[7]

The Court of Appeals for the Second Circuit affirmed the district court's findings and orders, except the order that defendants disgorge income earned from the proceeds of the offering.[8] It held that section 10(b) of the 1934 Act[9] and rule 10(b)-9[10] were violated

3. 458 F.2d at 1092.

4. 340 F. Supp. 913 (S.D.N.Y. 1971).

5. 15 U.S.C. § 77v(a) (1970).

6. 15 U.S.C. § 78aa (1970).

7. 340 F. Supp. at 936.

8. 458 F.2d at 1100-06.

9. 15 U.S.C. § 78j(b) (1970):

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

. . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

See A.T. Brod & Co. v. Perlow, 375 F.2d 393, 397 (2d Cir. 1967) (section 10(b) prohibits *all* fraudulent schemes in connection with the purchase or sale of securities).

10. 17 C.F.R. § 240.10b-9 (1972):

(a) It shall constitute a "manipulative or deception device or contrivance," as used in section 10(b) of the Act, for any person . . . to make any representation:

(1) To the effect that the security is being offered or sold on an "all-or-none" basis, unless the security is part of an offering or distribution being made on the condition that all or a specified amount of the consideration paid for such security will be promptly refunded to the purchaser unless (i) all of the securities being offered are sold at a specified price within a specified time, and (ii) the total amount due to the seller is received by him by a specified date . . . .

The rule further excepts the situation where there is a firm commitment from underwriters for the purchase of all the securities being offered.

by defendants' failure to dispose of Manor's shares on an "all-or-nothing" basis after the registration statement and prospectus had represented that this was to be the nature of the offering.[11] It also held that the failure of the prospectus to reflect developments subsequent to the effective date of the registration statement made the prospectus misleading in several material respects and in violation of the antifraud provisions of section 17(a) of the 1933 Act[12] and section 10(b) of the 1934 Act.[13]

Although these violations would have been sufficient to support the remedies ordered by the court, the *Manor* opinion went beyond the antifraud provisions to find a violation of the prospectus-delivery requirement of section 5(b)(2) of the 1933 Act.[14] The basis of this finding was the court's conclusion that a prospectus does not meet the requirements of section 10(a) of the 1933 Act[15] if it is untrue or becomes untrue during the period after the effective date of the registration statement.[16] Since the *Manor* prospectus did not reflect developments during the post-effective period, it thus failed to comply with section 10(a), and the use of the prospectus by defendants in connection with the sale of securities violated the prospectus-delivery requirement of section 5(b)(2).

Manor is the first case squarely to consider whether an inaccurate prospectus satisfies section 10(a) for purposes of section 5(b)(2). The thesis of the present discussion is that section 10(a) requires no more than a prospectus that conforms to the registration statement; alternatively, if some requirement of truth is read into section 10(a), this requirement should be no greater than that for the registration statement itself, and therefore truth should be judged as of the effective date of the registration. Under either alternative, developments during the post-effective period that render the registration statement

11. 458 F.2d at 1095.

12. 15 U.S.C. § 77q(a) (1970):
It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
(1) to employ any device, scheme or artifice to defraud, or
(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

13. 458 F.2d at 1094-95.

14. 15 U.S.C. § 77e(b)(2) (1970) provides:
(b) It shall be unlawful for any person, directly or indirectly—
. . . .
(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title [section 10(a) of the 1933 Act].

15. 15 U.S.C. § 77j(a)(1) (1970) reads in part, "a prospectus relating to a security . . . shall contain the information contained in the registration statement . . . ."

16. 458 F.2d at 1098-100.

and the prospectus untrue would not invalidate the prospectus under section 10(a) and would not subject defendants to liability for violation of section 5(b)(2).

The *Manor* court did not discuss the reasons for its holding that section 10(a) contains an implict requirement that the prospectus be truthful. However, the court cited *SEC v. North American Finance Co.*,[17] in which the Arizona district court stated that use of a prospectus containing a material misrepresentation was "in violation of section 5(b) of the Securities Act . . . and may have given rise to liabilities to purchasers under Section 12(1) of the Act . . . ."[18] The Arizona court did suggest one ground for reading a truth requirement into section 10(a) when it stated:

> The registration process and the requirement for delivery of a prospectus meeting the statutory standards are intended to require full and fair disclosure of the character of the securities being sold, thereby making available to investors the information necessary in exercising an informed opinion as to the quality and nature of the investment.[19]

The goal of "full and fair disclosure" could not be realized if the prospectus, on which investors must depend for information about an offering, contains untrue statements. Thus, the argument runs, there must be an implicit requirement in section 10(a) that the disclosures made by the prospectus be truthful.[20]

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17. 214 F. Supp. 197 (D. Ariz. 1959). North American's registration statement and prospectus were certified by one of its principal bookkeepers, who represented that he was an "independent accountant" as required by section 7 and schedule A of the 1933 Act, 15 U.S.C. §§ 77g, 77aa (1970). The SEC charged North American and a broker-dealer copartnership with violating section 5(b) of the 1933 Act by offering and selling securities in interstate commerce without complying with the section 10 prospectus requirements; engaging in fraudulent and deceptive transactions in violation of section 17(a)(3) of the 1933 Act; and obtaining money and property by means of untrue statements and omissions of material fact in violation of section 17(a)(2) of the 1933 Act. The copartnership was also charged with inducing the purchase of stock through manipulative and deceptive devices in violation of section 15(c)(1) of the 1934 Act, 15 U.S.C. § 78o(c)(1) (1970). 214 F. Supp. at 199-200.

18. 214 F. Supp. at 201.

19. 214 F. Supp. at 201 n.2. In subsequent proceedings, the SEC revoked the broker-dealer registration of the firm involved in *North American*. Eugene Rosenson, 40 S.E.C. 948 (1961). In finding that the firm had willfully violated sections 7 and 10 of the 1933 Act by filing false and misleading registration statements and prospectuses, the SEC stated: "It is implicit in the requirements of Sections 7 and 10 that a registration statement and prospectus contain certain information, and that such information be true and correct." 40 S.E.C. at 952. However, it should be noted that this language represented at best an alternative holding. The Commission had already found that North American's broker-dealer had willfully violated the antifraud provisions of the securities acts, 40 S.E.C. at 95, and this finding was sufficient to support the Commission's revocation of the broker-dealer's registration.

20. As further support for its finding of a truth requirement in section 10(a), the *Manor* court analogized to several SEC proceedings which had stated or suggested that rules 17a-3 to -5, 17 C.F.R. §§ 240.17a-3 to -5 (1972), under section 17(a) of 1934 Act,

Despite the surface appeal of this argument, the basic structure of the 1933 Act suggests that while there is a requirement of truth for the prospectus, it is not contained in section 10(a). One court described the program embodied in the 1933 Act as follows:

> The program has two major aspects: One relates generally to disclosure of pertinent information in connection with offerings of securities to the public whether by way of primary or secondary distributions so that investors may have an opportunity to exercise an informed judgment; the other . . . is designed to curb fraud and deception by imposing liability for misrepresentations.[21]

More specifically, section 5 of the 1933 Act makes it unlawful to engage in distribution of securities without filing a registration statement and delivering a prospectus.[22] Sections 7[23] and 10[24] specify the contents of these documents. Violation of section 5 subjects a securities vendor to civil liability under section 12(1).[25] Sections 5, 7, 10,

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15 U.S.C. § 78q(a) (1970), requiring broker-dealers to maintain and file certain records, implicitly required that these statements be true. 458 F.2d at 1098 n.22. The court cited Lowell Niebuhr & Co., 18 S.E.C. 471 (1945); Herman Bud Rothbard, SEC Securities Exchange Act Release No. 5998 (June 30, 1959); and Pilgrim Sec., Inc., SEC Securities Exchange Act Release No. 5958 (May 15, 1959). None of these cases involved section 10(a) of the 1933 Act. Furthermore, the Commission found "willful" violations of section 17(a) of the 1934 Act in these cases. Section 12(1) of the 1933 Act, 15 U.S.C. § 77*l*(1) (1970), the provision affected by *Manor*, would impose liability regardless of the willfulness of the conduct. These cases are also distinguishable on the ground that the liability for failure to comply with the truth requirement was imposed directly on the broker-dealer responsible for the misrepresentation in contrast with the potential for derivative liability in *Manor* for violation of section 12(1). In *Rothbard* and *Pilgrim* the Commission rested its revocation of the broker-dealers' registration on multiple violations of the 1933 and 1934 Acts rather than solely on the violation of the section 17(a) implicit truth requirement. For these reasons the broker-dealer records cases provide inadequate precedent for the *Manor* court's holding.

The *Manor* court also cited GAF Corp. v. Milstein, 453 F.2d 709, 720 (2d Cir. 1971), where, having decided that the section 10(b) antifraud provision was inapplicable to the transaction at issue, the Second Circuit found an implicit truth requirement in section 13(d), the disclosure provision of the 1934 Act (15 U.S.C. § 78m(d) (1970)). On this basis, it held that injunctive relief was available to the plaintiff corporation. The *Milstein* court emphasized that this was necessary in order to give the plaintiff an effective remedy and promote the underlying policies of the Act. This rationale is inapplicable to section 10(a) in *Manor*, however, since the relief available through the antifraud provisions was more than adequate.

21. Wilko v. Swan, 127 F. Supp. 55, 58 (S.D.N.Y. 1955).

22. 15 U.S.C. § 77e (1970).

23. 15 U.S.C. § 77g (1970).

24. 15 U.S.C. § 77j (1970).

25. 15 U.S.C. § 77*l* (1970) reads in part:

> Any person who—
> (1) offers or sells a security in violation of section 77e of this title [section 5 of the 1933 Act] 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.

and 12(1) thus carry out the disclosure aspect of the 1933 Act's program. The other aspect of the program, that concerned with prevention of fraud and deception, is embodied in sections 11,[26] 12(2),[27] and 17(a).[28] As will be demonstrated, these latter sections provide ample sanctions for misrepresentations in a prospectus.[29] *Manor* scrambled the carefully delineated functions of the Act's two distinct aspects when it read a truth requirement into section 10(a).

Close scrutiny of specific provisions of the 1933 Act reveals the deficiency in *Manor*'s interpretation of the prospectus-delivery requirement. Under section 5(b)(2), it is unlawful for any person to transmit in interstate commerce any registered security for the purpose of sale unless accompanied by a prospectus that complies with section 10(a). With some exceptions not material in this context, section 10(a)(1) requires that a prospectus contain "the information contained in the registration statement."[30] This language was adopted as part of the 1954 amendments to the 1933 Act and replaced the Act's original language, which required that the prospectus contain the "same statements made" in the registration statement.[31] The 1954 Senate Committee Report made this comment on the change in phrasing:

> This conforms to a long standing interpretation and eliminates any doubt that, to meet the requirements of Section 10(a), a prospectus need not repeat information *in the exact form* in which it appears in other parts of the registration statement. [The amended section] continue[s] the existing statutory requirements as to the contents of the full prospectus which must be used in connection with the "sale" of registered securities.[32]

The amendment was thus directed at the form of the prospectus, and no change in substantive requirements was contemplated. The phrase "information contained in," as it appears in the amended version of section 10(a), may be read as substantially equivalent to the phrase "same statements made" in the original Act.

Legislative history lends support to the view that the phrase "same statements made"—and thus the present language "information contained in"—should be interpreted to require only that a prospectus

26. 15 U.S.C. § 77k (1970).

27. 15 U.S.C. § 77*l*(2) (1970).

28. 15 U.S.C. § 77q(a) (1970).

29. *See* notes 49-51 *infra* and accompanying text.

30. 15 U.S.C. § 77j(a)(1) (1970). The prospectus often constitutes a part of the registration statement. *See* 17 C.F.R. § 230.404(a) (1972) (prospectus may be filed in lieu of item and answer form); SEC, Form S-1, General Instructions C, 1 CCH FED. SEC. L. REP. ¶ 7122 (1972) (suggesting that a prospectus be filed as part of the registration statement).

31. Securities Act of 1933, ch. 38, tit. I, 48 Stat. 81.

32. S. REP. No. 1036, 83d Cong., 2d Sess. 16 (1954).

substantially mirror the registration statement. A House Committee Report, supporting the enactment of the 1933 Act, contained an expression of this view: "[A security] . . . may be sold . . . only if the buyer is given *a substantial replica* of the information included in the 'registration statement' . . . ."[33] Furthermore, the interpretation of section 10(a) by the Federal Trade Commission, the predecessor of the SEC, and scholarly commentary support this "mirror image" view of that section's requirements. For example, in a 1933 article discussing the incidence of section 12(1) liability, Professor Harry Shulman stated:

> The first part of Section 12 does not deal with the truth or falsity of the representations in the registration statement or prospectus. It puts upon the seller only the burden of ascertaining the existence of a registration statement and the conformity of the prospectus with that statement.[34]

The FTC delineated the requirements of section 10(a) in an early release by reference to a situation in which the issuer desired to substitute new information for that contained in the prospectus. In those circumstances, "since under the Rules of the Commission the prospectus must not omit certain items contained in the registration statement, such changes can be effected only by a regular amendment to the statement filed with the Commission."[35]

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33. H.R. REP. No. 85, 73d Cong., 1st Sess. 6 (1933) (emphasis added). *See also* 77 CONG. REC. 2931 (1933) (remarks of Representative Wolverton). There was no suggestion during the debates that section 10(a) required an independent content for the prospectus or that the phrase "same statements made" meant anything other than technical conformity.

34. *Civil Liability and the Securities Act*, 43 YALE L.J. 227, 243.

35. FTC Securities Act of 1933 Release No. 97, pt. 14 (Dec. 28, 1933), 11 Fed. Reg. 10949, 1 CCH FED. SEC. L. REP. ¶ 1028 (1971). The release further provides that

> under section 11 the accuracy of the registration statement is to be judged by the date upon which it becomes effective. It is, therefore, unnecessary, and probably impossible, to amend it to include facts which occur after its effective date. It may, of course, be necessary to supplement the information contained in the prospectus in order that it may not be misleading within the meaning of sections 12(2) and 17.
>
> The use of supplementary information, however, does not require an amendment of the prospectus, and no further papers need, therefore, be filed with the Commission. On the other hand, if it is proposed to substitute new information for that contained in the prospectus, since under the rules of the Commission the prospectus must not omit certain items contained in the registration statement, such changes can be effected only by a regular amendment to the statement filed with the Commission. In any case in which it could properly be made, such an amendment, being filed after the effective date of the registration statement, would become effective itself, under section 8(c) of the Act, "on such date as the Commission may determine, having due regard to the public interest and the protection of investors."

If, as the *Manor* court suggests, section 10(a) imposes a truth requirement, it would seem that under the "supplement-substitute" rule, if it were necessary to substitute information into the prospectus in order to avoid section 12(2) liability for failure to disclose a material fact, it would also be necessary to amend the registration statement to avoid section 12(1) liability for nonconformity. Alternatively, it could be argued that the conformity requirement should only extend to information available as of the original date of effectiveness. *See* 1 L. LOSS, SECURITIES REGULATION 294 (2d ed. 1961).

Congress did make one exception to the rule of strict conformity between the registration statement and the section 10(a) prospectus. Section 10(a)(3) deals with the situation in which a prospectus is used nine months after the effective date of the registration statement. Under these circumstances, the information contained in the prospectus "shall be as of a date not more than sixteen months prior to such use."[36] Professor Loss, in discussing section 10(a)(3), noted:

> There is no requirement that this so called "nine-month prospectus" be filed as an amendment to the registration statement, . . . for § 10(a)(3) obviously cuts across the clause in the first part of § 10(a) to the effect that the prospectus shall "contain the information contained in the registration statement."[37]

It is significant that by enacting section 10(a)(3), Congress acknowledged that the information contained in the prospectus may become inaccurate in some respects over the course of time. Yet, the case of the nine-month-old prospectus represents the only situation in which Congress expressly provided that the prospectus must be amended to avoid a section 5 violation. This suggests that in the case of a prospectus less than nine months old, no more is required for purposes of section 5 than strict conformity with the registration statement.

Thus, there is little in authority, history, and the structure of the 1933 Act to support the conclusion that section 10(a) imposes an obligation of truthful disclosure on the prospectus. However, assuming that this conclusion was correct, the prospectus should not be held to a higher standard of truthfulness than that applied to the registration statement. Since the language of section 10(a) defines the content of the prospectus in terms of the information "contained in the registration statement," any requirement of truth for the prospectus should be bottomed on the truthfulness demanded of the registration statement. Therefore, section 10(a)'s language might most readily be accommodated to the *Manor* court's finding of an obligation of truth in that section if the language were construed to mean that the prospectus must contain the information *required* to be in the registration statement—in other words, that the prospectus must independently meet the truth requirements of the registration statement.

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36. 15 U.S.C. § 77j(a)(3) (1970):

> [N]otwithstanding the provisions of paragraphs (1) and (2) of this subsection when a prospectus is used more than nine months after the effective date of the registration statement, the information contained therein shall be as of a date not more than sixteen months prior to such use, so far as such information is known to the user of such prospectus or can be furnished by such user without unreasonable effort or expense.

It should be noted that the reasonable effort standard imposed by this provision is more lenient than the absolute liability imposed by section 12(1) for a violation of section 5. *See* note 25 *supra*.

37. 1 L. Loss, *supra* note 35, at 295.

In a further extension of section 10(a), however, the court in *Manor* concluded that in order to maintain its validity the prospectus must reflect developments subsequent to the effective date of the registration statement.[38] This means that the prospectus must meet a higher standard of truthfulness than the registration statement, which under sections 8(d)[39] and 11[40] must be truthful only as of the effective date.[41]

38. 458 F.2d at 1100.

39. 15 U.S.C. § 77h(d) (1970):

> If it appears to the Commission at any time that the registration statement includes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, the Commission may . . . issue a stop order suspending the effectiveness of the registration statement. When such statement has been amended in accordance with such stop order, the Commission shall so declare and thereupon the stop order shall cease to be effective.

This section is a corollary to section 8(b), 15 U.S.C. § 77h(b) (1970), which allows the Commission to refuse to permit a registration statement to become effective if it appears that it "is on its face incomplete or inaccurate in any material respect . . . ." *See* Red Bank Oil Co., 20 S.E.C. 863 (1945), for the application of the two subsections.

40. 15 U.S.C. § 77k (1970):

> 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 [signers of the registration statement; directors of and partners in the issuer; persons who with consent are named as about to become a director or partner; persons who have consented to be named as having prepared or certified a registration statement or valuation or report used therein, including accountants, engineers, appraisers, or other authorized professionals; and underwriters.]

Various defenses are built into section 11 as well as certain limitations on damages.

Criminal liability is imposed by section 24, 15 U.S.C. § 77x (1970):

> Any person who willfully violates any of the provisions of this subchapter, or the rules and regulations promulgated by the Commission under authority thereof, or any person who willfully, in a registration statement filed under this subchapter, makes any untrue statement of a material fact or omits to state any material fact required to be stated therein or necessary to make the statements therein not misleading, shall upon conviction be fined not more than $5,000 or imprisoned not more than five years or both.

41. There is some ambiguity on the face of the statute regarding whether the registration statement speaks only from its effective date, as the *Manor* court pointed out. 458 F.2d at 1099 n.24. *See* 1 L. Loss, *supra* note 35, at 290-91. Liability exists under section 11 "[i]n case any part of the registration statement, when such part became effective, contained an untrue statement . . . ." 15 U.S.C. § 77k(a) (1970). A stop order may be issued under section 8(d) "if it appears to the Commission *at any time* that the registration statement includes any untrue statement . . . ." 15 U.S.C. § 77h(d) (1970) (emphasis added). Section 8(d) might be read to mean that the Commission may issue the stop order "at any time" it discovers an untrue statement which existed at the effective date or alternatively that it may issue a stop order "at any time" a statement becomes untrue, even if it is after the effective date. There is legislative history to support the latter reading:

> In determining whether a stop order should issue, the Commission will naturally have regard to the facts as they then exist and will stop the further sale of securities, even though the registration statement was true when made, [and] it has become untrue or misleading by reason of subsequent developments.

H.R. REP. NO. 85, 73d Cong., 1st Sess. 20 (1933). However, the Commission has consistently supported the former, holding that section 8(d)

> does not . . . permit the Commission to issue a stop order if it finds that a state-

Although willing to assume that the registration statement does speak as of its effective date,[42] the court in *Manor* stated: "Even those SEC decisions holding that the registration statement need not be amended to reflect post-effective developments recognize that the prospectus must be amended or supplemented in some manner to reflect such changes."[43] However, the cases cited by *Manor* refer to a duty to disclose post-effective developments in the prospectus in order to avoid liabilities under sections 12(2) and 17(a).[44] There was no suggestion in these cases that a violation of the duty to amend would render the prospectus deficient for the purposes of section 10(a) and result in liability under section 12(1).

Moreover, *Manor*'s conclusion that the prospectus must reflect post-effective developments may have been unnecessary since the court might have found that the prospectus in *Manor* was untrue as

ment which reflected the truth as of the time the registration statement became effective no longer reflects the truth. It does, however, permit the Commission *at any time* that it finds a statement does not reflect the truth as of the time that the registration statement became effective to issue a stop order.

Charles A. Howard, 1 S.E.C. 6, 10 (1934) (emphasis original). The registration statement must, however, be amended to encompass material developments subsequent to filing but prior to effectiveness. 1 S.E.C. at 9; Paper Sales Co. of Detroit, 2 S.E.C. 748, 752 (1937). *See also* Kinner Airplane & Motor Corp., 2 S.E.C. 943 (1937). The *Manor* court cited Franchard Corp., SEC Securities Act Release No. 4710 (July 13, 1964), for the proposition that "in some situations it may be necessary to amend the registration statement to reflect post-effective changes." 458 F.2d at 1099 n.23. However, in *Franchard*, the registrant attempted to amend its registration statement, which was untrue at the effective date, to reflect post-effective developments by supplementing the prospectus, which was part of the registration statement. The SEC denied effectiveness to this method of amendment, stating:

> [T]his form of presentation is inadequate and misleading when numerous and significant changes in the issuer's affairs during the period between the effective date and the date of the post-effective amendment have clearly outdated the original prospectus. In such cases "supplementation" of the outmoded prospectus necessarily results in an obscure and uncoordinated presentation.

Id. at 31. Thus, in *Franchard* the SEC was not imposing a requirement that the registration statement be amended to reflect post-effective changes; rather it was merely considering the acceptability of post-effective amendments that had already been filed by the issuer.

42. 458 F.2d at 1099. Having concluded that "appellants were obliged to reflect the post-effective developments . . . in the prospectus," the court did not find it necessary to "reach the question whether the registration statement speaks only as of its effective date." 458 F.2d at 1099 & n.24.

43. 458 F.2d at 1099, *citing* Charles A. Howard, 1 S.E.C. 6, 10 (1934); Funeral Director's Mfg. & Supply Co., 39 S.E.C. 33, 34 (1959).

44. Charles A. Howard, 1 S.E.C. 6, 10 (1934). In Funeral Director's Mfg. & Supply Co., 39 S.E.C. 33, 34 (1959), the Commission observed: "For purposes of stop order proceedings under Section 8(d) of the Act, the adequacy and accuracy of the disclosures in a registration statement are to be tested as of the date the registration becomes effective." The Commission continued in a footnote:

> In this connection it is to be noted, however, that *Sections 12(2) and 17(a)* of the Act impose an obligation on vendors of securities which are the subject of an effective registration statement to disclose to purchasers changes in material facts occurring after the effective date of the registration statement which render the disclosures therein inaccurate.

39 S.E.C. at 34 n.3 (emphasis added).

of the effective date. First, the prospectus stated that arrangements had been made to set up an escrow account for subscribers' proceeds; apparently this representation was false on the effective date.[45] Moreover, it appears that, contrary to the suggestion that an escrow fund would be set up, the parties involved in the offering never intended to establish such a fund.[46] Thus, the court could have found that the prospectus was false on the effective date because it misrepresented the parties' intentions.[47] It might also be contended that the principals of the issuer and underwriter never intended to conform with the registration statement representation that shares would be sold only for cash and that there would be no special compensation for certain purchasers and brokers. Although there was no evidence directly on point, the speed with which the principals altered their stated plans and implemented transactions that violated the terms of the offer in the registration statement strongly suggests that they did not intend to comply with such terms at the time the statement became effective.[48] Through this analysis of the facts, the *Manor* court could have reached the same result without extending the requirement of truth that it held implict in section 10(a) beyond the effective date of the registration statement.

In addition to the lack of theoretical support for the *Manor* court's interpretation of section 10(a), there are substantial policy grounds for rejecting the court's reading. Before *Manor*, a person who sold a security accompanied by an untrue prospectus or a prospectus that was misleading because of post-effective developments could be held liable to his purchaser under section 12(2) of the 1933 Act.[49] However, such a person could avoid liability by proving that "he did not know, and in the exercise of reasonable care could not have known"[50] of the alleged untruth in the prospectus. Similarly, if

45. 458 F.2d at 1090.

46. 458 F.2d at 1090.

47. Evidence of conduct in direct and flagrant conflict with a particular intent stated in a registration statement to be then existing may, under some circumstances, offer a clear basis for the conclusion that this intent did not in fact exist at the time the statement became effective.
National Invested Sav. Corp., 2 S.E.C. 113, 117 (1937).

48. *See* 458 F.2d at 1090-94.

49. 15 U.S.C. § 77*l* (1970):
Any person who—
(2) offers or sells a security . . . 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 statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable 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 . . . .

50. 15 U.S.C. § 77*l*(2) (1970), set out in note 49 *supra*.

the registration statement, on which the prospectus is based, contained an "untrue statement of material fact," liability was imposed by section 11, which also provides for a due-diligence defense.[51] The effect of *Manor* is to make it a violation of section 5(b)(2) to sell a security by means of a prospectus that is untrue either as of the effective date of the registration statement or thereafter. This exposes issuers, underwriters, and broker-dealers to liability for the purchase price of the securities under section 12(1).[52] Of major significance is the fact that unlike section 12(2), section 12(1) contains no provision for a reasonable care defense; liability under section 12(1) is absolute.[53]

A possible consequence of imposing this burden of absolute liability under section 12(1) is to upset the proper balance between liability and nonliability in the securities business. As stated by Professor (now Justice) Douglas and Professor Bates in 1933, "risks should not be placed so high as to deter substantial and honest men from engaging in legitimate business."[54] While any requirement of truth is not effective unless the penalties are sufficiently "severe to make it improvident not to tell it,"[55] it is suggested that the *Manor* holding has gone beyond the need to encourage truth-telling and may deter honest men from engaging in securities distributions once they perceive the spreading threat of section 12(1) liability. Before *Manor*, the prudent broker-dealer, for example, could feel safe in selling a security if there was a registration statement in effect and if the prospectus mirrored that registration statement; and he was safe from liability to purchasers for untruths in the prospectus unless he failed to exercise due care with respect to its contents.[56] *Manor* thus imposes an unnecessary, and an almost overwhelming, burden on the broker-dealer. Not only must he determine the truth of the prospectus at the effective date of the registration statement, but he must continually

51. 15 U.S.C. § 77k (1970), set out in part in note 40 *supra*.

52. 15 U.S.C. § 77*l*(1) (1970), set out in note 25 *supra*. Since *Manor* was an action by the SEC brought under sections 22(a) of the 1933 Act and 27 of the 1934 Act, the court did not discuss the implications of the case with respect to section 12 of the 1933 Act, a private remedy creating civil liability.

Section 12 specifies that "Any person . . . shall be liable to the person purchasing such security from him . . . ." 15 U.S.C. § 77*l* (1970). Thus, the section provides for "an action by a buyer against his immediate seller." 3 L. Loss, *supra* note 35, at 1719. Since each party could join his immediate seller under FED. R. CIV. P. 14, the liability of all the parties could be determined in one action. Therefore, the broker would not necessarily be held ultimately liable.

53. It should be recognized that as to the underwriter, liability under both sections 12(1) and 12(2) may be relieved by the execution of indemnification agreements; or warranties and undertakings in the underwriting contract may be the basis of a contract action against the issuer. Certain other transactions are exempted by section 4 of the 1933 Act, 15 U.S.C. § 77d (1970).

54. *The Federal Securities Act of 1933*, 43 YALE L.J. 171, 172.

55. *Id.*

56. *See, e.g.*, Demarco v. Edens, 390 F.2d 836 (2d Cir. 1968).

investigate the factual basis of that document to determine that it has not become false and thus invalid. And despite his efforts, the broker-dealer may find himself liable for false information in the prospectus when he has no effective access to the information upon which liability may turn. For example, an issuer may deliberately conceal changes in circumstances that render the 10(a) prospectus void, and the broker-dealer will have no opportunity to protect himself from absolute liability under section 12(1).

Given the factual setting of *Manor*, the court's interpretation of section 10(a) was unjustified. Most of the relief sought by the SEC—an injunction and the disgorging of proceeds retained by defendants—could have been granted on the basis of defendants' violations of section 12(2) of the 1933 Act and the general antifraud provisions of the 1933 and 1934 Acts.[57] The underwriter and broker-dealers involved in the distribution of Manor stock were informed participants in the acts and decisions that rendered the prospectus false. Thus, even if suit had been brought against the defendants in *Manor* to recover civil damages, the equities would have supported imposition of maximum liability under section 12(2) and the antifraud provisions. In factual settings unlike that in *Manor*, however, the court's interpretation of section 10(a) could, as noted above, create inequitable results.

Limiting *Manor* to its holding of fraud violations would prevent the establishment of precedents leading to extended liability for innocent participants in securities offerings. In fact situations similar to *Manor*, liabilities would still be imposed for use of a false prospectus through the antifraud provisions of the securities acts and section 12(2). If further protection of the investor is needed beyond that supplied by these provisions, it should be afforded through legislative amendments or new enactments, not by a strained judicial interpretation of section 10(a).

57. *Cf.* GAF Corp. v. Milstein, 453 F.2d 709, 720 (2d Cir. 1971), discussed in note 20 *supra*.