## CORPORATE HINANCE AND THE ECURITIES IAWS

FOURTH EDITION

Charles J. Johnson, Jr. Joseph McLaughlin

# CORPORATE FINANCE AND THE SECURITIES LAWS Fourth Edition

Charles J. Johnson, Jr. Joseph McLaughlin



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Printed in the United States of America

1234567890

#### Library of Congress Cataloging-in-Publication Data

Johnson, Charles J., 1932

Corporate finance and the securities laws / Charles J. Johnson, Jr., Joseph McLaughlin.—4th ed. p. cm.

Includes index.

ISBN 0-7355-6310-1 (loose-leaf: alk paper) 1. Corporations—Finance—Law and legislation—United States. 2. Securities—United States. I. McLaughlin, Joseph, 1941—II. Title.

KF1428.J58 2006 346.73'.0666—dc22

2006013761



September 2006

0735563101

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  - communication reforms
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C.J.J., Jr.

For
Joseph Nicholas McLaughlin
and
Genevieve Lardiere McLaughlin
J.McL.

#### **ABOUT THE AUTHORS**

CHARLES J. JOHNSON, JR. is one of the country's most experienced securities lawyers. A graduate of Yale College and Harvard Law School, he began the practice of law at Brown & Wood in 1956 and became a partner in 1967. He is now a Retired Partner of Sidley Austin LLP. During his last ten years as a member of the firm, he was head of its corporate and securities practice.

Mr. Johnson has acted as counsel to issuers and investment banking firms in hundreds of major financial transactions, including public offerings of debt and equity securities, leveraged buyouts, issuer tender offers, underwritten calls and institutional private placements. Among the transactions in which he has played a major role are the initial public offering by Communications Satellite Corporation and numerous first mortgage bond financings by Duke Power Company and Public Service Electric and Gas Company. He represented Merrill Lynch, Pierce, Fenner & Smith Incorporated when it went public in 1971 and subsequently worked on the public offerings of several other securities firms. He has represented the underwriters in a large number of securities offerings by money center banks and bank holding companies.

The author has written many articles for legal journals, including "Application of Federal Securities Laws to International Securities Transactions," which appeared in the *Albany Law Review*. He contributed a chapter on legal considerations in the establishment of a United States commercial paper program for a book published by *Euromoney*. The *Review of Securities & Commodities Regulation* has published articles by him on former Rules 10b-6 and 10b-7, on underwritten calls, and on Rule 415 and the integrated disclosure system.

Mr. Johnson has been an active participant in continuing legal education programs, including Practicing Law Institute seminars on the mechanics of underwriting, international finance transactions, and the 10b series of rules. He has also been a regular speaker at the Practicing Law Institute's *Annual Institute on Securities Regulation* where he has lectured on such matters as the regulations of the National Association of

Securities Dealers, Inc., innovative financial products, and special disclosure problems. He has spoken at conferences sponsored by the Institute for International Research on Law in the Euromarkets and on Eurocommercial paper.

Mr. Johnson also has presented papers or participated in programs sponsored by the American Bar Association, the Southwest Legal Foundation, the Securities Industry Association, the New York Society of Securities Analysts, and the Fordham Corporate Law Institute.

Mr. Johnson is an elected member of the American Law Institute. He served a three-year term as a member of the Committee on Securities Regulation of The Association of the Bar of The City of New York, the final year as Chairman of its Subcommittee on the Issue and Distribution of Securities.

JOSEPH McLAUGHLIN is a partner of Sidley Austin LLP in New York City, where he has one of the country's most diversified securities practices. A graduate of Columbia College and Columbia Law School, he was also a Jervey Fellow of the Parker School of Foreign and Comparative Law at Columbia Law School and did post-graduate work at the University of Munich. He practiced with Sullivan & Cromwell for seven years, where he worked on a wide variety of securities transactions.

Mr. McLaughlin became general counsel of Goldman, Sachs & Co. in 1976. He worked closely for many years with the firm's investment banking departments, as well as with its equity and fixed-income research, sales and trading areas. He was active in securities industry matters, including the Federal Regulation Committee of the Securities Industry Association, the Corporate Financing Committee of the National Association of Securities Dealers, Inc. and the Legal Advisory Committee of the New York Stock Exchange, Inc. During this period. Mr. McLaughlin contributed to industry and SEC initiatives involving securities research, trading practices, short sales, the new capital rule, margin regulations, underwriters' liability, the "Papilsky rules" and shelf registration. Many of these subjects are discussed in this book.

After experimenting with a teaching career, Mr. McLaughlin joined Brown & Wood LLP, a predecessor firm of Sidley Austin LLP, where he is a member of the corporate and securities group as well as the broker-dealer regulatory group. He works on domestic and international public offerings and private placements and spends a significant part of his time on regulatory and litigation matters for securities industry associations and more than 20 major broker-dealer clients. He also represented two of

the leading groups responsible for the SEC and legislative initiatives that produced the Private Securities Litigation Reform Act of 1995.

Mr. McLaughlin is a leading writer and speaker on Securities Offering Reform, electronic communications and the securities laws, the listing of foreign securities on U.S. exchanges, and the future of U.S. securities regulation. He also co-chaired an American Bar Association committee's Task Force on Sellers' Due Diligence and Similar Defenses Under the Federal Securities Laws as well as its Task Force on Rule 10b-6.

Mr. McLaughlin is an elected member of the American Law Institute. He is a frequent speaker at programs sponsored by the Practicing Law Institute and The Federalist Society.

### PREFACE TO THE FOURTH EDITION

The appearance of this edition at this time is obviously the result of the SEC's recent success in adopting Securities Offering Reform, which certainly represents the most significant change in at least 25 years in the way in which public securities offerings take place in the United States. There is still work to be done in bringing the Securities Act of 1933 up to date, particularly in connection with private placements, but the SEC and its staff deserve hearty congratulations for what they have recently achieved.

Like its previous editions, this book is about doing deals—transactions in which companies raise funds in the U.S. and international capital markets. We do not intend this book as a complete treatise on the U.S. federal securities laws, nor do we intend it as an investor's or issuer's guide to the capital markets. Rather, we are trying to explain the legal environment in which capital markets transactions take place, just as we are trying to explain the capital markets transactions to which that environment is always trying to adapt. What we are describing in this book is in many ways just as much an ecosystem as a tropical rain forest—and, unfortunately, sometimes just as impenetrable.

We have tried to retain the book's practical orientation, which we believe was responsible for the previous editions' considerable success. We caution, however, that the pace of change in the capital markets is still accelerating. Many of the topics discussed in this book may need to be revisited within a relatively short time. For that reason, we have reluctantly put aside the previous editions' case-bound format in favor of the current edition's loose-leaf presentation, which will enable us to publish periodic updates without requiring our readers to purchase a new book.

As in the previous editions, our focus has remained the raising of capital by business entities. We have not discussed public finance—the sale of securities by federal or state governmental entities or their instrumentalities—or the corporate and specialized securities aspects of mergers and acquisitions. Nor have we devoted space to the parallel

structure of SEC rules and forms that are designed specifically for the needs of "small business."

As in the case of the previous edition, we have had the full support of our colleagues at Sidley Austin LLP. Many of them provided us with valuable insights into their areas of special expertise.

A special debt is owed to Norman D. Slonaker, who is really one of the preeminent transactional lawyers in the United States.

We also thank Michael Hyatte, who joined Sidley Austin LLP after many years in the SEC's Division of Corporation Finance and possesses a unique knowledge and understanding of the Securities Act of 1933.

Many of our colleagues provided us with valuable insights into their areas of special expertise. These include:

- Renwick D. Martin, Giselle M. Barth and Jack M. Costello, Jr. regarding the chapter on asset-backed securities.
- Craig E. Chapman regarding the discussion of trust preferred and other hybrid capital instruments.
- Barbara J. Endres regarding the chapter on manipulation and the discussion of Rule 10b-18.
- David M. Katz regarding the chapter on self-regulatory organizations.
- Robert Mandell regarding the chapter on convertible and exchangeable securities.
- Edward D. Ricchiuto regarding the discussion of tender and exchange offers and debt restructurings.

Our colleagues A.J. Alexis Gelinas, Jacob J. Amato III and Shelley Howard Grant provided help on tax issues; Michael S. Sackheim on issues arising under the Commodity Exchange Act and the Commodities Futures Modernization Act; and Thomas R. Smith, Jr., John A. MacKinnon, Frank P. Bruno and Brian J. Kaplowitz on issues arising under the Investment Company Act of 1940.

Joseph W. Armbrust, Robert J. Donatucci, Alan L. Jakimo, Michael T. Kohler, Jonathan B. Miller, Daniel M. Rossner, John Russell and L. Markus Wiltshire read certain chapters and provided important suggestions.

Much expertise that used to be taken for granted at large Wall Street law firms has migrated into the legal, compliance and capital markets departments of the investment banking firms. We are therefore grateful for the help of Katherine Bartholomaus, John W. Curtis, Susan Dowling, Elizabeth J. Ford, Robyn Huffman, Randolph Stuzin and Robert Wall of Goldman, Sachs & Co., Mitchell B. Kleinman of Keefe,

Bruyette & Woods, Inc. and Ranada R. Fergerson of Banc of America Securities LLC.

Any errors or omissions are, of course, the sole responsibility of the authors.

We also thank Christa M. Lange, Joseph Taylor Boston, Michael J. Fillinger, Sarah E. Kagen and Megan I. Scanlon of Sidley Austin LLP s library staff for their patient and diligent support as well as the junior author's assistant for many years, Blanche Wyche-Maloney.

Charles J. Johnson, Jr. Joseph McLaughlin New York June 2006

#### PREFACE TO THE FIRST EDITION

This book is about doing deals—structuring them, shepherding them through the regulatory process, keeping them out of trouble, and getting them closed. It is about the Federal securities laws, those laws and regulations administered by the Securities and Exchange Commission that have a direct impact on every aspect of corporate finance and that must be complied with if a deal is to get done.

A corporation that decides to go public or to raise additional funds to finance a growing business must comply with the Securities Act of 1933 and the applicable provisions of the Securities Exchange Act of 1934. If debt securities are being sold to the public, the Trust Indenture Act of 1939 will be applicable. If securities are being issued by a public utility holding company or one of its operating subsidiaries, then competitive bidding may be required under the Public Utility Holding Company Act of 1935. An obscure provision of the Investment Company Act of 1940 may come into play when least expected.

The securities laws regulate other types of financial transactions such as corporate restructurings, offers to exchange new securities for existing securities, and stock repurchase programs. At the same time, corporate financial officers and investment bankers must contend with regulations administered by state securities commissions, the National Association of Securities Dealers, Inc., and the Federal Reserve Board. In the case of a hybrid instrument—a security tied to the performance of a commodity, a stock or bond index, a foreign currency, or the rate of inflation—care must be taken to assure that the transaction does not run afoul of the Commodity Exchange Act.

Guiding their clients through this morass of regulation are lawyers of a special breed known as securities lawyers. I have been one for over 33 years, practicing in New York City with Brown & Wood. In writing this book, I have called upon my experiences as a securities lawyer to flesh out the descriptions of the statutes and rules with some practical observations on how they are applied in real-life situations and how they can best be coped with when a crisis arises in the course of a financial

transaction. I have described the mechanics and practices of corporate finance in addition to the legal principles that govern them. I have not hesitated to insert editorial comment where I have thought it appropriate.

This book places securities regulation in an historical perspective. I believe that the law can be understood more fully and applied more effectively with a knowledge of its development over the years. Also, the history of the securities laws and the development of investment banking practices are a part of the culture of the financial community. A knowledge of the way that these laws and practices have evolved adds zest to an already fascinating business.

This book is directed primarily to lawyers working in the field of corporate finance, members of the "green goods" bar to use a Wall Street term. By discussing the law in the context of specific types of transactions, my objective is a book that will be useful to experienced securities lawyers as well as those just learning the law of corporate finance. Also, the lawyer whose practice is not devoted primarily to securities regulation may find it helpful to read through the relevant chapters if a client is about to engage in a financial transaction such as a public offering of convertible debentures or the establishment of a commercial paper program.

I hope this book will be useful to businessmen as well. I hope it will be read by corporate officers responsible for financial transactions—the chief executive officer, the chief financial officer, and those who assist them. It also can provide insights to investment bankers. The legal aspects of corporate finance are so intertwined with the business aspects that a businessman cannot fully perform his functions without some knowledge of securities regulation.

The practice of securities law is a fascinating occupation. Equally fascinating is the work of the corporate financial officer and the investment banker. The intellectual challenge of corporate finance is a source of constant stimulation to the securities lawyer and the financial experts that he represents. There is a camaraderie in the practice of securities law. I value the relationships that I have developed over the years with investment bankers, corporate financial officers, and members of the accounting profession, to say nothing of the scores of other securities lawyers with whom I have worked on hundreds of financial transactions. I have learned from all of them, and many have become my close friends.