

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

----- X
:
In Re: WORLDCOM, INC. SECURITIES :
LITIGATION :
:

----- X
:
THIS DOCUMENT RELATES TO: :

02 Civ. 3288 02 Civ. 4973 02 Civ. 8234
02 Civ. 3416 02 Civ. 4990 02 Civ. 9513
02 Civ. 3419 02 Civ. 5057 02 Civ. 9514
02 Civ. 3508 02 Civ. 5071 02 Civ. 9515
02 Civ. 3537 02 Civ. 5087 02 Civ. 9516
02 Civ. 3647 02 Civ. 5108 02 Civ. 9519
02 Civ. 3750 02 Civ. 5224 02 Civ. 9521
02 Civ. 3771 02 Civ. 5285 03 Civ. 2841
02 Civ. 4719 02 Civ. 8226 03 Civ. 3592
02 Civ. 4945 02 Civ. 8228 03 Civ. 6229
02 Civ. 4946 02 Civ. 8229 03 Civ. 7298
02 Civ. 4958 02 Civ. 8230 03 Civ. 7299

Master File No.
02 Civ.3288 (DLC)

----- X
:
**BRIEF OF THE SECURITIES INDUSTRY ASSOCIATION AND THE BOND
MARKET ASSOCIATION, AMICI CURIAE, IN SUPPORT THE MOTION OF
UNDERWRITER-RELATED DEFENDANTS FOR SUMMARY JUDGMENT**

George R. Kramer
Securities Industry Association
1425 K Street, N.W.
Seventh Floor
Washington, D.C. 20005
202-216-2000

DAVIS POLK & WARDWELL
450 Lexington Avenue
New York, New York 10017
212-450-4000

Marjorie E. Gross
The Bond Market Association
360 Madison Avenue
New York, New York 10017
646-637-9200

*Attorneys for the Securities Industry Association and the
Bond Market Association*

TABLE OF CONTENTS

	<u>PAGE</u>
TABLE OF AUTHORITIES	ii
I. BENEFITS OF INTEGRATED DISCLOSURE AND SHELF REGISTRATION.....	3
II. CONCERNS REGARDING DUE DILIGENCE	4
III. INTERPRETATION OF THE DUE DILIGENCE STANDARD.....	6
A. What Is Reasonable Investigation Varies Depending on Context.....	6
B. Impact of Integrated Disclosure System on Due Diligence	8
C. SEC Position on Due Diligence in Shelf Offerings	9
CONCLUSION.....	11

TABLE OF AUTHORITIES

<u>CASES</u>	<u>PAGE</u>
<u>Escott v. BarChris Constr. Corp.</u> , 283 F. Supp. 643 (S.D.N.Y. 1968).....	10
<u>Feit v. Leasco Data Processing Equip. Corp.</u> , 332 F. Supp. 544 (E.D.N.Y. 1971).....	10
<u>Shaw v. Digital Equip. Corp.</u> , 82 F.3d 1194 (1st Cir. 1996).....	2
<u>In re Software Toolworks</u> , 50 F.3d 615 (9th Cir. 1994)	4
<u>Wielgos v. Commonwealth Edison Co.</u> , 892 F.2d 509 (7th Cir. 1989).....	2

<u>STATUTES & RULES</u>	
15 U.S.C. § 77k(a) (1997).....	4
15 U.S.C. § 77k(b) (1997).....	4
15 U.S.C. § 77k(c) (1997).....	4
17 C.F.R. § 230.176 (2003).....	.8, 9
17 C.F.R. § 230.415 (2003).....	<u>passim</u>

<u>OTHER AUTHORITIES</u>	
Reasonable Investigation and Reasonable Grounds for Belief, Securities Act Release No. 33-6335, 1981 SEC LEXIS 946 (Aug. 6, 1981)	<u>passim</u>
Delayed or Continuous Offering and Sale of Securities, Securities Act Release No. 33-6423, 1982 SEC LEXIS 979 (Sept. 2, 1982).....	<u>passim</u>
Shelf Registration, Securities Act Release No. 33-6499, 1983 SEC LEXIS 315 (Nov. 17, 1983).....	<u>passim</u>
Barbara Ann Banoff, <u>Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415</u> , 70 Va. L. Rev. 135 (1984)	3

	<u>PAGE</u>
J. Fitzsimmons, <u>Due Diligence</u> , in <u>Securities Underwriting: A Practitioner's Guide</u> (Kenneth J. Bialkin & William J. Grant, Jr. eds., PLI 1985)	10
1 Louis Loss & Joel Seligman, <u>Securities Regulation</u> (3d revised ed.)	3

The Securities Industry Association (“SIA”) and The Bond Market Association (“TBMA”) respectfully submit this memorandum of law as amici curiae in support of the Underwriter-Related Defendants’ motion for summary judgment. In particular, the SIA and TBMA urge that in determining the motion, insofar as it raises the so-called due diligence affirmative defense provided to underwriters by sections 11(b) and (c) of the Securities Act of 1933 with respect to non-expertised portions of a registration statement, the Court give due consideration to the context in which the offerings at issue occurred, namely, under the shelf registration procedures prescribed by Rule 415 promulgated by the SEC, 17 C.F.R. § 230.415 (2003). In applying the legal standard for “reasonable investigation” set out in the statute, the Court should adopt a flexible approach that takes into account the practical limitations, both as to time and scope, on underwriters’ ability to perform pre-offering investigations and the extent of such investigations reasonably necessary in light of the extensive available information concerning the issuers that are permitted by the SEC to use the shelf registration procedures.

Shelf registration offerings have become an essential part of the capital raising markets in the United States,¹ but the future of such offerings would be put in jeopardy if the Court were to issue a ruling that required an underwriter to perform the same due diligence for a shelf offering as it would for an offering involving a pre-effective waiting period. If underwriters were required to utilize the same time-consuming diligence procedures with respect to offerings off of a shelf registration as they use for non-shelf deals, then either underwriters would have to be willing to proceed without the statutory

¹ Since 1995, shelf registrations of corporate debt securities have averaged 48% of all corporate debt underwritings by number of issues and 54.6% of the dollar amount underwritten. See Annex 1.

diligence defense Congress intended them to have or issuers would not be able to have the benefit of underwritten financing off of a shelf registration, as the SEC intended they should.

Beginning in the 1960's, the SEC undertook "to integrate the disclosure requirements of the Securities Act [of 1933] and the Securities Exchange Act of 1934." See Reasonable Investigation and Reasonable Grounds for Belief, Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, at *1 & *8 (Aug. 6 1981). Prior to 1964, the disclosure system of the Securities Act and the disclosure system of the Exchange Act operated independently of each other and commentators noted that this state of affairs resulted in needless duplication and overlap. Id. at *8. Over the next several years, the SEC took steps to allow better coordination between the two systems of disclosure. The SEC's decision to act was expressly premised on its view that all available information concerning widely traded securities, including debt securities, of major companies is rapidly absorbed by modern markets and reflected in the pricing of those securities, the so-called efficient market theory. See Wielgos v. Commonwealth Edison Co., 892 F.2d 509, 510 (7th Cir. 1989).

One such step was the adoption of Form S-3 in 1982, "a streamlined registration form available only to certain well-capitalized and widely followed issuers about which a significant amount of public information is already available." Shaw v. Digital Equip. Corp., 82 F.3d 1194, 1205 (1st Cir. 1996). This permitted the incorporation by reference into a Securities Act registration statement of the extensive information already on file with the SEC as part of the issuer's Exchange Act reporting. Only a description of the new offering and certain updated information with respect to matters occurring since the last Exchange Act filing is therefore necessary in the registration statement for the new

issuance. Another step, also in 1982, was the adoption of Rule 415, making “shelf registration,” the continuous or delayed offering of registered securities, more widely available.

I. BENEFITS OF INTEGRATED DISCLOSURE AND SHELF REGISTRATION

These changes were intended to reduce the “time and expense necessary to prepare [registration statements]” and thereby eliminate “artificial delays to rapid access to today’s capital markets.” Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, at *13. Shelf registration allows for even more rapid and repeated access to the markets; once effective, the shelf registration allows an issuer to access the market at any time and on extremely short notice, often as little as a few hours, without any further SEC review. The benefits of shelf registration include lowering compliance costs, promoting innovative distributions, and decreasing the cost of raising capital. Barbara Ann Banoff, Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 Va. L. Rev. 135, 145-53 (1984); 1 Louis Loss & Joel Seligman, Securities Regulation 368-69 (3d revised ed.). The flexibility afforded by shelf registration in terms of timing an offering allows a registrant to move quickly to take advantage of “market windows” and, for example, obtain favorable interest rates on debt before market conditions change. See Shelf Registration, Securities Act Release No. 33-6499, 1983 SEC LEXIS 315, at *12 (Nov. 17, 1983).

Indeed, rapid access to the markets was an important factor motivating the adoption of integrated disclosure and the wider use of shelf registration. 1 Loss & Seligman, Securities Regulation 362 (“Unless SEC administration of the Securities Act permitted issuers to sell securities as rapidly in the United States as in Europe, it was

reasonable to assume that a considerable portion of both American and foreign issues would be sold exclusively abroad.”) Preparation of traditional registration statements would generally begin several weeks in advance of the proposed offering. By contrast, offerings of securities under shelf registration by design take less time, and the time for performing due diligence procedures between the issuer’s decision to undertake a shelf securities offering and its completion is sharply reduced. Securities Act Release No. 33-6335, 1981 SEC LEXIS 946 at *16-17.

II. CONCERNS REGARDING DUE DILIGENCE

Under section 11(a) of the Securities Act, underwriters, among others, can be civilly liable for material misstatements or omissions in an effective registration statement. 15 U.S.C. § 77k(a) (1997). Under section 11(b), however, if a defendant shows that it undertook a reasonable investigation of and had reasonable grounds to believe in the accuracy of the non-expertised portions of the registration statement, then the defendant will not be liable. 15 U.S.C. § 77k(b) (1997).² The standard of reasonableness is “that required of a prudent man in the management of his own property.” 15 U.S.C. § 77k(c) (1997). The reasonable investigation is also known as “due diligence.”

As to the integrated disclosure system, some commentators expressed concern that the reduction in preparation time and competitive pressures would not leave

² With respect to any part of a registration statement presented on the authority of an expert other than the defendant, a defendant has a defense to liability if it can show that it had no reasonable ground to believe and did not believe there was a material omission or misstatement. Thus, with respect to expertised portions of the registration statement, such as audited financial statements, underwriters need only show that they “had no reasonable ground to believe, and did not believe . . . 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.” *In re Software Toolworks*, 50 F.3d 615, 623 (9th Cir. 1994) (quoting 15 U.S.C. § 77k(b)(3)(C)).

sufficient time to conduct an investigation that would be deemed reasonable under section 11. Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, at *17. Certain underwriters also noted that the periodic reports incorporated by reference would often have been composed by the issuer subject only to the fraud standards under Rule 10b-5 and without consultation with the underwriters, who would then be held to a higher standard of civil liability under section 11 than the original preparers of the reports. Id. Moreover, issuers could be expected to be reluctant to modify previously filed reports in response to underwriter comments, fearing that doing so might expose them to liability for the prior filing. Id. at *18.

When adopting Rule 415, the SEC noted that many of the concerns were not very different from those pertaining to the integrated disclosure system more generally. See Delayed or Continuous Offering and Sale of Securities, Securities Act Release No. 33-6423, 1982 SEC LEXIS 979, at *12 (Sept. 2, 1982). Commissioner Thomas wrote a dissent detailing a number of concerns, including the impact of Rule 415 on underwriter's due diligence. "Rule 415 does not provide time for underwriters to discharge adequately their due diligence responsibilities" and "[u]nder the Rule . . . because there is little if any time between selection of the underwriters and the sale, no due diligence is practical at any time during the pre-sale process." Id. at *45.³ Thus, while recognizing the benefits of an integrated disclosure system and shelf registration, the SEC was also aware of concerns that the integrated disclosure system and the expanded use of shelf registration would impact the manner in which underwriters discharge their due diligence

³ Commissioner Thomas's comments related to the temporary version of Rule 415 that made shelf registration for primary offerings available to issuers ineligible to use Form S-3, but the final version of the rule addressed this concern by revising the rule to further limit its availability. Securities Act Release No. 33-6499, 1983 SEC LEXIS 315, at *3 (noting that the rule was being limited "to primary offerings of securities qualified to be registered on Form S-3 or F-3 and to traditional shelf offerings").

obligations.⁴ Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, at *13-20; Securities Act Release No. 33-6499, 1983 SEC LEXIS 315, at *16-17.

III. INTERPRETATION OF THE DUE DILIGENCE STANDARD

In interpreting the Securities Act to allow for integrated disclosure, the SEC did not intend to eliminate the statutory requirement that there be a reasonable investigation to establish a due diligence defense. However, the SEC expressly recognized that what constituted a reasonable investigation would vary depending on changing circumstances. More specifically, the SEC understood that the integrated disclosure system and shelf registration would cause underwriters to adopt new due diligence techniques and that underwriters would not be required to employ older techniques that are incompatible with the new system.

A. What Is Reasonable Investigation Varies Depending on Context

In response to concerns about the potential impact of integrated disclosure and shelf registration on due diligence obligations, the SEC noted that the “integrated disclosure system, past and proposed, is . . . not designed to modify the responsibility of underwriters and others to make a reasonable investigation” and “nothing in the Commission’s integrated disclosure system precludes conducting adequate due diligence.” Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, *31.

While as provided in section 11(c) of the Securities Act, in assessing what constitutes a “reasonable investigation” and reasonable “belief” under section 11(b), the

⁴ Even Commissioner Thomas, as discussed in more detail below, never extended her concerns about due diligence to primary offerings of debt qualified to be registered on Form S-3, such as WorldCom’s bond offerings at issue here. *Id.* at *46. Commissioner Thomas took a contextual approach, evaluating various circumstances such as the type of issuer and the type of security in order to determine whether shelf registration and the due diligence techniques compatible therewith would provide sufficient protection to investors. Securities Act Release No. 33-6423, 1982 LEXIS SEC 979, at *55-64 (distinguishing between debt and equity offerings and between Form S-3 and non-Form S-3 registrations).

standard remains that of a prudent man in the management of his own property, the SEC also stated that

“[a]lthough the basic requirements of due diligence do not change in an integrated system, the manner in which due diligence may be accomplished can properly be expected to vary in some cases. . . . Historical models of due diligence have focused on efforts during the period of activity associated with preparing a registration statement, but the integrated disclosure system requires a broader focus. Issuers, underwriters and their counsel will necessarily be reevaluating all existing practices connected with effectuating the distribution of securities to develop procedures *compatible with the integrated approach to registration*.”

Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, at *35-36 (emphasis added).

As noted by Chairman Shad in a special concurring opinion, “Other due diligence techniques should therefore be reviewed in light of the shelf rule, *as adopted*, and the rapidly changing marketplace.” Securities Act Release No. 33-6499, 1983 SEC LEXIS 315, at *45 (emphasis added).

Thus, the integrated disclosure system and the shelf registration rule as they now exist provide the context in which the reasonableness of the underwriters’ investigation and belief must be evaluated. The prudent man standard must be interpreted from the point of view of a prudent man who has determined to buy securities in a shelf offering recognizing the timing and manner of such offering and the qualifications that the issuer must meet even to be eligible to use the shelf registration process. In light of the existence of Rule 415 permitting shelf offerings, it would be unfair to penalize an underwriter who participates in a shelf offering of an appropriate issuer for not conducting the type of due diligence required for a non-qualifying issuer. To do so would be to read the due diligence defense out of the statute.

B. Impact of Integrated Disclosure System on Due Diligence

Recognizing that the particular circumstances of an offering affect the determination of what is reasonable, in discussing the integrated disclosure system, the SEC stated its belief that courts would “take into account every circumstance including the fact of incorporation by reference, that may legitimately affect the ability of an underwriter . . . to conduct a reasonable investigation” Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, at 41. Due to the exigencies of “compressed preparation time and the volatile nature of capital markets,” an underwriter may apply “somewhat different, but equally thorough, investigatory practices” such as developing a “reservoir of knowledge” about companies through a review of Exchange Act reports and analysts’ reports. Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, *36-37. The reservoir of knowledge would allow for an expedited verification process once the underwriter was actually chosen by the issuer. *Id.* at *37.

In addition to suggesting alternative ways that underwriters could discharge their due diligence obligations in an integrated disclosure system, the SEC also responded to due diligence concerns by adopting Rule 176. 17 C.F.R. § 230.176 (2003). Rule 176 is a non-exclusive list of circumstances that may bear on the determination of whether a defendant has discharged his due diligence obligation under section 11. Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, *42. Circumstances to consider include the “type of issuer” and “[r]easonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts.” 17 C.F.R. § 230.176 (2003). It is thus clear that underwriters may reasonably rely on such persons, including the issuer’s auditors whose professional skill and expertise with respect to accounting and financial reporting makes such reliance “reasonable *in the light of all the circumstances.*”

Securities Act Release No. 33-6335, 1981 SEC LEXIS 946, at *46 (emphasis added).

What is perhaps most relevant here is that Rule 176 represents a recognition that “there may be legitimate variation in the nature of investigation performed and in the basis for reasonable belief.” Id. at *52.

C. SEC Position on Due Diligence in Shelf Offerings

When adopting Rule 415, the SEC took into consideration concerns about the adequacy of due diligence and addressed those concerns by limiting the availability of Rule 415 to those offerings where “due diligence concerns are mitigated by other factors.” Securities Act Release No. 33 6499, 1983 LEXIS 315, at *3. For example, the availability of Rule 415 for certain types of offerings was limited to issuers who met the qualifications for use of Form S-3. The SEC recognized that new due diligence techniques would have to be adopted in place of those techniques not compatible with shelf registration. Id. at *3-4 (noting that “widespread market following of such companies and the due diligence procedures being developed serve to address the concerns about the adequacy of disclosure and due diligence”). The SEC took particular note of the use of underwriter’s counsel and other anticipatory or continuous due diligence techniques. Id. at *19-23.

The SEC also recognized that “the method of due diligence investigation may not be the same for all registrants” and that it expected that “the techniques of conducting due diligence investigations of registrants qualified to use short form registration . . . would differ from due diligence investigations under other circumstances.” Id. at *22. In essence, the SEC determined that the due diligence techniques available in a shelf registration would differ from those with respect to issuers not eligible to use Form S-3. The corollary of that determination is that due diligence techniques compatible with shelf

registration do permit a reasonable investigation as to issuers who are eligible to use Form S-3 and shelf registration.⁵

Indeed, techniques have been developed by underwriters tailored to meet the special circumstances posed by Rule 415 offerings:

Offerings under rule 415 pose special problems for underwriters in terms of their ability to perform a reasonable investigation such as is necessary to establish the due diligence defense. . . . The SEC has addressed these concerns, referring to certain techniques that have developed or are developing to enable underwriters to adapt to the integrated disclosure system and the shelf registration procedure.

John D. Fitzsimmons, Due Diligence, in Securities Underwriting: A Practitioner's Guide 205-06 (Kenneth J. Bialkin & William J. Grant, Jr. eds., P.L.I. 1985).

Finally, it was recognized at the time Rule 415 was adopted that offerings of debt securities by major public companies, such as those at issue in the instant motion, were particularly well suited for shelf registration and the due diligence techniques compatible with shelf registration. There was apparently general agreement, even on the part of Rule 415 detractors, that shelf registration is appropriate for debt securities of issuers eligible to use Form S-3. Securities Act Release No. 33-6423, 1982 SEC LEXIS 979, at *15, *24 (Dissenting Commissioner Thomas noting that “I favor, however, a continuation of the praiseworthy provisions of the Rule that permit major companies rapid access to the market for the sale of their debt securities”). Thus, while Commissioner Thomas expressed concerns about due diligence and Rule 415, those concerns clearly did not extend to debt offerings, such as those at issue here. Securities Act Release No. 33-6423,

⁵ Thus, whether a due diligence technique was found to be insufficient in a non-shelf registration context, e.g., Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 581-84 (E.D.N.Y. 1971); Escott v. BarChris Constr. Corp., 283 F. Supp. 643, 692-98 (S.D.N.Y. 1968), really has no bearing on what would be reasonable in a shelf registration context because the contexts are different and consideration must be given to all circumstances giving rise to that difference.

1982 SEC LEXIS 979, at *55-56. Commissioner Thomas noted that “debt issuers have been shown to have a more compelling need than equity issuers to meet market ‘windows’ rapidly as a result of the high volatility of interest rates and the sensitivity of these rates to market trends.” Id. at *58.

Thus, even one of the more vocal critics of Rule 415 appears to have agreed that, with respect to offerings of debt securities by a major company such as Worldcom was at the time, the abbreviated diligence possible under the circumstances would satisfy the underwriters’ duty. Id. at *62; see also Securities Act Release No. 33-6499, 1983 LEXIS 315, at *45-46 (Commissioner Thomas, concurring in adoption of Rule 415 with respect to offerings of debt securities by major companies).

CONCLUSION

The test for establishing the underwriters’ due diligence defense should not be applied to the facts of the case before the Court in a way that would undercut the benefits of Rule 415 and the integrated disclosure system. Time-consuming due diligence procedures by underwriters that would prevent issuers from gaining rapid access to the markets were not contemplated by the SEC in adopting Rule 415 and would destroy one of the primary benefits of shelf registration, which was to allow major companies with disclosure information already on file to take advantage of transient market opportunities to sell securities without the delay inherent in the traditional offering process and related diligence procedures. Indeed, full-blown due diligence of the type done before integrated disclosure and shelf registration and still done for Form S-1 issuers can hardly be considered reasonable in the context of a shelf offering. Likewise, considerations such as whether the registrant was a well-seasoned issuer, whether the offering was for debt, and

whether there was widespread coverage of the issuer are all circumstances that must be considered when determining what is “reasonable”.

In proceeding to adopt rules permitting integrated disclosure and shelf registration under Rule 415, the SEC considered the impact of these changes on the ability of underwriters to perform due diligence, but concluded that the limited procedures possible given the time restraints of the more rapid shelf distribution process would be sufficient for underwriters to discharge their due diligence obligations. The SEC understood that underwriters involved in offerings pursuant to Rule 415 might change the fashion in which they discharge their due diligence obligations, departing from historical practice in order to conform to the context of Rule 415 and integrated disclosure. In applying the diligence standard in the context of a Rule 415 offering, as here, the Court should therefore not insist on diligence procedures that are impossible in the context of integrated disclosure and shelf registration.

Dated: New York, New York
October 1, 2004

DAVIS POLK & WARDWELL

By: _____
Robert F. Wise, Jr. (RW 1508)

450 Lexington Avenue
New York, New York 10017
(212) 450-4000

George R. Kramer
Securities Industry Association
1425 K Street, N.W.
Seventh Floor
Washington, D.C. 20005
202-216-2000

Marjorie E. Gross
The Bond Market Association
360 Madison Avenue
New York, New York 10017
646-637-9200
Of Counsel

*Attorneys For the Securities Industry
Association and the Bond Market
Association*