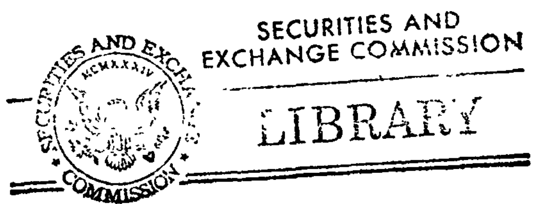
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THE S.E.C. REGISTRATION PROCESS AND SOME PRACTICAL PROBLEMS INVOLVED

Address by

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THE S.E.C. REGISTRATION PROCESS AND SOME PRACTICAL PROBLEMS INVOLVED

The major portion of my talk today will be concerned with the practical problems involved in registering a corporation's stock with the Commission. I then hope to be able to devote some of my time to a short discussion of one of the most interesting phenomenon in modern American business -- the franchise industry -- and certain securities law issues raised by franchising.

When a business "goes public," the role of the Commission, for the most part, is to administer the registration provisions of the Securities Act of 1933 and the registration and reporting requirements of the Securities Exchange Act of 1934.

Certainly most of you are familiar with the basic purposes of the Securities Act of 1933: That Act is designed to prevent fraud in the offer and sale of securities to the public and to provide disclosure to investors concerning securities offered for public sale, thus enabling them to make informed investment decisions. Disclosure is obtained by requiring the issuer of securities offered for public sale to file a registration statement with the Commission which describes the company and its operations and includes required financial statements and other data; this registration statement is available for public inspection as soon as it is filed. The part of the registration statement which contains the most significant information is the prospectus which must be furnished to investors to enable them to evaluate the investment worth of the securities offered.

The Commission's Division of Corporation Finance is responsible for the examination of all Securities Act registration statements except for those filed by investment companies, which are examined by the Division of Corporate Regulation. While the number of Securities Act registration statements increased from less than three thousand to more than four and one-half thousand from fiscal 1968 to fiscal 1969, an increase of, to be exact, 62%, there were, on the average, approximately 15 less people employed in the Division of Corporation Finance in fiscal year 1969 than in fiscal year 1968.

As you might expect, the substantial increase in the number of statements filed, coupled with a decrease in the number of people available to examine the statements, has resulted in an increase in the time elapsed from the date of original filing to the effective date. In the 1968 fiscal year, the median number of calendar days from the date of original filing to the effective date was 44. In the 1969 fiscal year, this period had increased to 65 calendar days.

In November of 1968, as the backlog of registration statements to be processed reached a record high, the Commission initiated procedures designed to cut the volume of the backlog and decrease the median processing time for registration statements filed under the Securities Act.1/ Under these provisions, a senior officer of the Division of Corporation Finance will briefly review every registration statement as it is filed. Based on this review, the reviewing officer, in essence, will make one of the following decisions:

1. That the registration statement is so poorly prepared or entails problems so serious that the staff will not review the statement. Counsel receives notice of this decision by letter, and he is requested to give consideration to the filing of an application for withdrawal of the registration statement. The staff letter is, curiously enough, known as "the bedbug letter."

2. The second type of decision available to the reviewing officer is that the staff will make only a cursory review of the registration statement and will provide no written or oral comments. This procedure is sometimes referred to as "expedited treatment." The chief executive of the registrant, counsel, the auditors, and the managing underwriter are requested to represent that they are aware that the staff has made only a cursory review of the registration statement and that they are aware of their statutory responsibilities under the Securities Act.

3. That the filing will be subject to the regular review process.

It is clear that an essential element in making this screening process work is a properly prepared registration statement Thus, it is equally clear that the persons charged with preparation of the registration statement must fully familiarize themselves with all aids to the proper preparation of their undertaking. These aids would include the Commission's own releases and the substantial body of material on the registration process prepared by practitioners in the legal and accounting fields. Of course, throughout this discussion I am assuming counsel is totally familiar with the company and other matters to be described in the registration statement. Absent this familiarity, counsel cannot possibly execute his task satisfactorily.

1/ Securities Act Release No. 4934 (November 21, 1968).

Registration statements must be filed at our Office of Company Filings in Washington, D. C. Generally, first time filings are assigned to a branch of the Division of Corporation Finance by rotation, except that if a particular branch has participated in a prefiling conference in regard to the registration statement, the statement may be assigned to that branch. In the course of the regular review process, one or more of the attorneys, accountants, and examiners in the branch will review the statement for compliance with the Commission's standards on disclosure. In the event the statement is deficient in some material respect, but not so poorly prepared as to call for a "bedbug letter," the registrant will be notified, usually by letter, and afforded the opportunity to correct the deficiency by amendment. In most cases, the registration statement is amended promptly in response to the Division's comments and declared effective thereafter in accordance with the Act and the rules thereunder.

The Commission in announcing the expedited review procedure in November of 1968 suggested certain measures to reduce the backlog of registration statements which merit particular mention in the context of the examination process, although they apply whether or not a statement will be subject to regular review. Thus, counsel for the issuer, the issuer's accountants, and any other persons responsible for the filing are urged to cooperate with the staff in pinpointing trouble spots in the filing. This step should be taken in the letter of transmittal, obviously, to facilitate the screening process as well as any subsequent examination.

Concerning communications with the staff regarding registration statements, I should mention that the staff is not equipped to conduct a prefiling review of a registration statement. The staff will participate, however, in a prefiling conference when representatives of the issuer need help with a significant specific problem. But, here again, even when specific problems are involved, representatives of the issuer are urged to exercise restraint in seeking prefiling conferences or otherwise communicating with the staff, in person or by telephone. Clearly, such communications interrupt and delay staff examination of pending statements.2/

2/ Securities Act Release No. 4950, issued on February 20, 1969, is illustrative of the kind of problem that may precipitate a prefiling conference; it is also an example of the Commission's continuing effort to help issuers over the hurdles of the registration process. That release sets forth matters to be considered by the Commission in determining whether relief should be granted from the Form S-1 requirement for certification of financials of companies acquired or to be acquired with the proceeds of an offering. Release No. 4950 was prompted by numerous requests for relief from such certification requirements.

One further point related to the registration process: the statutory scheme of the Securities Act clearly envisions that an offering may be made only by a prospectus meeting the requirements of the Act when an issuer's securities are in registration. As a result, as most of you are well aware, the issuer's management, counsel, and underwriters must impose certain limitations upon publicity to avoid violations of the Act and possible civil liabilities.

It is not necessary to go into the details of the so-called "gun jumping" problem in this discussion. Suffice it to say that in recent years the "gun jumping" problem most often arises when a company whose securities are publicly traded files a registration statement for additional securities. In that context there are difficulties involved in striking a balance between the interests of those persons who presently own the issuer's securities -- and are entitled to information concerning the issuer -- and the interests of those persons who would purchase securities of the issuer in a registered offering. As most of you know, Chapter V of "Disclosure to Investors -- A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts," better known as "The Wheat Report," discusses "gun jumping" in detail, and I commend that chapter, and for that matter the entire report, to your attention.3/

The Commission has issued a proposal to adopt the rules and amendments -- with some minor revisions -- recommended by The Wheat Report in regard to "gun jumping."4/ It should also be noted that just about one year ago the Commission implemented policies designed to promote the delivery of preliminary prospectuses to prospective purchasers prior to the effective date of a registration statement.5/

As a result of a number of exemptions in the Securities Act, certain securities and transactions are not subject to the registration and prospectus requirements of the Act. The principal exemptions of interest to the business seeking public funds are the exemptions for intrastate and Regulation A offerings.

3/ In addition to "The Wheat Report," on the subject of "gun jumping" generally, see Securities Act Release Nos. 3844 (October 8, 1957) and 5009 (October 7, 1969).

4/ Securities Act Release No. 5010 (October 7, 1969).

5/ Securities Act Release No. 4968 (April 24, 1969).

The intrastate or local offering exemption found in Section 3(a)(11) of the Securities Act appears deceptively simple; and, therefore, it is widely misunderstood.

The legislative history of Section 3(a)(11) and decided cases clearly indicate that the exemption is designed to apply only to local financing; that is, the securities offered must be part of an issue that is offered and sold only in the state where the issuer is resident and doing business. The exemption is unavailable if any portion of the offering is offered or sold to non-residents of the jurisdiction involved.

Similarly, the exemption is only available when the issuer, if a corporation, is both incorporated in and doing business in the state where the offers or sales are made. Although the issuer need not be doing business exclusively within the state, it is clear that the securities offered or sold may not represent an interest in a business which is predominantly out-of-state in character. In this connection, in a recent case sales to Michigan residents by a Michigan promoter of fractional undivided interests in oil and gas leases on land located in Ohio did not qualify for the intrastate exemption.6/ Although the promoter maintained offices in Michigan, he was not "doing business" in Michigan within the meaning of the Securities Act, since the income producing properties in which the promoter sold securities -- that is, the oil and gas operations -- were located in Ohio.

The intrastate exemption does not depend on non-use of the mails or the facilities of interstate commerce. Securities issued in a transaction properly exempt under Section 3(a)(11) of the Act may be offered and sold through the mails or by telephone or through advertisements -- provided, of course, in the case of advertisements that the advertisement indicates the offers and sales are limited to the residents of the state involved.

The intrastate exemption is not available to mutual funds and other types of investment companies because of Section 24(d) of the Investment Company Act of 1940. The intrastate exemption does not depend upon the amount of capital being raised; however, that factor is central to the availability of the Regulation A exemption, which affords an exemption for small public offerings of securities.

6/ Chapman v. Dunn 414 F.2d 153 (C.A. 6, 1969).

The maximum amount of securities which may be offered under Regulation A is $300,000, computed in the manner specified in Securities Act Rule 254. For our purposes, it is sufficient to mention that this maximum may be diminished by a variety of circumstances.

There is a bill currently pending in Congress that would amend the Securities Act to increase the maximum to $500,000.7/ The Commission is supporting the current proposal.

Under Regulation A, the issuer files a notification rather than a registration statement, and the basic disclosure document is called an offering circular instead of a prospectus. The notification required is less complex than a registration statement, and the requirements stated in the rules for the offering circular are less comprehensive than those for a prospectus; however, the basic concept of full and complete disclosure is just as applicable in a Regulation A offering as in any other offering. Also, under Regulation A the financial statements of the issuer need not be certified by an independent public accountant. There is no filing fee or registration fee in connection with Regulation A. The rationale is that in small offerings the issuer should be able to avail itself of a simplified and less costly procedure than a full registration.

The filing of this notification and offering circular, together with whatever exhibits are required, is made with the Regional Office of the Commission for the region in which the issuer's principal business operations are conducted or are proposed to be conducted, rather than in our Washington, D. C. office as in the case of full registration. Filing must take place at least 10 days prior to any offering of securities. No sale may be made unless the purchaser has received the offering circular in compliance with Securities Act Rule 256; further, there is no provision in Regulation A for offers prior to expiration of the 10-day waiting period. It should be mentioned that after the mere lapse of 10 days following the filing of a notification, the issuer may begin to sell; however, since material filed under Regulation A is examined in the Regional Office to determine whether the exemption is available and whether required disclosure standards have been met, the issuer would be well advised to wait for a comment letter from the Regional Office before beginning to sell.

The Commission may order a temporary suspension of any Regulation A exemption if, among other things, it has reason to believe that the exemption is not available to the issuer or that the notification, offering circular, or sales literature contains false or misleading

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7/ S. 336, 91st Cong., 1st Sess. (1969).

statements or omits to state material facts. Upon entry of a suspension order, the issuer and any other person on whose behalf the notification was filed is notified and is given opportunity to request a hearing on the matters which are the basis of the order. If no hearing is requested, and the Commission does not order one on its own motion, the order becomes permanent on the thirtieth day after its entry. If a hearing is requested, or otherwise ordered, the Commission will, upon consideration of the entire record, either vacate the order or enter a permanent suspension order.

The issuer is required to file with the Regional Office copies of all sales material to be used in connection with the offering at least five working days before it is to be used. This includes copies of any advertisement to be published, the script of any radio or television broadcast to be made, and every letter, circular, or other written communication proposed to be provided to more than 10 persons. This is, of course, in addition to the offering circular, which, as I have stated, must be provided to every person to whom the securities are offered.

Generally speaking, the exemption is not available if the issuer or any of its affiliates or predecessors, within the preceding five years, has been subject to a stop order proceeding under the Securities Act or to a suspension proceeding under Regulation A, has been convicted of a crime involving the purchase or sale of securities, is subject to any temporary or permanent injunction in connection with the purchase or sale of securities, or is subject to a Post Office fraud order. Similarly, the exemption is not available to the issuer if any of its directors, officers, or principal security holders, or its underwriter or any of its principals has been guilty of certain conduct as described in the Regulation. The absence of the exemption in the cases mentioned does not foreclose the issuer from publicly offering its securities. It means merely that he must use the full registration process in order to do so. In cases where there is a recent history of offenses under the federal securities laws, criminal conduct involving securities, or postal fraud, it is clearly in the public interest for the issuer to be required to adhere to the more stringent requirements of the registration process.

I mentioned fractional undivided oil or gas interests, or similar mineral interests, in relation to the intrastate exemption; it is also pertinent to mention that Regulation A is not available for these interests. A separate exemption, Regulation B, is available, however, limited to offerings of not more than $100,000.

Through releases and other efforts we have attempted to reduce the areas of ambiguity concerning disclosure standards; similar attempts have been made regarding the exemptive provisions of the Securities Act.

The Commission recognizes, however, that the statutes and rules it administers are complex; thus, as a matter of policy, in order to promote compliance with those statutes and rules, the Commission encourages written requests for assistance from the staff in difficult interpretive questions on the exemptive provisions of the Securities Act and any other questions under the federal securities laws. Such inquiries and the responses to them are now non-public under the Commission's interpretation of the Public Information Act.8/ Affected persons should, therefore, feel free to discuss problems in detail with the staff. I should note that the Commission is studying comments on a proposal to make such inquiries and responses available to the public.

This discussion up to now has been concerned with the presentation of a general picture of the process of "going public" from the Commission's viewpoint. What are, from the Commission's viewpoint, the general consequences of "going public"?

Essentially, the major consequence is that the company will be subject to continuing disclosure requirements through the Securities Exchange Act of 1934. That Act complements the Securities Act in that it provides for self-regulation by national securities exchanges under appropriate guidelines and procedures. It further provides for registration of brokers and dealers, the principal conduits through which information reaches the investing public. Although the Exchange Act is generally looked upon as being regulatory in nature, it is quite clear that the Congress employed the basic disclosure philosophy here, as well as in the Securities Act. This can be seen in the reporting requirements of Sections 12, 13, 14, and 15(d), the proxy requirements of Section 14, and the insider provisions of Section 16.

The sharp increase in filings under the Securities Act is paralleled by a sharp increase in filings under the Exchange Act, and while it is not necessary to belabor this point with more statistics, the Commission's urgings on preparedness apply equally to Exchange Act filings.

The Commission has proposed amendments to rules and forms relating to registration and reporting under the Exchange Act.9/ The Commission has received in excess of 350 letters containing over 1,100

8/ 5 U.S.C. 552.

9/ Securities Exchange Act Release Nos. 8680 through 8686 (September 15, 1969). For the background to the proposals, once again, I commend your attention to "The Wheat Report."

pages of substantive comment in response to these and other proposals under the Securities Act prompted by "The Wheat Report." The staff is now completing its review of these letters and is submitting its recommendations on each proposal to the Commission.

I would now like to say a few words concerning sales of franchises and securities law issues raised by such sales. A recent article in Fortune magazine 10/ contained the following statistics on the franchise industry: There may now be more than 1,200 franchise companies and between 400,000 and 600,000 franchise outlets in this country. Their sales total somewhere between 80 and 110 billion dollars annually; if the generally accepted figure of 90 billion dollars is realistic, it follows that this industry accounts for about 10 per cent of our gross national product and 26 per cent of all retail sales.

The central concept of the franchise system, the factor that sets it apart from other forms of business enterprise, is the manner in which it combines the strengths normally associated with big business -- such as a ready access to technological expertise, a large advertising budget, and the ability to make purchases in quantities sufficient to qualify for substantial discounts -- with the strengths of a small business. It entails, in particular, the willingness of a manager to work harder and for longer hours for an enterprise which he considers to be his own. To the extent that any particular franchise is in keeping with this concept and the franchisee plays an active role in the management of his franchise, we will see that there is less likelihood that the sale of the franchise to the franchisee will be found to be a security. To the extent that the franchisor is offering a bare investment opportunity to prospective purchasers rather than an opportunity to own and manage their own business, there is more likelihood that he is offering a security and will have to comply with the requirements of the securities laws. Why is this distinction relevant?

Perhaps the landmark case in this area of the law was the Howey case 11/ decided by the Supreme Court in 1946. Although the case does not deal with what is generally known as a franchise, it enunciates principles which bear directly on the issue we are discussing. The

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10/ Fortune, March 1970,"Franchising's Troubled Dream World," 118.

11/ S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946).

Howey Company was an owner of large citrus groves in Florida. The company sold individual lots of the groves to public investors who, for the most part, were not residents of Florida. At the same time, a second company, under common control and management with the Howey Company, sold these same persons service contracts under which that company assumed complete responsibility for the management of the citrus crop on the individual purchaser's lot.

The relevant section of the Securities Act of 1933 for determining whether a security was present here is Section 2(1) of that Act which defines a security as, among other things, "any . . . certificate of interest or participation in any profit-sharing agreement" or "investment contract." The two terms, profit-sharing agreement and investment contract have been viewed as similar.12/

The Supreme Court found that the Howey case did involve an investment contract and, therefore, a security. In order to reach this conclusion they had to arrive at a meaning for the term "investment contract," a term which is not defined in the Securities Act of 1933. To quote from the Howey decision, "an investment contract for purposes of the Securities Act means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise. Such a definition . . . embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."13/ The fact that a portion of the investors in the Howey case insisted on managing their own lots and did not purchase a service contract did not deter the court from finding that the company

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12/ Coleman, "A Franchise Agreement Not a Security under the Securities Act of 1933," 22 Bus. Law 493, at 497, n. 11. While Mr. Coleman was a member of the Commission's staff at the time he authored this article, his views therein are his own and do not necessarily reflect the views of the Commission or its staff. For a view in opposition to Coleman's general thesis, see Goodwin, "Franchising in the Economy: The Franchise Agreement as a Security under Securities Acts, Including 10b-5 Considerations," 24 Bus. Law 1311.

13/ S.E.C. v. W. J. Howey Co., supra at 298-299.

was offering an investment contract.14/ The requirement that the investor is led to expect his profits "solely" from the efforts of others may possibly be more stringent than what courts would demand today before finding a franchise to be an investment contract.15/

Although Howey did not deal directly with a franchise, that case may require a finding that certain franchise agreements are investment contracts and, therefore, securities. For example, it might be argued that a franchisor who sells a franchise unit with the understanding that he will not only set up that unit for the franchisee but also be responsible for operating policy and management may be selling a security. The franchisee in this example, like the investor in Howey, is making an investment that will depend for its success or failure on the business judgment and efforts of persons other than himself. A so-called pyramiding arrangement where a person invests in a sales distribution network without himself taking any active role in either sales or management may present the same possibility of the sale of a security.

Section 2(1) of the Securities Act of 1933 also defines as a security "any . . . evidence of indebtedness," and this provides another basis upon which certain franchise operations may be required to register under that Act. In 1946 the Tucker Corporation set up a franchise system to raise capital and provide future retail outlets for the proposed Tucker automobile. Franchisees were assessed twenty-five dollars for each automobile they wished to reserve for future delivery. The Commission held that "since these franchise agreements provided for the repayment of deposits they were 'securities' within the meaning of Section 2(1) of the Securities Act . . . The sale of these agreements without an effective registration statement constituted a violation of Section 5 of the Securities Act."16/

As the franchise industry has expanded with such vigor in recent years, the Howey and Tucker cases, both of which were decided in the 1940s, have increased immeasurably in importance. Of even greater importance in the near future may be the enactment of statutes which will either redefine the term "security" to include thereunder certain types of franchises or adopt separate registration requirements for franchises similar to those

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14/ 15% of the acreage sold by Howey during the period referred to by the court was not covered by service contracts. Id. at 295.

15/ Coleman, supra at 503-504.

16/ In the Matter of Tucker Corp., 26 S.E.C. 249 at 253 (1947).

already applying to securities. Among the states, Oklahoma, California, and Massachusetts 17/ are considering proposed legislation of this nature. A bill of this type was passed by the New York Legislature 18/ but vetoed by the Governor of that state in May of 1969. The Senate Subcommittee on Urban and Rural Economic Development, Senator Harrison Williams Chairman, is holding hearings on the franchise industry, but no bill has as yet been introduced, and any legislation in this area in this session of Congress is extremely unlikely. Senator Hart has introduced a bill, which is currently pending before the Senate Judiciary Committee, that concerns itself with the antitrust implications of franchises.19/

While my discussion of franchises and of the S.E.C. registration process in general may be familiar to the experienced securities practitioner, I hope that my comments today will be of some benefit to you. I would especially emphasize the point made earlier in these remarks that a counsel who keeps himself fully informed as to the nature of his client's business and developments in the securities laws is benefiting both that client and the Commission. I think we have seen that such preparedness is being rewarded by the efforts of the Commission to make the registration process smoother and less burdensome for those registrations that are properly prepared when first filed.

17/ Oklahoma, House Bill No. 1724; California, Senate Bill 647; and Massachusetts, H. 2279.

18/ New York, S. 4915.

19/ United States, S. 1967.