FILE COPY

ADMINISTRATIVE PROCEEDING
FILE NO. 3-789

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
ORCHARD SUPPLY BUILDING CO. 720 West San Carlos Street San Jose, California
(81-41)
Securities Exchange Act of 1934 Section 12(h)

INITIAL DECISION

Sidney L. Feiler
May 1, 1967

CONTENTS

ADMINISTRATIVE PROCEEDING
FILE NO. 3-789

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of
ORCHARD SUPPLY BUILDING CO. 720 West San Carlos Street San Jose, California
(81-41)
Securities Exchange Act of 1934 Section 12(h)

INITIAL DECISION

BEFORE: Sidney L. Feiler, Hearing Examiner

APPEARANCES: Fred A. Wool, Esq. of Wool, Richardson & Colbert, 700 First National Bank Building, San Jose, California 95113 for Orchard Supply Building Co.

Norman R. Cohen and W. Stevens Tucker, Esqs., for the Division of Corporation Finance

I. THE PROCEEDINGS

These are proceedings instituted by order of the Commission pursuant to Section 12(h) of the Securities Exchange Act of 1934, as amended ("Exchange Act"), to determine whether a finding should be made, as requested in an application filed by Orchard Supply Building Co. ("Applicant"), that an exemption of its common stock from the provisions of Section 12(g) of the Exchange Act would not be inconsistent with the public interest or the protection of investors. Exemption from Section 12(g) would have the additional effect of exempting Applicant from Section 13 and 14 of the Exchange Act and any officer, director, or beneficial owner of more than 10% of Applicant's equity securities from Section 16 of the Exchange Act.

Section 12(g) of the Exchange Act requires the registration of the equity securities of every issuer engaged in interstate commerce, or in a business affecting interstate commerce, or whose securities are traded by use of the mails or any means or instrumentality of interstate commerce, with certain exceptions set forth therein, within one hundred and twenty days of the last day of its first fiscal year ended subsequent to the effective date of Section 12(g), August 20, 1964, on which such issuer has total assets exceeding $1,000,000, and a class of equity security held of record by 750 or more persons, or after July 1, 1966, by 500 or more persons. Applicant meets the requirements for registration under this Section.

Section 12(h) of the Exchange Act empowers the Commission acting by order, upon application of an interested person and after notice and opportunity for hearing, to exempt any issuer in whole or in part from the registration provisions of Section 12(g) or from the periodic reporting and proxy soliciting provisions of Sections 13 and 14 of the Exchange Act and from the reporting and trading provisions of Section 16 of the Exchange Act, if the Commission finds, by reason of the number of public investors, the amount of trading interest in the securities, the nature and extent of the activities of the issuer, the income or assets of the issuer, or otherwise that such exemption is not inconsistent with the public interest or the protection of investors.

The matters put in issue by the order for proceedings are:

1. Whether the number of public investors and the amount of trading interest, actual or potential, in applicant's securities is sufficiently limited to justify the requested exemption;
2. Whether the nature and extent of the activities of Applicant are such as to justify the requested exemption;
3. Whether adequate information is and will be available to investors concerning the financial and business affairs of Applicant, the management of Applicant, the principal holders of the securities

of Applicant, any transactions of management in the securities of Applicant, and the nature and description of Applicant's securities; and

4. Generally, whether the requested exemption is consistent with the public interest and with the protection of investors.

Pursuant to notice, a hearing was held in San Francisco, California. The Applicant and the Division were represented by counsel. Full opportunity to be heard and to examine and cross-examine witnesses was afforded the parties. At the conclusion of the presentation of evidence, opportunity was afforded the parties to present oral argument, but such argument was waived. Proposed findings of fact and conclusions of law, together with supporting briefs, were filed by the parties.

Upon the entire record and from his observation of the witnesses the undersigned makes the following:

II. FINDINGS OF FACT AND LAW

A. The Applicant

Applicant, a California corporation with its principal place of business in San Jose, California, was organized as a regular stock corporation on July 12, 1945 by Orchard Supply Company, Ltd. ("Parent"), a non-profit, non-stock cooperative association organized under California law for the purpose of purchasing for its members hardware, farm supplies, fertilizers

and equipment. Parent organized Applicant for the purpose of purchasing real property and to erect store buildings thereon which it leased to Parent and Orchard Supply Sales Corporation ("Orchard Sales"), a second stock corporation organized by Parent to make sales of merchandise to non-members.

All of the common stock of both Applicant and Orchard Sales was owned by Parent. Applicant, however, pursuant to the terms of the California permit under which it was first financed, issued and sold for the full par value thereof 2500 preferred shares having a par value of $100, which shares are now outstanding.

On August 31, 1955 Parent, as owner of all the stock of Orchard Sales, directed that company to cease doing business and as the owner of all the common stock (the only stock entitling the owners thereof to vote) of Applicant, directed the latter to carry on the mercantile business conducted by Orchard Sales. Pursuant to said directions, Orchard Sales ceased to do business and Applicant took over its business. Since that time Applicant's merchandise sales have been made to the general public and have not been confined to members of the former Parent cooperative.

On August 30, 1956 permission was received by the Applicant to issue common shares of its stock to Parent in exchange for certain of its common shares of $100 par value owned by Parent and the satisfaction of indebtedness owed by the Applicant to Parent. These shares were distributed to the then members of Parent

who received it in a distribution accompanying Parent's dissolution on or about November 1, 1956.

Applicant is currently engaged in the operation of three diversified hardware stores conducting a retail business in the City of San Jose, California. It had total assets of $1,742,328 as of March 31, 1966 and net income of $103,362 for the fiscal year ending March 31, 1966 on sales of $3,581,994. Its assets have been in excess of one million dollars since 1963.

B. Number of Public Investors in Applicant and Amount of Trading Interest in Applicant's Securities

The stockholders' equity in the Applicant consists of 2500 shares of authorized and issued 5% cumulative preferred stock, $100 par value and 227,500 shares of common stock, $1 par value, of which 212,079 shares have been issued and are outstanding. Of the total common shares outstanding, 169,706 were issued to Parent in 1956 in satisfaction of Applicant's obligations to Parent when accounts between them were settled. Parent, in turn, on November 1, 1956 on its dissolution transferred these shares to its members who then became shareholders of the Applicant.

On June 5, 1958, pursuant to its application, the Applicant received permission to sell and issue an aggregate of not to exceed 55,294 shares of its common stock to any or all of its shareholders, at par, for cash or as consideration for the cancellation of any indebtedness of Applicant to them, $1 of said indebtedness to be cancelled for each share so issued. Successive extensions

of time to complete this disposition were obtained and sales under this authorization continued until the spring of 1960. A total of 42,373 shares were sold to shareholders under the authorization bringing the total of common shares outstanding to its present number of 212,079. The preferred stock was issued early in the history of Applicant. There has been no trading activity in the preferred shares. The chief officer of the Applicant is Albert B. Smith, its president, who is the largest stockholder.

The Applicant's stock journal reflects the transfer of a total of 199,928 shares from the time Parent transferred its shares to its members. These transfers have been classified

as follows:

	Shares	Shares
Purchases of New Stock Authorized by Corporation Commissioner's Permit dated June 5, 1958		
By Officers and Directors (Excluding Albert B. Smith)	27,000	
By Albert B. Smith	4,000	
By other shareholders	11,373	42,373
Transfers by reason of deaths of shareholders by way of probate, joint tenancy etc.		44,054
Reissues of certificates for lost certificates, transfers to and from joint tenancies or tenancies in common, consolidation of certificates, correction of names, etc.		24,002
Purchases of small lots from Shareholders desiring to sell		
By officers and directors		5,873
By employees, including manager, purchasing agent, and office manager		1,752
Purchases from shareholders desiring to sell		
By Albert B. Smith	54,483	
By other shareholders	27,391	81,874
Total Transfers shown by Journal		199,928

(Applicant's Ex. No. 6)

Parent distributed the shares of Applicant it received to approximately 1600 members. As of June 14, 1965, the date of Applicant's filing for exemption, the number of common shareholders was approximately 1,151 and the number of preferred shareholders was 269. The number of common shareholders had been reduced by 77 to approximately 1075 as of the date of the hearing.

An analysis prepared by Applicant shows the following breakdown of shareholders with respect to the number of shares held as of December 19, 1966.

Number of Shareholders	Number of Shares
46	1-10
26	11-25
479	26-50
274	51-100
180	100-250
80	250-500
32	500-1,000
6	1,000-2,500
1	2,954
1	5,508
1	5,566
Isabel Smith	9,028
Albert B. Smith	58,483

(Applicant's Ex. No. 7)

Albert B. Smith has evinced the most interest in purchasing common stock of the Applicant. His father was one of the founders of Parent. He became a member of the Board of Directors in 1960, was elected president in May 1960, and holds those offices at the present time. As previously noted, he owns 58,483 shares or approximately 27.5% of the total shares

outstanding. His mother, Isabel Smith, owns an additional 9,028 shares or approximately 4% of the outstanding common.

Smith, after he assumed the office of president in May 1963, made a formal written offer to stockholders offering to buy common stock of the Applicant at $1.25 per share. He made a second formal offer in 1965, offering to pay $1.40 per share. On the first offer Smith acquired approximately 30,000 shares; approximately 20,000 on the second. After his second formal offer he acquired approximately 3,000 additional common shares when he increased his offer to $1.75. Smith determined the price he would offer on an arbitrary standard. He testified that outside of his own interest in acquiring shares there has not been any current interest expressed by anyone in acquiring shares, most of the stockholders being more interested in disposing of holdings. The common stock of the Applicant is not listed on any exchange nor do any brokerage firms evince any interest by regularly inserting bid or offer prices in over-the-counter services.

C. Information Available to Shareholders and Investors

The Applicant retains a firm of accountants whose duties include the preparation of monthly statements, supervision of the annual taking of inventory, and the preparation of an annual financial statement. Attached to an annual statement in evidence is a transmittal letter from Applicant's accountants in which it

is noted that the information contained is based on the accounting records of the Applicant and, "Since the terms of our engagement did not provide for an examination in accordance with generally accepted auditing standards, we are unable to express an opinion on the accompanying financial statements." Smith testified that there have been "continuing feuds" with Applicant's accountants over their recommendation that they be retained to make an audit of the Applicant's accounts so that they can submit a certified statement.

The annual statement is not sent to the stockholders, nor is it made public. Instead, prior to the annual meeting which takes place on the second Thursday in May, a notice of meeting is sent to the stockholders outlining the business to be transacted at the meeting. Attached to it is a short report from the Board of Directors of highlights of the year. A synopsis is also annexed, prepared by the accountants, summarizing assets, liabilities, and including statement of income. Stockholders are then requested to sign an enclosed proxy form.

The annual statements differ from those required under Commission rules and regulations in that they are not certified and do not contain certain supplementary information and detailed schedules required by applicable rules and regulations.

The synopses are highly condensed and do not contain breakdowns of major items required by Commission rules. A serious

deficiency, from the standpoint of stockholders and investors, is the failure to supply information sufficient for a determination of per share earnings or the book value of outstanding stock, although that information could be ascertained by recourse to the annual statements submitted to the Board of Directors.

The information sent to stockholders with the notice of annual meeting does not conform to existing proxy requirements set forth in the Commission's proxy rules. No reports are furnished during the year to stockholders in the nature of interim reports showing transactions of management in the securities of Applicant or noting other important developments as required by the Commission's rules and regulations.

D. Contentions of the Parties

The Applicant contends that the requested exemption is both consistent with the public interest and the protection of investors. It concedes that the number of its common stockholders is substantially in excess of the minimum number of the 500 required for filing. There is agreement that at the date of the filing of the application there were approximately 1151 common shareholders and 259 preferred shareholders. The number of the former had dropped to 1075 as of the date of the hearing. However, the applicant points out that an analysis of the breakdown of the number of shareholders previously set forth (page 9) as well as further analysis of its corporate records shows that out of the total

number of stockholders 551 owned less than 50 shares, 151 owned more than 50 but less than 75 shares, and 123 owned 76 to 100 shares each. It urges that since there are only 426 shareholders who owned 76 or more shares and the book value of those shares is approximately $2.24, the number of shareholders holding less than 75 shares each should be disregarded under the rule of de minimis and only the remaining group of 426 should be measured against the applicable standard.

Additionally, it is argued that the amount of trading interest in the Applicant's securities is sufficiently limited to justify the exemption. It is pointed out that there has never been a sale of stock by the Applicant to the general public but that Applicant's original stockholders were members of the Parent cooperative who received shares on dissolution of the Parent. The additional offer of stock made in 1958 was confined to the existing stockholders and here it is pointed out the authorized issue was not completely sold out. Further analysis of the record of transfers set forth herein on page 8 shows, according to Applicant, that only Smith was interested in actually purchasing large amounts of Applicant's stock and that a substantial proportion of transfers which have occurred were not purchase and sale transactions as such, but transfers by reason of the death of shareholders and those occasioned by the issuance of new certificates for lost ones. It asserts that actual purchase and sale transactions over the last

ten years totaled 86,545 shares which, on a par value basis, averages out to $8,654.50 per year.

It is also maintained that Applicant is a strictly local concern conducting a retail business with customers in the immediate area and it is urged that since its only connection with interstate commerce is the purchase of merchandise which may come from without the State of California exemption should be granted for this reason.

Finally, it is argued that to require compliance with the registration and other provisions of the Exchange Act would merely add a heavy financial burden on the Applicant's business and would benefit neither the shareholders nor the investing public, which has not until now shown any interest in the Applicant's securities.

Applicant further alleges that information about its financial and business affairs, its management, its principal shareholders, any transaction of its management in its securities, and the nature and description of such securities, is available to any shareholder who makes inquiry. It states that it is willing to furnish such information to its shareholders annually as a condition to its being granted an exemption, but asks for relief from the certification requirements, stating that it would suffer a very substantial increase in accounting costs if such were required.

The Division, for its part, contends that the registration provisions of Section 12(g) of the Exchange Act were enacted in the public interest and that the Applicant has not made out a case for exemption from these requirements. It points out that the number of shareholders of Applicant is substantially in excess of the minimum required for registration, that the owners of approximately two-thirds of the total outstanding shares have no intimate knowledge of the affairs of the Applicant either as a substantial stockholder, like Smith, or as a director, but are wholly dependent on company reports furnished them as well as information which they may glean in informal talks with Smith on their visits to Applicant's premises. It is urged that these investors need the protection of the registration, reporting, proxy, and insider trading requirements of the Exchange Act.

It is further argued that there has been substantial trading activity in the common stock of the Applicant even though full information about the company was not available nor is it listed on any exchange. Smith, himself, testified that there has been substantial interest in the sale of shares by holders thereof and many trades have actually taken place. It can be expected, the Division contends, that there will be increased trading interest when further information about the Applicant is made public.

Additionally, it is argued that the Applicant has made substantial sales, has assets in excess of the required minimum for registration, and has substantial earnings per share with an

increasing book value per share. Finally, it is urged that granting of the required exemption would not be in the public interest, that lack of disclosure of information relative to their investment would deprive stockholders of basic safeguards enabling them to make informed decisions about their investment and that compliance would be likely to engender more public interest in the securities of the Applicant.

III. CONCLUDING FINDINGS

The history of the distribution of the common stock of the Applicant establishes that there is no over-the-counter market in its securities and that trading in its securities has been confined to transactions between the company and its member-shareholders or between shareholders. While this is an important factor, it is not determinative of the issues herein.

Section 12(g) of the Exchange Act was enacted as part of the Securities Act Amendments of 1964.[1/] These Amendments were preceded by a Special Study of Securities Markets of the Securities and Exchange Commission, authorized by Congress; a Report of the Special Study, including a Supplement containing comments from the Chairman of the Commission on recommendations contained therein;[2/]

1/ Pub. Law 88-467, 88th Cong. (Aug. 20, 1964)

2/ House Doc. No. 95, 88th Cong. 1st Sess. (1963)

hearings before the House Committee on Interstate and Foreign Commerce and the Senate Committee on Banking and Currency on proposed legislation and reports of those Committees; [3/] discussion of the proposed Amendments in the Congress and the enactment of the legislation.

With respect to the obligations of issuers of publicly held securities, it was pointed out in the Special Study that, "The keystone of the entire structure of Federal securities legislation is disclosure. Making available to investors adequate financial and other information about securities in which they might invest or have invested is the best means of enabling them to make intelligent investment decisions and of protecting them against securities frauds." [4/] There was unanimous agreement by those conducting the Special Study and by the congressional committees concerned that ideally all public companies in which there is public investor interest ought to be included in the coverage of the filing, reporting, and proxy requirements of the Exchange Act. However, it was decided on purely practical grounds that the number of issuers required to file should be manageable from the regulatory standpoint and not disproportionately burdensome on issuers in relation to the national public interest to be served. After an

---

3/ Sen. Report No. 379, 88th Cong. 1st Sess. (1963); House Report No. 1418, 88th Cong. 2d Sess. (1964).

4/ Special Study, op. cit., Pt. 3, p.1.

exhaustive research of the problem it was recommended in the Special Study Report that the filing, reporting, and proxy requirements of the Exchange Act be extended, in stages, to all issuers having 300 or more equity security holders.[6/] The final legislation incorporated the 500 shareholders and $1,000,000 asset standard. This standard is the result of very careful administrative and legislative study and is not to be lightly disregarded.[7/]

In the instant case, the amount of assets of the Applicant is substantially in excess of the amount required for filing - almost double. The number of shareholders is more than double the required minimum number of 500. Under any standard they must be considered "public" stockholders.[8/]

Applicant argues for the application of the principle of de minimis to exclude from consideration those shareholders not owning over 75 common shares. There is no warrant for this in the legislative history. Small shareholders are those primarily

---

6/ Special Study, op. cit., Pt. 5, pp. 149-153.

7/ "It is clear that by any standard the companies with between 500 and 1,000 shareholders represent substantial enterprises. In addition, your committee believes that the primary test in selecting coverage standards for inclusion in S.1642 should be the public interest as measured by the number of shareholders. A company with between 500 and 1,000 shareholders represents a substantial public interest. The asset test is designed to assure that no disproportionate burden is placed either on the companies or on the Government in relation to the public interest to be served." (Report, Senate Banking and Currency Committee, op. cit., p.21).

8/ S.E.C. v. Ralston Purina Co., 346 U.S. 119(1953).

benefited by the disclosure provisions of the Exchange Act since they have no other practical way of obtaining information on their investment. Also, the book value standard which Applicant suggests is only one measure of the value of a security and by no means the most important. The contention, therefore, is rejected.

While Applicant does distribute some financial information to its stockholders, the brief synopsis sent to stockholders in advance of the annual meeting falls far short of the detailed annual statement required under the Commission's rules. There are other deficiencies, but perhaps the chief one is the failure to provide a certified statement. Applicant in its opening brief offered to provide its shareholders with the information required under the reporting, proxy and insider trader provisions of the Exchange Act, providing that certification were not required (P.15). Certification furnishes substantial protection to investors. It assures them that the accounts of their company have been subject to an independent audit in accordance with generally accepted accounting standards and Commission regulations. In the instant case it could and should redound to the benefit of Applicant and its shareholders by attracting potential investors who might not be willing to consider investing without this protection.[9/] Applicant thus might find itself in a better position to raise needed capital. Certification also carries with it the distinct possibility of expansion of general trading interest in

---

9/ Special Study, op. cit., Pt. 3, pp 15-17.

Applicant's stock so that the pattern of trades being negotiated only between existing stockholders may be broken. It should also be noted that Applicant's accountants have recommended this procedure to Applicant as a matter of good business practice.

It has been urged that certification would result in a material increase in Applicant's costs. No proof has been submitted on this point outweighing the advantages of full compliance. If special problems were to arise an application for relief could be made at an appropriate time.

Despite the paucity of public information on the affairs of the Applicant there has been substantial trading in its stock. In the last ten years 86,545 shares were involved in actual purchase and sale transactions or approximately 40% of the total outstanding shares. It was found in the course of the Special Study that companies with a number of shareholders comparable to those of Applicant do not in many instances have a substantial amount of stock transfers.[10/] The undersigned concludes that the average yearly turnover of 4% of the common shares of Applicant does not justify the requested exemption.

Applicant has urged that it is primarily a local retail concern and that the nature and extent of these activities

---

10/ See Table IX-a - Special Study, op. cit., Pt. 3, p. 21.

warrant the granting of an exemption. This contention does not give full weight to the extent of its business operations. Applicant has substantial sales - a yearly total in excess of $3,500,000. The impact of those sales on interstate commerce cannot be immaterial. The extent of Applicant's business establishes the Applicant should be subject to the regulations under consideration here rather than the contrary.

The burden of justifying an exemption from statutory and regulatory requirements is on an applicant.[11/] It has been concluded that the number of public investors and the amount of trading interests, actual or potential, in Applicant's securities is not sufficiently limited to justify the requested exemption. The nature and extent of the activities of the Applicant, including its assets and gross sales, are not such as to justify the requested exemption. It has also been found that adequate information in proper form would not be available to investors concerning the financial and business affairs of Applicant, its management, and other key items of information required to be furnished under Sections 12, 13, 14, and 16 of the Exchange Act, if the application were granted. It is therefore concluded that the required exemption would not be consistent with the public interest and the protection of investors. Accordingly,

---

11/ S.E.C. v. Ralston Purina Co., supra.

IT IS ORDERED that the application of Orchard Supply Building Co. for an exemption of its common stock from the provisions of Section 12(g) of the Exchange Act is denied.

Pursuant to Rule 17(b) of the Commission's Rules of Practice a party may file a petition for Commission review of this initial decision within fifteen days after service thereof on him. This initial decision, pursuant to Rule 17(f) shall become the final decision of the Commission as to each party unless he files a petition for review pursuant to Rule 17(b) or the Commission, pursuant to Rule 17(c), determines on its own initiative to review this initial decision as to him. If a party timely files a petition to review or the Commission takes action to review as to a party, this initial decision shall not become final as to that party. 12/

Sidney L. Feiler
Hearing Examiner

Washington, D. C.
May 1, 1967

12/ All contentions and proposed findings have been carefully considered. This initial decision incorporates those which have been found necessary for incorporation therein.