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VENTURE CAPITAL FINANCING UNDER THE SECURITIES LAWS

An Address By

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Securities and Exchange Commission

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NATIONAL VENTURE CAPITAL ASSOCIATION

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Our capital markets present so many challenging problems and prospects that there are a wide variety of topics that would be interesting to discuss this noon. With this group at this time, however, it seems obvious that I should devote my time to remarks relating to the proposed revisions to Securities Act Rule 144 and Form S-16, submitted last October on behalf of this association by your counsel, Kenneth Bialkin.

If I were of a malicious nature, I would retain attention by encouraging your expectation that, before I am through speaking, probably right at the end, I will break the news of the Commission's response to these proposals. That kind of dramatics is fun, and I would like to have staged this occasion that way.

Unhappily, from _your_ point of view, we have been rather preoccupied with other matters that have seemed more pressing, from _our_ point of view, so I cannot tell you today just where we will come out. Instead, as so often seems necessary, I will talk around the subject without finally coming out anywhere. During the process, however, I may convey the impression that we likely will not favor granting everything you have asked for. If that is the thought you carry away from this luncheon, I doubt that you will have been deceived.

Finally, I should make a disclosure. The remarks which follow are my own and do not necessarily, in all respects, reflect the views of the Commission, nor, I might add, the views of the Division of Corporation Finance. I would hope, however, that we are not very far apart.

To be sure that you all have clearly in mind what your counsel has submitted for our consideration, let me first summarize the present situation, and then the proposed changes.

In the typical circumstance we presume to be of concern to you, one or more venture capitalists supply capital to a new enterprise by purchasing stock or other securities in a private placement, meaning the securities were not registered for sale under the Securities Act. The securities are thus restricted in the hands of the venture capitalists.

Sooner or later, especially if the new enterprise prospers, the holders of these restricted securities will want to realize the increased value and liquidate their position so as, among other things, to make capital available to finance other new enterprises. But, full value for these shares can be realized only if they can be offered widely and if the securities delivered to the purchasers will not be restricted in their hands.

Obviously, that can be achieved through registration of the securities at the time of resale, but we are reminded that registration, especially a full-dress registration statement on Form S-1, is time-consumming and expensive. Accordingly, your proposals are aimed at increasing the availability of an exemption from registration for public resales and, where registration is necessary, increasing the availability of the bobtailed Form S-16.

Your first proposal is an amendment to Rule 144 relating to the conditions in which a holder of restricted securities can lawfully make unregistered sales to the public. The proposal has four elements: first, a substantial increase in the volume limitations on sales by non-affiliates under the rule; second, a conditioning of the use of the new volume limitations on certain qualitative performance standards for the issuer; third, an increase in the required holding period to three years for those who would use the revised rule; and fourth, elimination of the requirements that no solicitations of buy orders be made in connection with the sales.

With these amendments, the holders of restricted securities would be able to make unregistered sales in much larger volume than is now permitted by Rule 144, and to

solicit the purchasers, which is forbidden by Rule 144, in exchange, so to speak, for holding three years instead of two and provided that the issuers have established an earnings record -- not now a condition to Rule 144 sales.

The other proposal is an amendment to Form S-16, the registration form available for secondary distributions where the issuer meets the requirements for the use of Form S-7. Form S-16 is a drastically simplified form of registration which is much easier and presumably cheaper to prepare than a Form S-1. The bulk of the required disclosures in Form S-16 which relate to the issuer, rather than the terms of the offering, are accomplished by incorporating by reference the issuer's filings under the Exchange Act, namely, its most recent annual report on Form 10-K and subsequent quarterly reports on Form 10-Q, and current reports on Form 8-K.

Because these disclosures repose in documents that are publicly available but that are not required to be delivered to purchasers, the use of the form is thought to be suitable only for the securities of issuers that have been reporting companies -- that is to say, have made Exchange Act filings -- for a reasonable period of time and have achieved a reasonable degree of stability of earnings and market seasoning.

At the time of the adoption of Form S-16, such qualitative standards were already imposed as conditions for the use by issuers of Form S-7. For convenience and symmetry, in adopting Form S-16 for secondary offerings, rather than develop new qualitative standards, the Commission simply incorporated those for the Form S-7. In short, Form S-16 says that if the issuer qualifies for the use of S-7 for its own primary offerings, it may use S-16 to register a secondary offering.

Your proposal would break the symmetry, and relax the standards for the use of Form S-16 for secondary offerings in four respects: first, the issuer need have had net income for only the last three years, instead of five, and instead of at least $500,000 net income for each of the five years, it is enough if it reached that level in the most recent year; second the issuer need have been an Exchange Act reporting company only for the most recent year rather than three years; third, the issuer need have been free from defaults in principal and interest in its outstanding debt and dividend and sinking fund installments on its preferred stock, if any, only for the last three

rather than ten years; and fourth, certain requirements regarding the existing market for the class of securities involved are set forth.

These proposals have obviously been thought out with care, and display a conscious effort to accommodate the needs of investor protection while making it somewhat easier, at least in terms of legal requirements, for venture capitalists to liquidate positions in a company which has shown an ability to survive and prosper. We respect the spirit in which they have been submitted, and they are receiving careful attention.

These proposals concern an area of the application of the Federal securities laws that has been troublesome from the very beginning. While it is fair to say that the federal disclosure system works comfortably and well for the primary offerings of substantial, established companies, it is also fair to say that it has not worked so comfortably in regard to smaller, promotional offerings and that the system is not in repose for this type of financing. After much attention over many years, we can be said to have achieved at best a rather uncertain equilibrium.

Why should this be so? Why should a system that works so well for the public marketing of millions of dollars of stocks and bonds by large companies be so troublesome as applied to the smaller offerings of small and new companies?

The basic problem is, and always has been, expense. The public marketing of securities costs time and money and relatively more of each as the offering gets smaller and the issuer gets newer. This is a well-established fact, but it is not so well-established how much of the expense is attributable to registration under the Securities Act. It seems likely to us that the necessity of registration may add more significantly to the time involved than to the cost, although time may be influenced by the degree of care applied to the preparation of the filing.

Over the years, the Commission has prepared rather comprehensive reports on the cost of flotation of registered issues, the latest of which was published in December 1974, covering the years 1971-1972. The relation of total costs to size of offering have not changed much over the years, and the differences are great. To illustrate, for registered stock offerings, primary and secondary, for cash, under

$1,000,000, the average underwriters' compensation, or spread, amounted to about 12-1/2 percent and other expenses to about 8-1/4 percent. In other words, net proceeds to the issuer were slightly less than 80 percent of the aggregate public offering price. Contrast this with offerings in the range of $20 to $50 million. For these, underwriters' compensation averaged 4.4 percent and other costs .6 percent, for total costs of about 5 percent, enabling the issuers to net about 95 percent of the aggregate public offering price.

How much of this is attributable to Securities Act registration?

Our study does not attempt to break this out. The one expense inescapably related to registration -- the registration fee -- is 1/50 of 1 percent of the expected aggregate offering price and is clearly insignificant for small offerings. Curiously, this fee becomes a more significant element of total expenses as offerings get very large, because it is directly proportionate to the size of the offering, while the other expenses are not. Very possibly, legal and accounting expenses are somewhat higher because of registration, although considering the countervailing hazards involved, perhaps they should not be.

In sum, these studies have led us over the years to conclude that the cost burdens upon small businesses raising equity capital from the public are indeed severe, but that

they would not be substantially reduced by an exemption from registration, particularly in relation to the benefits from registration received by investors. Indeed, it has been the Commission's experience that these benefits are markedly greater with these small offerings of new companies.

The argument is an obvious and ancient one that the laws should be relaxed for smaller offerings, because full registration is such a burden on them. Over the years, efforts to accommodate this point of view have not been happy. Consider the Commission's experience with this under the one provision in the Act clearly intended to permit relaxation for offerings solely because of size, the authorized exemption for small offerings in Section 3(b) of the Act, now the subject of Regulation A.

Prior to 1953, this exemption was perfected simply by filing a notice of offering -- an effort by the Commission to make life under the Federal law as cheap and easy as possible for small offerings -- and it came to be greatly abused, particularly by promoters of uranium mining ventures in the years following World War II. By popular demand from respectable investment bankers and dealers and others, the Commission felt constrained to tighten the conditions for exemption to the point where a Reg A offering, in terms of time and expense, more resembles a modified registration

procedure than it does an exemption. The memory of the earlier experience lingers, and generates resistance on our side to any temptation to revert to the old ways.

Your proposals, however, are not concerned with the status of the primary financing whereby the venture capital was supplied to the company. They assume that that transaction was a private placement exempt from registration under Section 4(2) and Rule 146. That is what makes the stock or other securities received restricted securities in the hands of the venture capitalist. You are concerned with subsequent resales, seeking to make it easier and cheaper to liquidate the position by public sale, at least where the venture has proved out and prospered.

The tight limitations on unregistered resales, it is argued, may serve adequately the needs of most individuals who, one way or another, find themselves with restricted securities, but they are not adequate for the venture capitalist, who has probably acquired a very substantial position -- an average of about $500,000 for your members, according to Professor Ofer's survey -- and whose business depends upon the ability to withdraw capital from one successful venture in order to help finance another.

There is every reason why the Commission should want to encourage professional venture capital activities. There has never been enough capital to support promising new ventures, and yet this type of capital employment not only fosters the great American dream, which is good for individuals and in its social effect, but also fosters the development of new ideas and techniques so important for the continued health of our economy.

Even in the best of times, as we have seen, raising such capital from underwritten public offerings was terribly expensive. Despite this, in booming markets some entrepreneurs have been willing to bear the expense either because private, professional venture capital was not available, or, as was often the case, because professional venture capitalists would invest only on terms of participation, and sometimes control, that public investors would not require. But we have not seen market conditions suitable for this sort of financing in recent years. We do not see them today. And there are reasons to doubt whether we should, even if we could, encourage resort to public offerings as the best way to finance all new ventures.

The furnishing of capital for new ventures of new companies, important as it is, has been a frustrating puzzle to planners and politicians for a long time. Efforts to solve it have led to proposals for some sort of government supported equity, or capital, banks, to the Small Business Investment Act, and related tax provisions, and to repeated urgings to the SEC to grant benevolent relief from formal disclosure requirements. Some of the efforts have sought to square the circle, so to speak, to reconcile the irreconcilable. The desire of new entrepreneurs to get equity capital without yielding any degree of control or participation in the action is understandable, in human terms, but so is the desire of the persons furnishing risk capital to obtain those very things.

From the earliest days it has been argued that registration, as administered by the SEC, inhibits promotional offerings not just because of time and expense but also because the generally cold and negative narrative that the process produces in prospectuses tends to kill the romance and unreasoning faith so essential in the heart of the investor in new enterprises.

One commentator, not long after the Act was passed, likened investing in new ventures to family formation. He put it this way:

> "The point * * * may possibly be made clearer by an admittedly imperfect analogy. One might raise the question of the probable effects upon the marriage rate throughout society if before a marriage could occur there had to be 'full disclosure' by both parties concerning their previous actions and behavior. Now it is doubtless true that in many instances such full disclosure would prevent imprudent marriages. On the other hand, it is at least conceivable that a requirement of 'full disclosure' would also have the effect of forestalling an even greater number of marriages which would turn out successfully.
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> "The parties would be in a sense 'warned off' by having certain facts brought forcibly to their attention. If one accepts the view that a high marriage rate is desirable he might well hesitate to urge the desirability of a 'full disclosure' provision in order to prevent injudicious marriages even though there seem to be a large number of the latter annually. In the writer's opinion, the similarities between marriage and capital investment are probably greater than might at first appear. A certain irrational optimism is perhaps a prerequisite to both." */

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*/ Buchanan, The Economics of Corporate Enterprise, 455-459 n.13 (1940).

Today, this comes across as a rather naive analogy, considering all of the gun-jumping reported to be prevalent, but the idea is a persistent one.

But promotional offerings, it is urged, are tender shoots that need special handling as far as strict registration and disclosure demands are concerned. a certain benign neglect. Inasmuch as the investor's pain is just as great when he loses his money on a new venture as on an old one, the assumption must be that new ventures are so desirable for our economy and society that we must accept the sacrifice of a few investors, or at least of their dollars, in order to have as many new ventures as we can. Or, perhaps the assumption is that, as long as the investor knows he is buying into a new venture, he knows he is taking a flier and therefore needs no further protection.

Tempting as this latter assumption is, we find no basis for it in Congressional policy as expressed in our acts, and we find recurring examples of small investors losing their life savings in new ventures. Furthermore, while small, promotional public offerings are the darlings of publicists seeking to encourage entrepreneurship by rugged individualists, we also have observed, as I have said, that the public offering alternative to venture capital financing, when available, has

often been resorted to precisely because small individual investors can be lured into furnishing risk capital with far less participation in future growth than any professional would accept. How much should this be encouraged?

There must, indeed, be many persons still angry over losses suffered from investing in the many new ventures that were financed by public offerings five or ten years ago. Human nature being what it is, many of them are no doubt still blaming crooks and conspiracies -- some with good reason, alas -- or the "system," which always seems stacked against the little guy. Too often, of course, the little guy is not, or was not, acting intelligently, despite all our efforts to enable him to do so. Which gives me an excuse, however transparent, to tell a story that I especially enjoy.

It concerns a Catholic priest and an Episcopal priest who were enjoying a morning of golf together for the first time. On the fairways they seemed evenly matched, but on the greens it was different, and for a reason.

On the first green, before attempting a fourteen foot putt, the Catholic priest bowed his head in solemn prayer. The Episcopal priest watched this with some scorn, saying to himself, "that's just like those fellows. He's probably praying to some imaginary patron saint of putters. How I

scorn this superstitious pleading for divine assistance in trivial endeavors!" Whereupon the Catholic priest addressed the ball and sank it with authority. It took the Episcopal priest three putts.

And so it went for several holes, the Catholic priest praying and one-putting, the Episcopal priest scorning and three-putting. After some deliberation, the latter decided the endeavor was not so trivial after all and that he would like some help wherever he could get it. He asked the Catholic priest, "I suppose you're praying to some imaginary patron saint of putters?" The Catholic priest said "No. I am praying directly to God." So the Episcopal priest tried this, but nevertheless three-putted. And this went on for several holes.

Finally, in exasperation, the Episcopal priest said to his friend, "I suppose you're praying in Latin?" The Catholic priest said, "No. Often I do, but this time it is in English."

The Episcopal priest responded, "Then I do not understand it. We pray to the same God and in the same language and yet with you it seems to work and with me it does not. How do you explain this?"

The Catholic priest said, "It does seem strange at first. But I have practiced and studied this matter for many years, and I have come to the conclusion that after all it works best when you know how to putt."

In sharp contrast to the coddling approach, Professor Kripke, an experienced and especially astute practitioner and scholar in this field, has asserted that investing in new ventures today is beyond the capabilities of ordinary investors insofar as the new ventures seek to exploit new and increasingly sophisticated technology. He argues that many new ventures today involve such advanced technological considerations that the best prospectus imaginable would not enable the ordinary investor to make an informed judgment.

Only professional venture capitalists, often with further professional advice, can hope to make such judgments. By this line of reasoning, perhaps high technology new ventures, at least, should not be permitted to register for sale to the public but should be forced to raise their funds from professionals in private placements. So far, we have not been able to persuade ourselves that this approach is the right policy or that it is acceptable under our statutory mandate, but Professor Kripke clearly has a point.

These conflicting attitudes keep life interesting for government regulators, but it is not necessary to choose amongst them in order to conclude that venture capitalists play a most important role in our capital markets and that they should be encouraged to increase and do more, especially in these times when the public offering alternative has largely disappeared. And, as evidenced by the proposals of your association, venture capitalists have a peculiar point of interest as to the application of the Federal securities laws.

Most of the public debate on this subject of financing new and small business has been directed to the primary offering by the issuer, but here I presume you are more or less at peace. As long as the primary offering is limited to one or a modest number of professional venture capitalists, the availability of an exemption from registration under Section 4(2) seems clear. It has seemed so for a long time and, I take it, has not been muddied up too much by Rule 146, even though you have aspirations for improving that rule as well. Your more pressing concern is with the resale, the liquidation of the position. As to that, Rule 144 has helped some and hurt some.

Rule 144 was born of great travail in the Commission's struggle to rationalize the law relating to the unregistered sale of restricted securities, to bring it closer to sound policy and to give it a greater degree of certainty. In the

process, from the restricted security-holder's point of view, the Commission gaveth a little and tooketh away a little -- in some situations, a lot.

Under the rule, far more than before, when such securities may be resold is determinable by objective criteria, but the quantity that may be resold and the permissible manner, while equally clear, are closely circumscribed. As Mr. Bialkin observed in his letter submitting the proposals, under the pre-Rule 144 lore, the time and circumstances permitting unregistered resale may have resisted precise determination, wrapped as the question was in hazy subjectivity laced with metaphysics. But, once you decided that you could sell, then you could sell any amount in any manner you pleased.

Now, in the absence of complications, you know you can begin selling after holding precisely 730 days, but the sales can only be dribbles through broker's transactions -- hardly enough for the prompt liquidation of a substantial position.

Why did the Commission do this? Why did it adopt a two-year rule, such as the bar had been pleading for for years, and then put such a tight limit on the quantity and method?

In terms of direct historical antecedent, the development of this position began with the so-called Wheat Report, which concluded, first, what everyone had long known, namely, that the state of mind of the purchaser at the time of purchase had no practical relationship to whether or not purchasers should have the benefits of registration upon public resale. Upon that subsequent event, whether or not the person doing the reselling acquired the securities with or without a view to their eventual distribution is totally irrelevant to investor protection. But, Commissioner Wheat's report went on to say, the prospective purchasers on the resale may be affected by whether the resale involves a distribution rather than ordinary trading transactions.

That is to say, if the holder of restricted securities of a reporting company sells them in the public market through ordinary brokers transactions in modest amount relative to the trading volume or the outstanding shares, the potential and actual purchasers are wholly disinterested in the sellers' state of mind at the time of acquisition and need no more protection than if they were buying from someone else. But if the sales are made through special retail selling effort, especially involving extra brokers'

compensation and hence extra selling pressure, or if the quantity being sold is enough to have a probable effect on the market, then a distribution is involved and something more than routine Exchange Act disclosures and protections are appropriate.

One must applaud this analysis as a valiant effort to bring the question of registration or not closer to realistic policy objectives. Even though Mr. Wheat's specific proposals were rejected by the Commission, this approach carried through into Rule 144. Perhaps it is not an entirely comfortable position given the words of the Act, but it makes practical sense, which the act, read more literally, does not. Of course, the specific provisions of Rule 144, as to what are brokers transactions and what is a significant quantity of securities, are arbitrary, as they must be, but they are drawn on rule provisions and Commission attitudes of long standing.

As a matter of interest, the proposed Federal Securities Code being developed by the American Law Institute under the direction of Professor Loss comes out pretty much the same way, in general approach, with broad authority in the Commission to vary the detailed requirements. Under the Code, the policy approach toward which the Commission is striving is expressly

embodied in statute. Nothing turns on the state of mind of the purchaser of securities in a private placement. His right to make public resales without registration turns entirely on a minimum holding period plus the quantity to be offered relative to the outstanding shares and the manner of offering, both of which are subject to Commission rulemaking. In terms of the systematics of the Code, a "secondary distribution" must ordinarily be subject to a filed offering statement, but the offering is <u>not</u> a distribution if it is a "<u>limited offering</u>" or made through "<u>trading transactions</u>." In substance, this is the result we are seeking.

Returning to today's laws and realities, the question is how far we should go in giving our blessing to unregistered resales of restricted securities. Obviously, the precise limits imposed by Rule 144 are arbitrary, in the logical sense, though I think not in the popular sense. They were not selected in a careless or irresponsible manner without regard to their effect on issuers and investors. They were arbitrary in the sense that reason can lead us to the position that unregistered resales should be forbidden where the method of sale or the relative quantity being sold indicate

that investors need the protection of Securities Act registration, but reason cannot settle upon 1 percent, or one week's trading volume, or any other exact standard.

It is inevitable in law-making, including SEC rulemaking, that precision and predictability are antithetical to equity in the particular case. The search for precision ineluctably leads to arbitrary distinctions in marginal cases. So we cannot do what Rule 144 set out to do -- that is, provide certainty to counterbalance the harsh certainty of Section 12(1) -- without settling upon some arbitrary criteria that will always be under a certain degree of attack. If 1 percent is all right, why not 1.1 percent, or 1.4 percent, and so on? While we can never prove that any number is the right number, we can persuade ourselves that it is within the range of reason and as good as any other number. Thus we can, and must, defend any arbitrary limitations we place on Securities Act exemptions. Anyone can, and does, argue that if 1 percent is legal, then 1.1 percent must be also. If we accede to such blandishment, we start down the road to the constructive repeal of the Act.

In summing up, let me assure you once more that we place a high value on the venture capital process. It deserves the support and encouragement of the government in all respects. But we are also charged with preserving that special form of investor protection embodied in the disclosure system and its attendant allocations of legal responsibilities

and burdens. In balancing the interests involved, we are inclined to think that the lines drawn by Rule 144 are about right, certainly for investors at large, and therefore view with some reluctance the proposal to reexamine them even for so worthwhile a cause as the facilitating of venture capital financing. A reexamination of the standards for the use of Form S-16 and Form S-7 is a less sensitive matter, and we are giving your proposal in this regard especially careful study.

We do, in any event, appreciate your concern and understanding, and I trust it will extend to an understanding of our task in weighing conflicting but desirable policies when we make our position known.