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THE SECURITIES AND EXCHANGE COMMISSION AND THE FINANCING OF SMALL BUSINESSES

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Your Program Committee has assigned to me the discussion of the various means available to small businesses in order to raise money through the issuance of securities, with particular reference to the Federal statutes which are administered by the Securities and Exchange Commission. This subject has been before the Commission for some time. In fact, during the past year, we have held symposia in different financial centers at which a group of staff specialists and I have addressed public forums, discussing the needs and problems of small businesses with their owners and representatives and have attempted to explain the nature of our jurisdiction and the methods available for exemption from, or expeditious compliance with the Securities Act. We are prepared to put on a similar general review for the joint benefit of the investment bankers, the lawyers, the accountants and the fiscal managers of small businesses wherever an adequate group of such persons can be gathered together and we would welcome any suggestions in this regard.

Our general concern in this area is, of course, the question of public financing of small businesses under the Securities Act of 1933. There are other small organizations within other areas of the jurisdiction of the Commission, such as among the listed companies and the investment companies. However, such organizations generally do not present peculiar problems due to their size, and are generally considered and treated much as are other companies in the same category.

The symposia to which I have referred were initiated largely to discuss the merits of the charge which has sometimes been made that the Securities Act has operated to impede small businesses in obtaining the capital necessary for their development. Upon investigation, we have been unable to find any substantial basis for this accusation. Small businesses must compete in the capital market with other enterprises for the investors' savings. From the very nature of things, they are under great handicap in so doing, but this has nothing to do with the Securities Act. Usually we find in the last analysis that the charges so made against the Securities Act and its administration are derived from lay sources and are based upon misconceptions as to the terms of the Act and as to the various exceptions and exemptions contained in it generally favoring an effort of a small businessman to raise capital by public subscription.

In the administration of the powers and responsibilities vested in it by the securities acts, the Commission is guided by two more or less overlapping standards, that of the public interest and that of the protection of investors. I say two standards, since the term "public interest" includes more than concern for a protection of investors as such. It requires the Commission to look beyond these immediate interests and to take into consideration the welfare of the economy as a whole. Thus, while it is looking to the protection of prospective investors in dealing with small business, or big business for that matter, it must be careful not to erect such burdensome requirements as to discourage the raising of the capital necessary to the growth of business and industry.

Under the Securities Act any company which intends to distribute its securities in order to raise capital by means of a public offering of securities through the use of the mails or instruments of interstate commerce, or whose controlling persons desire to market their holdings by such means, must register the securities with the Commission unless an exemption from such registration is available. While I have agreed to deal with the particular subject of exemptions, I think I should spend a minute to describe that from which the issuer is exempted. Registration is simply the process whereby a registration statement is filed with the Commission and after a lapse of time becomes effective. Such statement consists largely of a prospectus which describes the issuer, its business and management and the proposed offering and provides certain financial and other information necessary to an informed investment appraisal of the offering. This document must be signed by the issuer, its directors and certain officers of the issuer and subjects them and their attorneys and accountants to strict liability for material omissions or misstatements. Securities may not be offered for sale before the statement is filed and they may not be sold before it is effective, which usually takes about three weeks. The staff of the Commission reviews the document when it is filed and any inadequacies or omissions are normally brought to the attention of the issuer for correction. Investors must be furnished with a prospectus in connection with the offering and sale of the security.

Since small businesses sometimes have occasion to make public offerings which are too large to be exempt from registration, as I will explain later, the Commission has adopted two registration

forms for use by certain types of issuers who might fall within this category. One of these is for commercial and industrial enterprises in the promotional or development stage and the other is for mining companies in that stage. These forms are tailored to provide the necessary disclosure with respect to companies having a small organizational set-up and no significant record of earnings or operating results.

Quite honestly, registration of a security issue involves rather more than this brief description might indicate, but it is hardly so burdensome or complicated as some have suggested. But that is another subject, and I think I should repair to the exemptions.

The Act itself provides in sections 3 and 4 a number of exemptions for certain types of securities, for securities issued in certain transactions and for certain transactions in securities. Most of these exemptions are not pertinent to our discussion. They cover, for example, the issue of municipal securities, the securities of certain cooperatives and of railroad and some other common carriers, certain exchange transactions, etc. Three exemptions are, however, fairly within the framework of my assignment. The first of these is the so-called intrastate exemption. This exemption, designed for local financing, is set forth in section 3(a)(11) of the Act. It applies to --

> "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

The exemption provided by this section, due to practical considerations, is primarily an exemption for small issues for the simple reason that the offering and sale of a large issue is very apt to fail to meet all of the terms and conditions of the exemption. Since I have a captive audience of lawyers whose job it is to advise their clients with respect to these matters, I shall undertake to discuss with you a few of the limitations of this exemption.

By the use of the words "a part of an issue" in section 3(a)(11), it was intended to limit the availability of the exemption expressly to a situation in which the entire issue of securities is offered and sold exclusively to residents of the state concerned. Each of these words is important. It is to be emphasized that the "issue" concept makes the exemption incapable of combination with another exemption. To determine whether or not an offering is "a part of an issue" involves a consideration of whether or not it should be integrated with another offering previously made, currently being made or proposed to be made. If the offerings are in fact a part of the same issue, no exemption is available under section 3(a)(11) unless the aggregate offering meets all of the conditions of the exemption.

The requirement of section 3(a)(11) that the issuer must be "doing business" within the state is satisfied only by substantial operational activities in the state of residence. It is not enough that the bookkeeping, stock record or other similar functions normally incident to being incorporated in the particular state are carried on there. A couple of examples may serve to clarify this requirement.

A corporation which was developing or exploring uranium properties in State B performed none or limited activities in the state of its incorporation, (State A) other than the maintenance of its principal office, bank accounts and business records. An exemption under section 3(a)(11) would not be available for an offering in State A to raise funds for the further development of the uranium properties since the company had no substantial operational activities in the state of its incorporation. In the same vein, the position has been taken that a company organized in State A, whose sole business was holding the securities of a subsidiary operating solely in State B, could not avail itself of a section 3(a)(11) exemption for an offering of securities in State A for the purpose of providing additional capital for its subsidiary.

Section 3(a)(11) requires that the financing be confined to a single state in which all of the offerees, the purchasers and the issuer are residents. Insofar as a corporation is concerned, its

residence is deemed to be the state of its incorporation. Thus, although many states hold a foreign corporation to be resident when it is admitted to do business within the state and consents to be sued therein, this is not determinative in considering the application of section 3(a)(11). For the exemption to be available, the entire issue, when the distribution is completed, must have come to rest in the hands of investors who are bona fide residents of the particular state. If any part of the issue, even a single share, is sold to a person who is a non-resident or who takes the securities with a view to their distribution outside the state and does in fact distribute them, the exemption for the entire offering would be made unavailable and the offering would be in violation of section 5. The law is explicit on this point and I cannot emphasize too strongly the importance of this matter and the need for counsel to take such steps as may be necessary as to avoid this unhappy result. A frequent device is the execution of letters showing the residence of the purchaser and denying any intent to sell to persons outside the state. However, as in the case of letters of intent generally, they are by no means an unbent reed, and extreme care must be exercised to assure an understanding of the nature and the importance of the representation.

Another example of the pitfalls to be avoided in connection with this exemption is illustrated by the problems arising when the securities are offered under an installment subscription plan. It has been considered that, even if the original subscription agreement is made within the state but the interim subscription agreement is transferable to a non-resident and subsequent payments are made by such non-resident, the subsequent payments constitute a sale out of the state, as a result of which the exemption is vitiated for the entire issue. This may serve to show why I say that as a practical matter the intrastate exemption is loaded with dynamite and must be handled with very great care.

Another exemption which is often used by small businesses is found in section 4(1) of the Securities Act. In fact, this exemption probably accounts for the vast bulk of such financing. Section 4(1) exempts, among other things, "transactions by an issuer not involving any public offering." It should be noted that this is not an exemption of the securities as such but is an exemption of a limited type of transaction in securities, and the Act still applies to subsequent transactions in the same securities. In common parlance, the language of the section has been turned around so that, instead of referring to transactions not involving any public offering, we usually refer to "private transactions" or "private offerings".

The question whether a public offering is involved in any particular case is a question of fact in which all of the surrounding circumstances must be considered. The question cannot be resolved solely upon the basis of the number or class of persons to whom the securities are offered or the number of persons with whom sales transactions are concluded. The Supreme Court has told us that the number of persons to whom the security is offered is not determinative and that in fact an offering to a limited number may be a public offering. Undoubtedly, however, in many cases the scope of the offering is a factor to be considered. This includes not only persons to whom an express offering is made but any person to whom an "offer" in the statutory sense is made, thus including any attempt to dispose of a security. Preliminary conversations and the solicitation of offers to buy or even of indications of interest are thus within the meaning of the term.

The relationship of the offerees to the issuer is of significance in determining whether or not an exemption is available under section 4(1). An offering to a class of persons who are intimately familiar with the business and affairs of the issuer is less likely to involve a ~~public~~ public offering than one made to persons having no special knowledge in this respect. The Supreme Court, in S.E.C. v. Ralston-Purina Co.,* stated that the availability of the exemption depends upon whether the particular persons affected need the protection of the Act. The Court stated that "an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'"; that the "exemption question turns on the knowledge of the offerees..."; and that "The focus of inquiry should be on the need of the offerees for the protection afforded by registration." The effect of this decision is to limit the applicability of the exemption to those persons who have such knowledge of the business and affairs of the issuer as would be substantially comparable to that which would be provided by the registration process.

Another factor of importance in a private issue is the size of the offering and the number of units offered. Frequently, a large issuer will place a sizeable issue of debt securities with a comparatively few institutional investors. Because of the ability of such institutions to insist upon and to receive information even more extensive than that usually provided in a prospectus and their ability

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* 346 U.S. 119 (1953)

to negotiate the transaction on equal terms, such private placements, as they are called, can be effected within the limitations of the exemption provided by section 4(1). On the other hand, the placing of an issue of stock consisting of a large number of units with a relatively small group under circumstances which indicate probable reoffering and resale in whole or in part to a larger group would suggest the unavailability of the exemption. If, in such a case, the initial purchasers would be underwriters as the term is defined in section 2(11) of the Act because they would have "purchased from an issuer with a view to ... the distribution of any security", and therefore no exemption would be available under section 4(1), either for such persons or for the issuer. To meet this problem, an issuer will usually require the purchasers in a private offering to furnish a written representation that they are taking the securities for investment and not for the purpose of distribution. This precaution is a salutary one since it causes both parties to the transaction to give thought to the intentions of the purchaser. But this representation should be a serious one and not given perfunctorily to set the basis for a formal claim to exemption. The mere giving of such a representation is, of course, not conclusive. The surrounding facts and circumstances may be such as to raise a question as to the actual intention of the purchaser. This is illustrated by the question reasonably arising when a person who is in the business of buying and selling securities represents that he is acquiring securities of an issuer for investment and not for resale.

In addition to these statutory exemptions which require no filing with or action by the Commission, section 3(b) of the 1933 Act gives the Commission wide discretion to adopt rules and regulations exempting the offering of limited amounts of securities upon such terms and conditions as the Commission may prescribe. The maximum amount of any issue which may be exempted pursuant to this authority is $300,000 in any one year. In addition, the Congress, during the session just closed, enacted a new section 3(c) which authorizes the Commission to adopt rules and regulations exempting, upon appropriate terms and conditions, the offering of securities by small business investment companies organized or licensed under the new Small Business Investment Act of 1958. Section 3(c) does not contain any maximum dollar amount so that the Commission may exempt such issues in amounts in excess of the $300,000 limit in section 3(b).

The principal exemption under section 3(b) which is currently of interest to small business is that provided by Regulation A. This exemption has been in effect in one form or another for a number of

years. At one time, the regulation did not require the issuer to make any substantial disclosure to investors, but merely entailed notification to the Commission and the filing of any sales materials used. In 1953, on the basis of the Commission's experience, and at the suggestion of Better Business Bureaus and some practitioners in the securities business who were interested in protecting the legitimate aims of the industry, the Commission completely revised Regulation A. One of the principal changes effected by the revision was the addition of a requirement that an offering circular containing certain minimum information, including financial information, be used in the offering of securities under the regulation. The purpose of this requirement was that the investor be furnished with such basic information as would indicate to him the essential characteristics of the enterprise in which he is being asked to invest his funds. Notwithstanding this change, the regulation was, and still continues to be, one designed primarily for the prevention of fraud in the sale of securities. Because of its importance, I think I should discuss this regulation in some detail.

Regulation A is not automatic and is not available to every issuer. Certain securities such as oil or gas rights and assessable stock are excluded because other regulations are drawn to provide for them. The securities of investment companies are also excluded. Regulation A is not available to an issuer if either he, his directors, officers, promoters or underwriters are subject to a stop-order under the Act or to a suspension order under Regulation A or have been convicted of or enjoined against certain conduct. In none of these cases, however, would the issuer be barred from filing a full registration statement for the securities to be offered.

The first step under Regulation A is for the issuer to prepare and file with the Commission what is called a "notification". This document must be in a relatively simple prescribed form and must set forth certain specified information in order that the Commission may determine whether, or the extent to which, the exemption is available. In order to assist in our review, the notification must be accompanied by certain exhibits, such as the company's charter or other instruments setting forth the rights of security holders, the underwriting contract, if any, and the consent of the underwriter to being named as such.

As I have already indicated, Regulation A now requires that an offering circular be used in connection with the sale of the securities offered thereunder except in certain cases involving offerings of less than $50,000. With the exception of brief advertisements, the offering circular is the first written sales material which may be presented to the investor in connection with the offering of the security. It must, in any event, be in the hands of the investor not later than the date of the confirmation of the sale and prior to the payment of the purchase price of the securities. I would like to emphasize that this requirement of an offering circular was adopted in large measure at the suggestion of representatives of the securities industry. It was felt that, as a protection to investment bankers as well as to the investing public, certain basic information should be furnished to each person to whom the securities are offered and that such material should be subject to the Commission's examination. This did not appear to impose any particular hardship, because in most cases the honest issuer and underwriter would, in any event, prepare and use some form of offering letter or circular.

However, in the absence of specific requirements governing the contents of such offering documents, it was evident that issuers not sophisticated in the ways of the securities markets might be at a loss to know what information to include in the offering circular in the interest of fair disclosure. Consequently, the requirements as to the contents of an offering circular are carefully set forth in a schedule attached to the notification form. We believe that these requirements are limited to what would be regarded as the essential facts concerning the company and the securities to be offered.

The preparation of the notification and offering circular should not be too much of a burden. The information required and described in the rule and the schedules is fundamental and is readily available to the company desiring to use the regulation. While I hesitate, before this group, to suggest that Regulation A is so fully and explicitly drawn as to make unnecessary the employment of an attorney to prepare the filing, many businesses find that they can do so. I will say, however, that we have observed that engagement of competent counsel ordinarily results in more carefully prepared material, serves to avoid or minimize the filing of correcting amendments at a later date and to save time and effort. In fact,

we have maintained and I believe it to be true that the procedure under Regulation A is as simple as it can be in view of the paramount necessity for protecting the American investor. The regulation itself, at first reading, seems rather formidable, but it should not be difficult to understand after a modicum of study. We are open, as always, to suggestions for improvement, but I must confess that we are satisfied that the current procedure involves just about the minimum protection which the investor could reasonably expect under the Securities Act.

At the expense of what might be the greatest administrative efficiency, the Commission has decentralized its work under Regulation A. To assist small business and their counsel and to save them the expense and time of trips to Washington, our rules provide for the filing of the necessary papers in one of our regional offices, usually the one closest to the principal place of the business of the issuer. However, in order that issuers wherever located may receive the same treatment, the Commission has issued explicit instructions to its staff, has provided them with appropriate manuals and maintains in Washington a Branch of Small Issues which reviews, on a post-audit basis, the work of the several regional offices. This decentralization, I am sorry to say, together with our desire to have the rules as explicit and as complete as possible, does make for a somewhat forbidding number of rules and instructions, but we feel that the saving in time and expense more than compensates for such complexities.

The Commission has nine regional offices located in strategically located cities throughout the country. Each regional office has a staff of attorneys and accountants who are available to discuss an issuer's problems with its representatives prior to filing and to give such assistance as their work-load permits in answering specific questions concerning compliance with the regulation, although they are not in a position to participate in the actual drafting of papers. A filing made in a regional office is carefully reviewed by the staff of that office and the issuer or its attorneys are promptly notified of and asked to correct any apparent deficiencies by appropriate amendment prior to commencement of the public offering.

The SEC maintains a staff in Washington and in our regional and branch offices who are there to advise with you generally as to the application of the statutes, the scope of the exemptions and as to meaning

of our rules, regulations and forms. I am certain that free resort to this advice will help to prevent inadvertent as well as somewhat technical violations of law with all the headaches and expense involved.

Perhaps I should utter what is doubtless an unnecessary word of caution at this point. The requirements under the securities acts are in addition to, and in no wise in lieu of the requirements of the laws of the respective states. Many states have blue-sky laws under which a state administrator may refuse to permit the sale of securities in the state, if he finds that such sale would be unfair or inequitable, and the administrator is usually empowered to specify the terms and conditions under which securities may be sold in that state. An issuer must smoke the pipe of peace with the appropriate state authorities as well as with the Commission before he may offer securities to the public.

My good friend and illustrious colleague in the government service, Mr. Wendell Barnes, has told you about the recently enacted Small Business Investment Act of 1958 and of the plans of the Small Business Administration under this statute. I would like to supplement his remarks with a brief discussion of the manner in which small business investment companies organized or qualified under the Small Business Investment Act may be affected by the statutes which we administer.

In enacting the Small Business Investment Act of 1958, Congress determined that small business investment companies authorized by that Act, should, in appropriate cases, be subject to the provisions of the Investment Company Act of 1940, except section 18(a) which requires that indebtedness shall have an asset coverage of at least 300% upon issuance. An exemption was also provided from the prohibition against the declaration of dividends or other distributions on capital stock unless certain asset coverages on indebtedness publicly distributed are maintained. In administering this new legislation, then, the Small Business Administration will be interested in seeing that sound capital structures are maintained consistent with the purposes of the Act. In other respects, the Securities and Exchange Commission is required to exercise its duties and responsibilities under the Investment Company Act.

Those companies operating to make capital available to small business under the Small Business Investment Act and which are to issue securities to the public will undoubtedly be investment companies under the Investment Company Act in the usual case. One important exception to this general statement is, however, specifically described in section 3(c) of the Investment Company Act to which I have previously referred. Under this section an investment company may be exempted from regulation under the 1940 Act if its own outstanding securities are beneficially owned by not more than 100 persons and if it is not engaged in making or proposing to make a public offering of its securities. You will note that both these elements must be present, so that if a public offering is involved or proposed or if the company has more than 100 security holders, registration under the Investment Company Act would be required. In counting the number of security holders, the beneficial holders of the securities of any company who own 10% or more of the voting securities of the investment company must be included. A considerable number of the small business investment companies will doubtless be financed privately by a limited group of persons, thus bringing them within this exception. The question as to whether a given company is making or proposes to make a public offering of its securities would apparently depend upon all the facts of the case, including the particular methods used to contact prospective security holders. I have already discussed some of the factors which are of consequence in reaching a determination whether a public offering is involved.

Small business investment companies which do not qualify under section 3(c) of the Investment Company Act will be required to register with the SEC. The Commission is most concerned with and sympathetic to necessary measures to aid small business in its efforts to raise capital. However, we feel that this should be done with due regard to investors who are expected to help finance these investment companies, and consistently with the intent of Congress in enacting the 1940 Act. The type of program contemplated by the Small Business Investment Act appropriately lends itself to cooperative regulation by the two agencies of the Government concerned, each operating in its own sphere of expertise.

In this pattern of regulation, the Securities and Exchange Commission would exercise its duties and responsibilities, with its

primary interest in the protection of the public security holder. The Small Business Administration would presumably direct its activities to assuring that these proposed investment companies will appropriately channel the resources available to them to meet the capital needs of the small business concerns with whose needs the Small Business Investment Act is primarily concerned. Neither the Investment Company Act nor, indeed, the other statutes administered by the Commission, ought to be viewed as burdensome obstacles placed in the path of corporations which must raise money from the public. On the contrary, we believe that the standards of conduct imposed by the fabric of the statutes which we administer will be of great assistance in contributing to the successful operation of small business investment companies having a public interest. To the extent that investors are provided with the safeguards granted by this legislation, a more favorable climate for the flow of capital in this area can be expected.

The objectives of the Investment Company Act in this area are to secure honest and unbiased management of other people's money; to give security holders a substantial voice in determining the company's policies and in the selection of management; to insure adequate and feasible capital structures; and to see that the shareholders are provided with informative periodic financial reports. The Act is long and involved, not only because it is quite detailed and specific in its requirements but also because it covers many different situations and considerations many of which bear no relation to the activities contemplated under the Small Business Investment Act, such as the sales activities of open end mutual funds, the problems involved in connection with face-amount certificate companies and periodic payment plan companies, and so on.

This is not the place, I think, to go into a detailed analysis of the many directives contained in the statutes and rules governing investment companies. Suffice it to say that they are based upon extremely careful studies of the industry and achieve the general statutory aim by setting up affirmative requirements or prohibitions directed to investor protection. That they have succeeded in the purpose of establishing public confidence in the investment company industry is perhaps best demonstrated by the pragmatic results. From the first year of the operation of this legislation in 1941, to the present the dollar value of investments in these concerns has grown from $2-1/2 billion to $16 billion, and the number of individual investors has increased manyfold.

It is our intention to mould the activities of the SEC under the Small Business Investment Act as nearly as possible to the purposes and aims of this legislation while at the same time preserving the integrity of the salutary provisions of the Acts which we administer. Our staff is working with the Small Business Administration to conform the pertinent rules, regulations and forms under the Securities Act for small business investment companies with those which will apply to such companies under the Investment Company Act and with the requirements of the Small Business Administration. It is contemplated that, insofar as it is practicable, there will be common forms for compliance with both the Securities Act and the Investment Company Act. Thus a registration statement under the Securities Act may also serve as the registration statement under the Investment Company Act. The same will apply to annual and other periodic reports required by virtue of an offering under the Securities Act and registration under the Investment Company Act.

I think that I should also mention at this point the possible effect of the Trust Indenture Act of 1939, which complements the Securities Act and, generally speaking, requires public offerings of debt securities to be issued under a qualified indenture. For qualification, certain required protective provisions must be included, and there must be a disinterested trustee. There are certain exemptions from the Act, largely based upon the size of the proposed issue. The Small Business Investment Act of 1958 adds a new provision to the Trust Indenture Act authorizing the Commission to exempt any class of securities issued by a small business investment company, subject to such terms and conditions as may be prescribed. There is no limitation upon our exemptive powers based upon the amount of the issue. Our staff is also giving consideration to the need for, and possible extent of, an exemptive regulation under this authority.

I would like to point out that, what with the exemptive powers granted by the new section 3(c) of the Securities Act of 1933, by section 6(c) of the Investment Company Act and by the new provisions of the Trust Indenture Act, the SEC is given authority to apply with very great elasticity its regulation in the field opened up by the Small Business Investment Act. I have no doubts whatever but that the Small Business Administration and the Securities and Exchange Commission, working together, will be able to lay out a clear, simple and safe course for

these new enterprises to follow with the minimum of governmental interference consistent with the general public and investor interest. This is a completely new field and there is plenty of room to maneuver. However, our eventual aim is clear, and with the help of industry and the bar, I have no doubt of our success.