SMALL BUSINESS AND SECURITIES

Address by

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before the

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It is a distinct pleasure for me to have been invited to speak this morning before the Section on Bank, Trust Company and Probate Law of the State Bar Association of Connecticut. I look forward to appearing before various bar associations because it gives me an opportunity to acquaint many of you with the work of the Securities and Exchange Commission and to present to you a few of the problems that now confront the Commission. It is an added pleasure for me to appear at this Association since I am a native Connecticutonian and coming up here today has given me the opportunity to renew acquaintances with a good many of my personal friends.

The charge has ofttimes been made that the Securities Acts have tended to impede small businesses in obtaining the capital necessary for their development. An article in the 1956 edition of the Harvard Business Review indicated that generally speaking, small businessmen have avoided public financing because, among other things, they are overawed by SEC regulations. There are a good many of you who may not be familiar with the scope of the statutes which we at the SEC administer. This morning I plan to present a cursory review of the six statutes that come under our jurisdiction and by explaining some of the exemptions available under our statutes, indicate the extent to which we believe the statement that the Securities Acts have impeded the growth of small businesses is unfounded.

The first federal security law was adopted in 1933. This statute has often been termed the "truth in Securities Act." Its basic purpose is the requirement that corporations seeking to raise capital by sale of new securities to public investors disclose all the underlying facts of their particular corporation, so that public investors are in a position to determine whether the securities to be offered meet their investment needs. In addition, this Act was designed to make unlawful the use of fraudulent devices to sell securities. Small businesses undertaking the issuance of new securities to the public will come in contact with the registration requirements of this particular statute.

In 1934, the Securities Exchange Act was passed. This Act created the Securities and Exchange Commission which is an independent federal regulatory agency composed of five bipartisan members. Each member is appointed by the President for a term of five years, by and with the advice and consent of the United States Senate. These terms are staggered, with one term expiring each year. The Commission is currently celebrating its 25th Anniversary as a regulatory agency. The 1934 Act requires that all national securities exchanges, of which there are now 14, register with the Commission, and that companies listed on these national securities exchanges similarly register and file annual, semi-annual and periodic reports. All listed companies

must file proxy solicitation material before stockholders votes are solicited. In addition, the Act requires that certain unlisted companies which have offered securities to the public pursuant to registration under the 1933 Act must undertake to file periodic reports. Under the Act brokers and dealers in securities must register with the Commission and file certain financial statements once in each calendar year.

In 1935, Congress passed the Public Utility Holding Company Act which was intended to regulate the public utility holding company systems. The purpose of this Act was the dissolution and simplification of large electric and gas holding companies which lacked physical integration as public utility systems. Today, there are some 18 systems containing operating companies with assets in excess of $10 billion.

The Trust Indenture Act was passed in 1939. This Act was meant to protect the public investors by requiring that certain protective features be incorporated in trust indentures and to insure that a degree of independence exists between the indenture trustee and the issuing company.

The last two acts that we administer were passed in 1940. The Investment Company Act regulates the publicly-held investment companies, including the mutual funds, and the Investment Advisers Act regulates persons who deal in investment advice to the public.

In addition to these six statutes, we act in an advisory capacity to the Federal District Courts in reorganizations under Chapter X of the Bankruptcy Act. As you can tell from this brief summary of the various acts which we administer, we are a "very busy agency."

The United States faces a period of tremendous economic growth within the next decade, growth which will necessitate vast sums of new capital. Small businesses will have to compete in this capital market with other enterprises seeking to gain their share of the investors' savings. From the very nature of things, they will be handicapped in their quest for these moneys because of the limitations of their size and the more advantageous terms that are to be offered by the large corporations. However, there are various ways that small businesses can compete, and the Securities Act of 1933 does grant small offerings certain advantages that are not offered to the large ones.

Let us take a hypothetical situation in order to present the problems which arise at the time when a company finds that it needs additional money. Assume for the moment that Small Business Company, Inc. finds itself in a position where it is necessary to raise some

additional funds. The president of the company calls in his attorney and chief financial adviser and presents the problem to them. The question then facing the attorney is the proper method of obtaining these additional funds.

The most obvious way of raising capital is, if the credit rating of the company so warrants, to go to a bank or other lending association and borrow the funds needed. Of course, obtaining money by these means would necessitate the fixed payment of interest charges in good or bad times. This can be a heavy burden for a small company struggling to grow and with only a slender margin left after taxes to plow back into operations. In times of economic hardship the requirement of interest charges could well throw a budding firm into bankruptcy.

With this in mind the attorney then looks for another method of raising the needed funds. Rather than enter into a loan with a financial institution, the company could issue debentures or other types of debt securities. This type of financing would entail the same disadvantages as the prior one unless the company were to issue income bonds. However, it is not always feasible or desirous for a company to issue this type of debt security.

The alternative to loan or debt financing is the sale of equity securities. One real fear that hinders executives of small firms from utilizing equity financing is their concern for keeping control of the business. They want to keep the company as their own -- to determine compensation, to deal with employees, to set prices, and in general to have flexibility of decision and be able to take risks if they so desire. Many executives feel that the sale of equity securities would, in effect, hinder their *modus operandi*. This fear is in most instances not warranted. The sale of stock to public investors does not in and of itself affect the control of the company. In fact, control is more likely to be diluted if a big minority interest is sold to one or two persons, rather than in the public market. By the use of equity financing there is no need whatsoever for management to divest itself of the majority interest of the company. They can still hold the reins for few companies would find it imperative to sell more than 49% of their stock interest, and if a greater percentage must be sold, practical control would very probably still exist. Therefore, equity financing does not in itself divest present management of their control position.

Having considered the various alternatives available, the attorney then advises the president of the firm that it would be advantageous to the firm for it to engage in equity financing. This

is the point at which the attorney comes in contact with the acts that we administer. Particular heed must be given to the requirements of the Securities Act of 1933. Section 5 of that Act sets forth the prohibitions relating to the offer or sale of securities in interstate commerce or by use of the mails. Among other things, it specifically makes it unlawful for any person to directly or indirectly sell a security by the use of any means or instruments of transportation or communication in interstate commerce or through the mails unless a registration statement is in effect. The provisions of Section 17 dealing with the fraudulent sale of securities in interstate transactions should be heeded in connection with any type of offering. This section is a blanket prohibition and applies to sales in interstate commerce whether or not a registration statement is required pursuant to the Act. There are basic exceptions to the Section 5 registration requirements of the Act and it is these exceptions that would be of prime importance to you who represent small businesses. Most important of these are the private offering exemption, the intrastate exemption and the exemption provided for in Regulation A.

The most commonly used exemption is referred to as the "private offering" exemption. Section 4(1) of the Securities Act exempts, among other things, "transactions by an issuer not involving any public offering." 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.

Neither the Act nor any SEC regulation defines what constitutes a public offering. The question of whether an offering is considered to be public is a question of fact in which all of the surrounding circumstances must be considered. The answer to this question, the Supreme Court has said, primarily depends upon the offerees' need of the protection afforded by registration. The number of persons to whom the securities are offered is not definitive and in fact an offering to a limited number may be a public offering. On the other hand, under this theory an offering may come under this exemption, even though there is a comparatively large number of offerees. An example recently used by the Supreme Court to illustrate this point is that of an offering of stock by a company to its executive personnel. The offerees, because of their positions have access to the same kind of information that the Act would make available in the form of a registration statement and therefore they would not need protection. The practical application of this principle is not always clear. The effect of the Supreme Court decision in SEC v. Ralston Purina Company is to limit the applicability of the exemption to those persons who have such knowledge of the beliefs and affairs

of the issuer as would be substantially comparable to that which would be provided by the registration process.

Another important factor in the determination of whether or not an offering is to be considered "private" is the size of the offering and the number of units offered.

The growth of private placements which is the placing of a sizable issue of securities with a comparatively few institutional investors would come under this private offering exemption. However, the placing of an issue with a relatively small group under circumstances which indicate probable reoffering and resale to a larger group would suggest the unavailability of this exemption. If the persons initially receiving the securities could be considered underwriters as the term is defined in Section 2(11) of the Act, no exemption would be available under Section 4(1) either for such persons or for the issuer. To combat this possibility the company usually requires the purchasers to furnish a written representation that they are taking for investment and not for resale. This is normally referred to as a letter of investment intent. The mere giving of such a representation is not conclusive but would be evidence to indicate that a private offering was intended.

At this point it might be helpful to illustrate the scope of the term "offer" as it has been developed in the courts. The highly publicized Arvida case relating to the financing and development of the extensive real estate holdings of Arthur Vining Davis in Florida is a prime example. There the Commission concluded that under the circumstances of that case a press release concerning Arvida constituted part of the effort to sell its securities and hence was an offer to sell. Since no registration statement had been filed at the time of this press release this "offer" was in violation of Section 5.

Incidentally, the offering of convertible securities or warrants presents problems in a proposed private offering. The initial purchaser in such case would have to acquire both the convertible securities and those into which they are convertible for investment and not for resale.

Section 3(a)(11) states what I shall refer to as the intrastate exemption. It applies to "any security which is 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." This exemption has developed, due to practical considerations, into an exemption primarily devoted to small issuers. In order to understand the scope of this exemption it is important to look to the wording of the section. This exemption

is available only for an "issue" offered and sold to local residents. The entire issue of securities must be offered and sold exclusively to residents of the state concerned. If another "offering" occurs simultaneously with, prior to, or subsequent to, this offering, the offerings might be considered integrated and thereby prohibit the use of the intrastate offering exemption.

This section requires that the issuer be "doing business within the state." "Doing business" is interpreted to mean that substantial operational activities must be in the state of residence. It is not sufficient that the bookkeeping, stock reporting and other similar functions normally incident to being incorporated in the particular state are carried on there.

The exemption further requires that the financing be confined to a single state in which all the offerees, the purchasers and the issuers are resident. Insofar as the corporation is concerned its residence is determined to be the state of its incorporation. If any part of the issue is sold to persons non-resident or who take securities with a view to their ultimate distribution outside the state and do so in fact distribute them, the exemption for the entire offering will be unavailable.

The exemptions I have previously referred to require no filing with or action by the Commission. However, 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. There has been a good deal of discussion in recent years as to the advisability of raising this $300,000 figure to $500,000. In fact, bills have been introduced in Congress to effectuate this change. Congress recently enacted a new Section 3(c) which authorizes the Commission to adopt rules and regulations exempting the offering of securities by small business investment companies organized or licensed under the new Small Business Investment Company Act of 1958. The Commission has recently adopted rules under this section which are intended to effectuate the purposes of the Small Business Investment Company Act by providing an exemption from our Acts if certain conditions are met.

The principal exemption of Section 3(b) which is currently of interest to small business is that provided by Regulation A. This exemption has been in effect for a number of years. 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 were 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 the suspension order under Regulation A or have been convicted of or enjoined against certain conduct.

Regulation A requires the issuer to prepare and file with the Commission what is termed as a "notification." This document is in a realtively simple prescribed form and must set forth certain specified information in order that the Commission can determine whether the exemption is available. Certain exhibits must accompany this notification. Regulation A further requires that an offering circular be used in connection with the sale of securities offered thereunder except in certain situations. This offering circular is usually the first written sales material which may be presented to the investor in connection with the offering of the security. It must 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 for the securities. The preparation of the notification and offering circular should not be a heavy burden for the small business. The information required is described in the rule and is readilly available to the company desiring to use the regulation. To illustrate the increased use of this Regulation A exemption, it should be noted that in the period January 2 to October 8, 1959, there were 700 filings under Regulation A for a total dollar value of $145,776,298. In the comparable period January 3 to October 9, 1958, there were 543 filings for a total value of $102,784,187. These figures clearly indicate the scope to which this Regulation A exemption has been utilized.

In order to facilitate filings under Regulation A and to assist small business and their counsel, our rules provide for the filing of the necessary papers in one of our Regional Offices. The bulk of your filings under this exemption would be in our Boston Regional Office. I sincerely urge you to make use of the facilities which the Commission has both in its Boston and New York offices in order that you may protect yourselves and your clients in dealings which you may undertake with public investors. The SEC maintains a staff in Washington and in the regional offices who are there to advise you as to the application of the various statutes which we administer and the scope of the exemptions pertaining thereto. I believe that your utilization of the staff will help to prevent inadvertent as well as technical violations of the law. The statutes are technical and require a good deal of concentrated effort on the part of persons interpreting them in order to insure that compliance will be had and that our work will be made easier and your offerings will be made promptly to the public.

Having examined the exemptions offered by the Act, our hypothetical attorney decides that none of them would be available for his particular client. Since he has already determined that equity financing would be the solution to his company's financial ills, he must register under the Act. Registration of the securities requires the filing with the Commission of a registration statement. This statement is composed of two parts. The first part is the prospectus which describes the company, its business and property. It sets forth the proposed use of the money from the sale of the securities, the company's capital structure, its management and principal stockholders. It also includes certified financial statements. The second part of the registration statement sets forth detailed information concerning such things as the underwriting arrangements, expenses of the issuance and distribution of the securities, historical financial data and other matters. Various exhibits must be filed to accompany the registration statement. The basic theory underlying this statement is full disclosure.

After it is prepared the statement is filed with the Commission in Washington, D. C., where it is reviewed by the staff. If any deficiencies are noted in the papers filed, the staff notifies the issuers and asks that appropriate amendments be submitted. When the staff has been satisfied that full disclosure has been given, the registration statement is cleared.

The time needed to clear the registration statement varies with the particular offering involved. The Commission has been literally swamped with registration statements and has been handicapped by the limited number of employees available. During the fiscal year ending June 30, 1959, there were 1,226 registration statements filed for a total dollar value of some $16.6 billion. We see no let-up in this volume in the immediate future.

As a word of caution I should add that the requirements of our statutes are in addition to the requirements of the state blue sky laws. Therefore, it is imperative that you check your local laws to insure against any possible violations.

In conclusion, let me reiterate that in my opinion the charge that the Securities Acts have tended to impede small businesses in obtaining the capital necessary for their development is completely unfounded. It is true that our requirements are complicated and must be met, but in light of the numerous exemptions available, small businesses may still compete in the public markets and take advantage of the ever-growing desire of the public to invest in the

capital markets. I have tried to show that it would be advantageous for small businesses to engage in equity financing rather than in the issuance of loan or debt securities. You, as attorneys who represent small businesses, should acquaint yourselves with the various statutes that we administer so that you will be in a better position to advise your clients when the problem of raising additional capital arises. You could then take advantage of our statutes, our exemptions and our assistance in any public offering that might be contemplated. By means of a thorough understanding of our role in the capital formation process you will be able to better serve your clients, your communities and our Nation.

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