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**News  
Release**

**SMALL ISSUER DISCLOSURE POLICY AND  
THE FRINGES OF "MERIT REGULATION"**

**Remarks To**

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State-Federal-Provincial  
Cooperative Securities Conference**

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The views expressed herein are those of Commissioner Cox and do not necessarily represent those of the Commission, other Commissioners or the staff.

It is a pleasure to again address the Rocky Mountain State-Federal-Provincial Securities Conference. In my talk here last year, I looked at the Commission's enforcement program and our efforts to design remedies that make it clear to the public that the SEC means business. I also discussed the particular impact of this policy in the "penny stock" and small-issue areas of more local interest.

Today, I would like to provide a brief update in this enforcement area, and then turn to another major area at the Securities and Exchange Commission, namely, our Full Disclosure Program. Developments in this field -- both in the areas of initial registration and periodic reporting -- will have a significant impact on small issuers and penny stocks.

#### ENFORCEMENT REMEDIES: ONE YEAR LATER

When I spoke here last year on the topic of "Making the Punishment Fit the Crime," I indicated that perhaps it was time for the Commission to look anew at different types of remedies in enforcement cases, such as fines, bars and other penalties. Since that time, there have been developments in four areas which I believe constitute a good "update" on where the Commission stands today.

First, in the area of fines, the Commission is beginning to accumulate experience in assessing fines -- a new power under the Insider Trading Sanctions Act of 1984. The Act allows the Commission to seek a penalty of up to three times the profits gained or loss avoided by an individual trading securities while in possession of material nonpublic information. Fines have been imposed in at least sixteen cases since the Act became effective, ranging from \$15,000 to \$800,000. The Commission has wrestled with many different factors in determining the appropriate "multiple" of profits to be sought as a penalty. In most instances, the penalty sought in addition to disgorgement has been the amount of the profit, or a "one times" penalty. However, I do not believe that this constitutes any sort of precedent, so that an observer could say that "the rule of thumb is that the Commission will seek a penalty equal to the profits." Rather, I believe this record is a result of the staff's efforts to proceed cautiously in this new area. While we do believe that there can be cases where the defendant's conduct is sufficiently egregious that the full "three times" penalty would be appropriate, in some cases this inquiry may be foreclosed because the defendant's assets are limited. The Commission remains committed to applying economic principles of deterrence under the Insider Trading Sanctions Act.

The Commission considered the adoption of fines in another area, in response to proposed legislation. Senate Bill 1382, proposed in this last session of Congress, would have tightened the filing deadlines for reports of sales of securities by insiders, and in addition, would have imposed a mandatory \$50,000 fine for each failure to comply. Although I am not opposed to the idea of fines for securities law violators, in this case I believed that the large nondiscretionary fine would simply have been unworkable. The Commission sent the Senate Committee considering the bill a report and recommendation that it not be passed. However, I believe that this proposal is an encouraging indication that the idea of expanding the use of fines as a remedy is beginning to catch on.

Second, in the area of bars, I note with some regret that the Commission continues to pursue the remedy of a bar from office in public companies for certain securities law violators. This remedy has been accepted in at least two settled cases since I spoke here last year, and the staff has been authorized to seek it in several others. I have indicated before my belief that disclosure should be the remedy of preference. In this area, unlike regulation of brokers, investment companies, advisers, or even public utilities, the Commission does not endorse the idea of "merit regulation," but usually relies on disclosure. I see no need to depart from that principle here. In a recent review of Commission enforcement remedies, one commentator noted that

Congress' affirmation of the use of a system of disclosure to bring about responsible corporate conduct \* \* \* weighs against the propriety of using bars to banish individuals from corporate offices and boards. 1/

I'll be discussing this idea of merit regulation versus disclosure outside of the enforcement context in greater detail shortly, for I believe it is an important distinction.

Third, in the area of contempt, I note with some encouragement that statistics have improved markedly since this time last year. Then, I reported to you that the number of contempt cases brought by the Commission in 1985 had sunk to three civil and no criminal contempt cases. In

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1/ Howland, The Insider Trading Sanctions Act of 1984: Does the ITSA Authorize the SEC to Issue Administrative Bars?, 42 Wash. & Lee L. Rev. 993, 1011 (1985).

1986, the fiscal year just ended, the Commission filed sixteen civil and criminal contempt cases; in the seven which are criminal contempt cases, four have led to convictions either by trial or by plea, and at least two of those to imprisonment. 2/ I believe this is the clearest indication possible that the Commission is taking its injunctions seriously.

Fourth, in the area of disgorgement, the Commission recently debated the effects of income tax benefits on the amount of damages to be recovered. Although this problem does not arise in cases brought by the Commission, recent private litigation involving tax-shelter investments squarely presented this policy issue. In the Randall v. Loftsgaarden decision, 3/ the Supreme Court took the position recommended by the Commission: that no "offset" of damages should be allowed defendants in suits for rescission under the Securities Act. The majority held that

the mere fact that the receipt of tax benefits, plus a full recovery under a rescissionary measure of damages, may place a \* \* \* plaintiff in a better position than he would have been absent the fraud, does not establish that the flexible limits of [remedies under the securities laws] have been exceeded. \* \* \*. Any residual gains to plaintiffs \* \* \* emerge more as a function of the Internal Revenue Code's complex provisions than of an unduly generous damages standard for defrauded investors. 4/

The Randall case was important to the Commission even though it didn't involve the enforcement program. The Commission pointed out in its brief that

[i]n a recent year, about two-thirds of the \* \* \* private offerings made under SEC Regulation D were limited-partnership, and thus presumably tax-shelter, ventures. Given this volume of offerings, the SEC lacks the resources to ensure that fraud in the offer or sale of tax-shelter

2/ These are preliminary figures prepared by the staff. These are subject to final revision and may differ slightly from the figures which will appear in the Commission's 1986 Annual Report.

3/ 106 S.Ct. 3143 (1986).

4/ Id. at 3153-54.

investments will be detected and prosecuted. Private damage actions under the federal securities laws are thus a necessary supplement to the Commission's enforcement activities. 5/

These examples show that in many important areas, the Commission is considering new remedies -- or reconsidering old ones -- in designing an effective program for the enforcement staff and for private parties to redress violations of the federal securities laws.

#### DISCLOSURE AND SMALL BUSINESS

With that enforcement update, I'd like to turn now to a different topic: the Commission's Full Disclosure Program, particularly as it relates to small issuers. This is an area of great significance, because 1986 is turning out to be a "bumper crop" year for small issuer initial public offerings. So far this year, the number of filings with the Commission's regional offices on Form S-18 was 60 percent higher than the same period in 1985. 6/ Although this doesn't appear to be as frenzied as the 1983 "hot issues" market, it could be characterized as at least very warm. Recent news articles have focused on the strong attraction of small businesses to public money, which in turn is bringing them in increasing numbers to the penny stock market. 7/ This may be due in part to the recovery of the penny stock market from the so-called "tailspin" of firm failures and investigations that began in 1984. 8/ In addition, the small-issue explosion appears to be a

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5/ Brief for the United States and the Securities and Exchange Commission as Amici Curiae in Support of Petitioners at 1-2, Randall v. Loftsgaarden, 106 S.Ct. 3143 (1986).

6/ Figures are for the eleven months ending August 31, 1986. See supra note 2.

7/ See Taking it to the Street: Going public can mean debt-free financing, but there are other costs to consider, Wall St. J., May 19, 1986, at 31D, col. 1.

8/ See Playing with Pennies: For small companies seeking a quick infusion of cash, the penny market may be the answer, Id. at 35D, col. 1.

successful export, as more funds have been raised in the Vancouver market and among private investors in Europe. 9/

I noted briefly earlier that the Commission historically relies on disclosure when dealing with issuers and traders of securities. The idea of "merit regulation" -- that some securities simply shouldn't be sold to anyone even if they want them -- exists in the regulatory schemes in some states, but is not part of the plan under the federal securities laws. Nonetheless, when the Commission applies its full disclosure mandate to small issuers, it may begin to look a little bit like merit regulation, and hence the Commission in certain instances may find itself on the "fringes" of merit regulation. For example, when a new issuer is making its first public offering, there may be no business of substance to disclose. The Commission faced this problem in some recent cases in the Salt Lake City area, where it initially appeared that full disclosure, even rigorously applied, still didn't tell the public very much about the securities being offered. A related phenomenon was noted by the Commission in its report on the "hot issues" market of 1983: "[d]uring hot issues markets, issuers are aware that the marketing of securities rarely is hampered by adverse disclosure." 10/ And in the area of periodic reporting by small issuers, the opposite problem surfaces: full disclosure, rigorously applied, may be burdensome. The Commission recently loosened the periodic reporting requirements for small issuers, and invited public comment on whether the thresholds for periodic reporting should be redesigned to be less onerous for small issuers while at the same time providing adequate disclosure to investors.

In each of these examples, the Commission faced decisions to treat small issuers differently only because they are small issuers. Uniformly applied policies of full disclosure don't do the whole job when small issuers are involved -- and thus I believe this brings the Commission to the "fringes" of merit regulation. Let's look at each area -- disclosure in initial public offerings and periodic reporting -- in more detail.

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9/ European Investors Again Flock to Buy Initial Offerings of Small U.S. Firms, Wall St. J., Jul. 31, 1986, at 29, col. 2; A Capital Idea: Small Firms Tap Northern Market, Id., Mar. 11, 1986, at 33, col. 2.

10/ Report of the Securities and Exchange Commission Concerning the Hot Issues Markets 41 (August 1984).

Initial Public Offerings of Small Businesses

One of the most difficult issues in small business public offerings is the so-called "blank check" offering. Typically, such an offering involves a small amount of capital being sought by a group of promoters who have only a vague idea of what they want to do with the proceeds of the offering. As I noted above, the rate of small issue filings in 1986 is about half-again that of 1985, and many fall into this category.

A recent series of cases involved about twenty offerings on Form S-18 and under Regulation A by Utah issuers filed with the Commission's Denver Regional Office. Although there was minimal disclosure, each filing was in apparent compliance with the requirements of Form S-18 and Form 1-A. There was little disclosure because there was little or no preexisting business involved. However, because of factors common to all the filings, the staff investigated further and found what it has alleged to be material omissions and misrepresentations in each of the filings. In particular, the staff alleged that the issuers failed to disclose the existence of an individual acting as a promoter of all the offerings, and that the audits of each issuer were not performed in accordance with Generally Accepted Auditing Standards. The staff requested and the Commission authorized stop orders in the case of the S-18 registration statements 11/ and temporary suspensions in the Regulation A offerings. 12/

It appears to me in cases like this, we may be regulating the small issuer differently for reasons

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11/ D. Swanson Barrell Enterprises, Inc., L.H. Beaslin Enterprises, Inc., Pompeii, Inc., New Order Technology, Inc., Peter Gun, Inc., 101 Inc., 102 Inc., 103 Inc., 104 Inc., 105 Inc., 106 Technology, Inc., 107 Inc., Securities Act Release No. 6657, 36 SEC Docket 977 (Sept. 17, 1986).

12/ Abbate, Inc., Securities Act Release No. 6658, 36 SEC Docket 978 (Sept. 17, 1986); Kevin D. Oakes Enterprises, Inc., Securities Act Release No. 6659, 36 SEC Docket 979 (Sept. 17, 1986); Tobin F. Cowley, Inc., Securities Act Release No. 6635, 35 SEC Docket 744 (Apr. 4, 1986); Thomas J. Kearl Enterprises, Inc., Securities Act Release No. 6636, 35 SEC Docket 745 (Apr. 4, 1986); Ramras, Inc., Securities Act Release No. 6637, 35 SEC Docket 746 (Apr. 4, 1986); Brian V. Hanson Enterprises, Inc., Securities Act Release No. 6638, 35 SEC Docket 747 (Apr. 4, 1986).

attributable only to its size. In effect, the Commission might appear to be saying "even with full disclosure, we may choose to investigate further before allowing your registration statement to become or remain effective, solely because it is a blank check offering, and we suspect there may be more going on behind the scenes." This would pose a dilemma for the small issuer that may amount to merit regulation by the Commission. Now, I'm not saying that this is the case with the filings which I just described. The Commission has only authorized proceedings as of this date, and I have not had occasion to further consider those cases nor form any opinion on the merits. But as a general matter, you can see that the small issuer with no operating history poses a small problem.

Although this policy problem exists where there is a full-disclosure filing made with the Commission, it is less of a question when an offering is made in reliance on a "non-filing" exemption. For example, the Commission recently filed a brief in a private case before the Tenth Circuit. 13/ The case, arising in Utah, involved a "blind pool" offering made in reliance on the intrastate exemption from registration. In a previous enforcement action, the issuers had consented to an injunction against violations of the registration requirements. 14/ However, in the ensuing subsequent private litigation, the issuers successfully established an intrastate exemption in the District Court. 15/ The Commission argued on appeal that, because the proceeds were only held within the state before being put to use outside the state, the intrastate offering exemption did not apply. 16/

In addition to dealing with the extent of disclosure made under our rules and regulations, the Commission has

13/ Busch v. Carpenter, No. 84-2501 (10th Cir., filed Oct. 26, 1984).

14/ SEC v. Mason Oil Co., No. C83-1169A (D. Utah, filed Oct. 17, 1983). See Litigation Release No. 10594, 31 SEC Docket 1078 (Nov. 7, 1984).

15/ Busch v. Carpenter, 598 F. Supp. 519 (D. Utah 1984).

16/ Brief of the Securities and Exchange Commission Amicus Curiae at 17, Busch v. Carpenter, No. 84-2501 (10th Cir., Filed Oct. 26, 1984). The Commission also argued that the intrastate exemption did not apply because the securities sold did not "come to rest" within Utah, and because the issuer was not "doing business" in Utah. Id. at 7-16.



undertaken several initiatives to redesign the forms used. Just yesterday, the Commission approved certain modifications to Form D which will enable issuers to file the same form with the Commission and with certain states, and removed the semi-annual updating and notice of final sale requirements. 17/ The release adopting these changes notes that they "mark a continuation of the Commission's efforts to reduce the costs of capital formation for issuers and to promote uniformity between federal and state regulation." 18/ Although we did not receive specific data on the cost savings of this change, the release does note that the final filing requirement accounted for about 37 percent of all the Form D filings in 1985. 19/

These are important and necessary changes in the Commission's administration of Regulation D, but I would note that there are other commentators who have suggested that we should go even further in loosening requirements, and should reexamine the ban on general advertising, resale restrictions and the integration doctrine. Last week, the Commission concluded its Fifth Annual Government-Business Forum on Small Business Capital Formation in Washington. One item on the agenda was the reexamination of Regulation D. The recommendations adopted by the Forum in this area include:

- removing certain restrictions on general solicitation and advertising;
- removing the requirement for audited financial statements or the substitution of clear standards of materiality;
- raising the dollar and investor number limitations on the use of Regulation D; and
- expanding the definition of "accredited investor" to include more individuals.

Non-exempt filings by small issuers have also received attention as the Commission continues to monitor experience with Form S-18. This area, too, was the subject of debates and recommendations at the Small Business Forum. A background report in this area presented by the staff noted that Form S-18 has become the form of choice in small issue

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17/ Securities Act Release No. 6663 (Oct. 2, 1985).

18/ Id. at 2.

19/ Id. at 7.

filings. Despite this widespread acceptance, the Forum participants discussed ways to make S-18 even more cost-effective. They adopted recommendations intended to increase the availability and usefulness of Form S-18, including:

- increasing the amount which can be raised on Form S-18 from \$7.5 million to \$10 million;
- streamlining the disclosure requirements, and clarifying that both the disclosure and liability levels should be lower.

These concerns coincide with a recent study of the experience of attorneys, underwriters and accountants with Form S-18. <sup>20/</sup> One conclusion of the study was that a majority of those professionals surveyed believe that the disclosure provided protects those involved in issuing securities more than it protects the investing public, and that the main benefit of Form S-18 was not the lesser amount of disclosure required, but rather the flexibility of filing with the Commission's regional offices. Although other benefits were suggested, these were characterized by the respondents as mostly "psychological." It's nice to hear that small issuers feel so good about filing Form S-18. However, this misses the point of the Commission's efforts in this area. Form S-18 is not designed as a convenient way for securities professionals to simply copy their best Form S-1 boilerplate in a regional-office filing. Experience with Form S-18 suggests that issuers may be piling on more disclosure without necessarily providing more information.

#### Periodic Reporting and Small Business

Assuming that the Commission successfully resolves all these issues, and small businesses can raise public funds in cost-effective ways consistent with principles of investor protection, we've only won half the battle. There remain significant issues in the area of periodic reporting which I would like to discuss.

This summer, the Commission adopted a rule change loosening somewhat the requirements for periodic reporting under the Securities Exchange Act by increasing the total

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<sup>20/</sup> Arnold and Hopkins, Small Firm Securities Registration in the S-18 Era: Perceptions of Professionals, 8 Corp. L. Rev. 135 (1985).

assets threshold from \$3 million to \$5 million. 21/ The staff estimated that this would relieve about 400 issuers of their periodic reporting obligations. 22/ At the same time, the Commission issued a concept release seeking public comment on various other ways to modify the periodic reporting system to more closely match reporting requirements with investors' need for information. 23/

When this action was taken, I questioned whether the initial step should be taken if we were considering redesigning the entire system. In other words, if the Commission was tacitly admitting that total assets and shareholder size may not be the best measures of which companies should be required to file periodic reports, then perhaps they ought not be modified even as an interim measure, so that the staff and the public would concentrate on the larger issue. However, I was assured that the intermediate step of increasing the total-asset threshold was beneficial and still maintained appropriate levels of investor information and protection.

Experience to date has indicated that there was some merit in my concerns. The period for public comment on the Commission's concept release expired this week, and the public file was not exactly brimming with comments. I submit that if the Commission had not taken the interim step, public interest in the subject would have remained high.

Among the options being considered by the staff is a multiple-classification system based on trading activity, number of shareholders, and the type of security about which information is sought. One possibility is that a "tiered" system may be adopted, like that now in use for Forms S-1, S-2 and S-3, although with different criteria. 24/ These issues were discussed at the Small Business Forum, and the participants recommended that the Commission:

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21/ Securities Act Release No. 6652, 51 Fed. Reg. 25,360 (1986).

22/ Id. at 25,361 n. 13.

23/ Securities Exchange Act Release No. 23407, 51 Fed. Reg. 25,369 (1986).

24/ Id. at 25,370.

- create a second tier of issuers, perhaps those who have made offerings only on Form S-18 or under Regulation A, who would not have increased disclosure requirements for their periodic reports; and
- provide a reduction in or exemption from periodic reporting for issuers with little trading volume.

As we consider modifications in this area, I believe that several concepts should be kept in mind. First, the public interest requires that even small issuers make periodic reports. Especially where there is not a robust trading market, investors must have relevant information about securities in order to be protected in their trading. Second, we should remember what Louis Brandeis said about sunlight and electric light -- they perform very effective deterrent functions. There is no small issuer exemption from the antifraud provisions. Effective enforcement of these provisions requires that information be available, not only to encourage truthfulness but also to discourage subterfuge. And finally, the disproportionate cost of disclosure, often cited by critics of small-issuer periodic reporting, is not an anomaly unique to our industry. It is simply a consequence of arithmetic. All fixed costs bear proportionately more heavily on small organizations. But the reason these costs are considered "fixed" in the first place is that their benefits presumably cannot accurately or appropriately be measured on a per-unit basis. Focusing on reporting costs per shareholder ignores the important deterrent and market confidence impact of that disclosure. I would hope that these concepts are not lost on the public and the Commission as we consider limiting further the number of issuers required to file periodic reports.

#### CONCLUSION

In summation, I note that the 1980s have brought together two popular perceptions that bode well for small business. First, people have the idea that "smaller is better." Second, the general attitude of business people and others seems to be to vigorously seek more growth -- a true entrepreneurial spirit. I do not believe that it is the Commission's charge to smother the fires of innovation and entrepreneurship in the name of investor protection. Rather, we should seek to provide an environment where both innovators and those whose money finances the innovations can proceed with confidence in the system.