SECURITIES LAW PROBLEMS OF THE SMALL BUSINESS ENTERPRISE

VIEWPOINT OF THE S.E.C.

Remarks by

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When a small business "goes public" the role of the Commission, for the most part, is to administer the registration provisions of the Securities Act of 1933 and the registration and reporting requirements of the Securities Exchange Act of 1934.

Certainly most of you are familiar with the basic purposes of the Securities Act of 1933: That Act is designed to prevent fraud in the offer and sale of securities to the public, and to provide disclosure to investors concerning securities offered for public sale thus enabling them to make an informed investment decision. Disclosure is obtained by requiring the issuer of securities offered for public sale to file a registration statement with the Commission describing the company and its operations, and including required financial statements and other data; this registration statement is available for public inspection as soon as it is filed. A prospectus which is a part of and contains the most significant information in the registration statement must be furnished to investors to enable them to evaluate the investment worth of the securities offered by the issuer.

Congress specified the information required in the registration statement and prospectus of a corporation or other private issuer, and authorized the Commission to prescribe appropriate forms and to vary the information requirements of registration statements and prospectuses. The Commission has prepared registration forms which vary in their disclosure requirements according to the nature of the issuer and the securities offered. In addition, the Commission through the years has issued rules and releases in a continuing process in an effort to inform the practitioner and the staff as to the Commission's views concerning the registration procedure and disclosure matters. For example, late last year the Commission issued a release on the registration process which contains the policies and practices followed by our Division of Corporation Finance in administering the registration requirements of the Act.1/

When a small business "goes public, " it is exceedingly important that the managers of the small business, its counsel and its accountants become fully acquainted with the Commission's releases and the substantial body of material on the registration process prepared by practitioners in the legal and accounting fields, particularly in view of the volume of Securities Act filings with the Commission.

During fiscal year 1969, the number of Securities Act registration statements filed with the Commission soared to a record 4,706. Compared with the 1968 figure of 2,906 registration statements, this represented an

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1/ Securities Act Release No. 4936 (December 9, 1968).

increase of 62% in the number of statements filed. Incidentally, 1968 was also a record year and the number of registration statements filed in that year increased 58% over 1967. Furthermore, there has been a striking increase not only in the number of filings, but also in the number of first time filings which ordinarily consume more time in the examination process. Of the registration statements filed in the 1969 fiscal year, 2,450, or over 50%, were filed by companies that had not previously filed a registration statement under the Securities Act.

The Commission's Division of Corporation Finance is responsible for the examination of all Securities Act registration statements except for Securities Act statements filed by investment companies which are examined by the Division of Corporate Regulation. In spite of the tremendous increase in filings, there were, on the average, approximately 15 less people employed in the Division of Corporation Finance in fiscal year 1969 than in fiscal year 1968.

As you might expect, with a substantial increase in the number of statements filed, coupled with a decrease in the number of people available to examine the statements, the time elapsed from the date of original filing to the effective date has also increased. In the 1968 fiscal year, the median number of calendar days from the date of original filing to the effective date was 44. In the 1969 fiscal year, the median number of calendar days from the date of original filing to the effective date was 65.

In November 1968, as the backlog of registration statements to be processed reached a record high, the Commission initiated procedures designed to cut the volume of the backlog and decrease the median processing time for registration statements filed under the Securities Act.2/ Under these provisions, a senior officer of the Division of Corporation Finance will briefly review every registration statement as it is filed. Based on this review, the reviewing officer, in essence, will make one of the following decisions:

1. That the registration statement is so poorly prepared or entails problems so serious that the staff will not review the statement. Counsel receives notice of this decision by letter, and he is requested to give consideration to the filing of an application for withdrawal of the registration statement.

2. That the staff will make only a cursory review of the registration statement and will provide no written or

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2/ Securities Act Release No. 4934 (November 21, 1968).

oral comments. This procedure is sometimes referred to as expedited treatment. The chief executive of the registrant, counsel, the auditors and the managing underwriter are requested to represent that they are aware that the staff has made only a cursory review of the registration statement and that they are aware of their statutory responsibilities under the Securities Act.

3. That the filing will be subject to the regular review process.

It is clear that an essential element in making this screening process work is a properly prepared registration statement. Thus, it is equally clear, as I have already noted, that the persons charged with preparation of the registration statement must fully familiarize themselves with all aids to the proper preparation of their undertaking. Incidentally, throughout this discussion I am assuming counsel is totally familiar with the company and other matters to be described in the registration statement. Absent this familiarity, counsel cannot possibly execute his task satisfactorily.

Since many registration statements, in particular first time filings, undergo the regular review process, and, since the small business going public will be filing for the first time, it is pertinent to refer briefly to the examination process.

Registration statements must be filed at our Office of Company Filings in Washington, D. C. Generally, first time filings are assigned to a branch of the Division of Corporation Finance by rotation, except that if a particular branch has participated in a prefiling conference in regard to the registration statement, the statement may be assigned to that branch. One or more of the attorneys, accountants and examiners in the branch will review the statement for compliance with the Commission's standards on disclosure. In the event the statement is deficient in some material respect, the registrant will be notified, usually by letter, and afforded the opportunity to correct the deficiency by amendment. In most cases, the registration statement is amended promptly in response to the Division's comments and declared effective thereafter in accordance with the Act and the rules thereunder.

The Commission in announcing the expedited review procedure in November 1968 suggested certain measures to reduce the backlog of registration statements which merit particular mention in the context of the examination process, although they apply whether or not a statement will be subject to regular review. Thus, counsel for the issuer, the issuer's accountants and any other persons responsible for the filing are urged to cooperate with the staff in pinpointing trouble spots in the

filing. This step should be taken in the letter of transmittal, obviously, to facilitate the screening process as well as any subsequent examination. In addition, the issuer's representatives are urged to exercise restraint in communicating with the staff, in person or by telephone, as, clearly, such communications interrupt and delay staff examination of pending statements.

Concerning communications with the staff regarding registration statements, I should mention that the staff is not equipped to conduct a prefiling review of a registration statement. The staff will participate, however, in a prefiling conference when representatives of the issuer need help with a significant specific problem. But, here again, even when specific problems are involved, representatives of the issuer are urged to exercise restraint in seeking prefiling conferences.3/

One further point related to the registration process: the statutory scheme of the Securities Act clearly envisions that an offering may be made only by a prospectus meeting the requirements of the Act when an issuer's securities are in registration. As a result, as most of you are well aware, the issuer's management, counsel and underwriters must impose certain limitations upon publicity to avoid violations of the Act and possible civil liabilities.

It is not necessary to go into the so-called "gun jumping" problem in this discussion. It is sufficient to highlight the problem for the small business "going public," since in recent years the "gun jumping" problem most often arises when a company whose securities are publicly traded files a registration statement for additional securities. In that context there are difficulties involved in striking a balance between the interests of those persons who presently own the issuer's securities -- and are entitled to information concerning the issuer -- and the interests of those persons who would purchase securities of the issuer in a registered offering. As most of you know, Chapter V of "Disclosure to Investors -- A Reappraisal of Federal Administrative Policies under the '33 and '34 Acts," better known as "The Wheat Report," discusses "gun jumping" in detail, and I commend that chapter, and for that matter the entire report, to your attention. 4/

3/ Securities Act Release No. 4950, issued on February 20, 1969, is illustrative of the kind of problem that may precipitate a prefiling conference; it is also an example of the Commission's continuing effort to help issuers over the hurdles of the registration process. That release sets forth matters to be considered by the Commission in determining whether relief should be granted from the Form S-1 requirement for certification of financials of companies acquired or to be acquired with the proceeds of an offering. Release No. 4950 was prompted by numerous requests for relief from such certification requirements.

4/ In addition to "The Wheat Report," on the subject of "gun jumping" generally, see Securities Act Release Nos. 3844 (October 8, 1957) and 5009 (October 7, 1969).

The Commission recently issued a proposal to adopt the rules and amendments -- with some minor revisions -- recommended by The Wheat Report in regard to "gun jumping."5/ It should also be noted that the Commission recently has implemented policies designed to promote the delivery of preliminary prospectuses to prospective purchasers prior to the effective date of a registration statement. 6/

As a result of a number of exemptions in the Securities Act, certain securities and transactions are not subject to the registration and prospectus requirements of the Act. The principal exemptions of interest to the small business seeking public funds are the exemptions for intrastate and Regulation A offerings.

The intrastate or local offering exemption found in Section 3(a)(11) of the Securities Act appears deceptively simple; and, therefore, it is widely misunderstood.

The legislative history of Section 3(a)(11) and decided cases clearly indicate that the exemption is designed to apply only to local financing; that is, the securities offered must be part of an issue that is offered and sold only in the state where the issuer is resident and doing business. The exemption is unavailable if any portion of the offering is offered or sold to non-residents of the jurisdiction involved.

Similarly, the exemption is only available when the issuer, if a corporation, is both incorporated in and doing business in the state where the offers or sales are made. Although the issuer need not be doing business exclusively within the state, it is clear that the securities offered or sold may not represent an interest in a business which is predominantly out-of-state in character. One final point of special interest here in the Southwest on the so-called "doing business" concept is that the property in which fractional undivided interests in oil, gas or other mineral rights are to be offered or sold should be located also in the particular state involved. In this connection, in a recent case sales to Michigan residents by a Michigan promoter of fractional undivided interests in oil and gas leases on land located in Ohio did not qualify for the intrastate exemption.7/ Although the promoter maintained offices in Michigan, he was not "doing business" in Michigan within the meaning of the Securities Act, since the income producing properties in which the promoter sold securities -- that is, the oil and gas operations -- were located in Ohio.

5/ Securities Act Release No. 5010 (October 7, 1969).

6/ Securities Act Release No. 4968 (April 24, 1969).

7/ Chapman v. Dunn 414 F.2d 153 (C.A. 6, 1969).

The intrastate exemption does not depend on non-use of the mails or the facilities of interstate commerce. Securities issued in a transaction properly exempt under Section 3(a)(11) of the Act may be offered and sold through the mails or by telephone, or through advertisements -- provided, of course, in the case of advertisements that the advertisement indicates the offers and sales are limited to the residents of the state involved.

The intrastate exemption does not depend upon the amount of capital being raised; however, that factor is central to the availability of the Regulation A exemption. Perhaps the most important exemption from the standpoint of the small business, Regulation A affords an exemption for small public offerings of securities if the amount to be raised is $300,000 or less.

The maximum amount of securities which may be offered under Regulation A is $300,000, computed in the manner specified in Securities Act Rule 254. For our purposes, it is sufficient to mention that this maximum may be diminished by a variety of circumstances.

From time to time, bills have been introduced in Congress to raise this maximum. In fact, there is a bill pending in Congress that would amend the Securities Act to increase the maximum to $500,000. 8/ The Commission is supporting the current proposal.

There are two points concerning the economics of Regulation A that are of interest to the small business: First, under Regulation A the financial statements of the issuer need not be certified by an independent public accountant. Second, there is no filing fee or registration fee in connection with Regulation A. In both instances, the rationale is that in small offerings the issuer should be able to avail itself of a simplified and less costly procedure than a full registration.

Under Regulation A, the issuer files a notification rather than a registration statement, and the basic disclosure document is called an offering circular instead of a prospectus. The notification required is less complex than a registration statement, and the requirements stated in the rules for the offering circular are less comprehensive than those for a prospectus; however, the basic concept of full and complete disclosure is just as applicable in a Regulation A offering as in any other offering.

8/ S. 336, 91st Cong., 1st Sess. (1969).

The filing of this notification and offering circular, together with whatever exhibits are required, is made with the Regional Office of the Commission for the region in which the issuer's principal business operations are conducted or are proposed to be conducted, rather than in our Washington, D. C. office as in the case of full registration. Filing must take place at least 10 days prior to any offering of securities. No sale may be made unless the purchaser has received the offering circular in compliance with Securities Act Rule 256; further, there is no provision in Regulation A for offers prior to expiration of the 10-day waiting period. It should be mentioned that after the mere lapse of 10 days following the filing of a notification, the issuer may begin to sell; however, since material filed under Regulation A is examined in the Regional Office to determine whether the exemption is available and whether required disclosure standards have been met, the issuer would be well advised to wait for a comment letter from the Regional Office before beginning to sell.

The Commission may order a temporary suspension of any Regulation A exemption if, among other things, it has reason to believe that the exemption is not available to the issuer, or that the notification, offering circular or sales literature contains false or misleading statements, or omits to state material facts. Upon entry of a suspension order, the issuer and any other person on whose behalf the notification was filed is notified and is given opportunity to request a hearing on the matters which are the basis of the order. If no hearing is requested, and the Commission does not order one on its own motion, the order becomes permanent on the thirtieth day after its entry. If a hearing is requested, or otherwise ordered, the Commission will, upon consideration of the entire record, either vacate the order or enter a permanent suspension order.

The issuer is required to file with the Regional Office copies of all sales material to be used in connection with the offering at least five working days before it is to be used. This includes copies of any advertisement to be published, the script of any radio or television broadcast to be made, and every letter, circular or other written communication proposed to be provided to more than 10 persons. This is, of course, in addition to the offering circular, which, as I have stated, must be provided to every person to whom the securities are offered.

Generally speaking, the exemption is not available if the issuer or any of its affiliates or predecessors, within the preceding five years, has been subject to a stop order proceeding under the Securities Act or to a suspension proceeding under Regulation A, has been convicted of a crime involving the purchase or sale of securities, is subject to any temporary or permanent injunction in connection with the purchase or sale of securities, or is subject to a Post Office fraud order. Similarly, the exemption is not available to the issuer if any of its directors, officers or

principal security holders, or its underwriter or any of its principals has been guilty of certain conduct as described in the Regulation. The absence of the exemption in the cases mentioned does not foreclose the issuer from publicly offering its securities. It means merely that he must use the full registration process in order to do so. In cases where there is a recent history of offenses under the federal securities laws, criminal conduct involving securities, or postal fraud, it is clearly in the public interest for the issuer to be required to adhere to the more stringent requirements of the registration process.

I mentioned fractional undivided oil or gas interests, or similar mineral interests, in relation to the intrastate exemption; it is also pertinent to mention that Regulation A is not available for these interests. A separate exemption, Regulation B, is available, however. In the interest of time, I will not discuss this exemption except to mention that it is limited to offerings of not more than $100,000.

Through releases and other efforts we have attempted to reduce the areas of ambiguity concerning disclosure standards; similar attempts have been made regarding the exemptive provisions of the Securities Act. The Commission recognizes, however, that the statutes and rules it administers are complex; thus, as a matter of policy, in order to promote compliance with those statutes and rules, the Commission encourages requests for assistance from the staff in difficult interpretive questions on the exemptive provisions of the Securities Act and any other complex questions under the federal securities laws.

Inquiries may be made directly to our headquarters office in Washington, D. C., or to a Regional Office or a Branch Office. Requests for assistance should be in writing, and the request should include a complete statement of the facts of the matter. The staff's response usually takes the form of interpretive letters or "no action" letters. The interpretive letters are opinions on the application of the law to the facts; in "no action" letters the staff indicates that it will not recommend enforcement action by the Commission if the persons concerned carry out their activities exactly as specified in the letter to the staff. When inquiries are directed to the staff, it should be borne in mind that these inquiries and the response to them are non-public under the Commission's interpretation of the Public Information Act. 9/ Thus, affected persons should feel free to discuss problems in detail with the staff.

This discussion up to now has been concerned with the presentation of a general picture of the process of "going public" from the Commission's viewpoint; next, from the Commission's viewpoint, I will discuss, in broad terms, the consequences for the small business of "going public."

9/ 5 U.S.C. 552.

Essentially, the major consequence is that the company will be subject to continuing disclosure requirements through the Securities Exchange Act of 1934. That Act complements the Securities Act in that it provides for self-regulation by national securities exchanges under appropriate guidelines and procedures. It further provides for registration of brokers and dealers, the principal conduits through which information reaches the investing public. Although the Exchange Act is generally looked upon as being regulatory in nature, it is quite clear that the Congress employed the basic disclosure philosophy here, as well as in the Securities Act. This can be seen in the reporting requirements of Sections 12, 13, 14 and 15(d), and the proxy requirements of Section 14. Even the insider provisions of Section 16 employ the disclosure concept.

A small business that has sold shares publicly may become subject to these continuing disclosure requirements in a number of ways. If a company has filed a registration statement under the Securities Act, it will be required to file periodic reports with the Commission under Section 15(d) of the Exchange Act.

By contrast, Section 12(g) of the Exchange Act may subject the public company to Exchange Act disclosure provisions whether or not a registration statement under the Securities Act has ever been filed. Section 12(g) requires a company with total assets exceeding $1 million and a class of equity securities held of record by 500 or more persons to register those securities with the Commission. Exemptions are provided for listed securities and certain other types of securities. If a company is within the purview of Section 12(g), it will also be subject to the reporting requirements of Section 13, the proxy requirements of Section 14 and the insider provisions of Section 16.

Similarly, Section 12(b) subjects a company whose shares are listed for trading on an exchange to certain disclosure requirements, including registration with the Commission, and such companies are also subject to the reporting, proxy and insider requirements of the Act.

The Commission has proposed amendments to rules and forms relating to registration and reporting under the Exchange Act.10/ For the most part, consideration of these proposals was prompted by "The Wheat Report."

Section 14 of the Exchange Act contains the proxy requirements. It is applicable to listed companies and Section 12(g) companies alike. Our Regulation 14 outlines what is expected of proxy statements. Those

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10/ Securities Exchange Act Release Nos. 8680 through 8686 (September 15, 1969). For the background to the proposals, once again, I commend your attention to "The Wheat Report."

of you who are familiar with this Regulation will agree that the subject matter is treated in some detail. In some instances, small companies not subject to the proxy rules may have solicited proxies without providing any definitive description of the subject matter to be voted upon, and without giving the shareholder an opportunity to express a preference as to the manner in which his shares are voted. The proxy rules require, among other things, that disclosure of the subject matter be complete and clear, and that the shareholder be provided an opportunity to have his shares voted either way on each proposal.

The provisions of Section 16 are generally referred to as the "insider trading" provisions. An "insider" is an officer or director of the issuer of any equity security registered under Section 12, or any person holding, directly or indirectly, the beneficial ownership of more than 10% of that class of security. Section 16(a) requires that each "insider" must reveal the amount of all equity securities of the issuer of which he is the beneficial owner. Our Form 3 has been provided for such reports. The "insider" must also report changes in such ownership within 10 days following the close of each month in which they occur. The reports of change are to be made on our Form 4.

Section 16(b) provides that any profits made by an insider, in a purchase and sale (or a sale and purchase) of an equity security of the issuer within six months, inure to the issuer, and can be recovered by the issuer or on its behalf by any shareholder.

In July 1968, Congress extended the scope of disclosure under the Exchange Act through amendments to Sections 13 and 14.11/ The Commission has adopted temporary rules and regulations to effectuate the purposes of the legislation.12/ In general, the amendments and the rules thereunder require disclosure of the identity of a person and his associates and their financing and intentions when they seek to acquire more than 10% of a class of equity securities registered pursuant to Section 12 of the Act or issued by a closed-end registered investment company, either by a tender offer or otherwise.

The new disclosure requirements apply to securities registered under Section 12 and securities issued by registered closed-end investment companies. The small business whose securities are not registered under the Exchange Act may desire the information provided by the new

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11/ Public No. 90-439, approved July 29, 1968 (82 Stat. 454).

12/ Securities Exchange Act Release Nos. 8370 (July 30, 1968) and 8392 (August 30, 1968).

disclosure provisions, especially if it is a possible take-over candidate. In this connection, it should be noted that companies whose securities are, for one reason or another, not subject to registration may register their securities voluntarily pursuant to Section 12(g)(1).

It is clear from the foregoing discussion that a small business that has "gone public" may be subject to extensive reporting requirements under the Exchange Act. The sharp increase in filings under the Securities Act is paralleled by a sharp increase in filings under the Exchange Act, and filings under the Exchange Act must be examined by the same staff members involved in the examination of Securities Act registration statements. From the point of view of numbers, the filings under the Exchange Act reach staggering totals. It is not necessary to belabor the point with statistics; suffice it to say that the Commission's urgings on preparedness apply equally to Exchange Act filings.

It is obvious that the foregoing discussion will tell the experienced securities practitioner very little that he does not already know; but, hopefully, it will be helpful to counsel for the small business who may have only a passing familiarity with the federal securities laws. I sincerely hope, however, that the point has been made to the experienced securities practitioner and the less initiated alike that the Commission needs your cooperation in its concern for the public interest. This cooperation, I can assure you, will inevitably redound to your benefit in your concern for the small business client if and when it decides to "go public."