MEMORANDUM #366

October 8, 1937

To: Chairman Douglas

From: Mr. Paul P. Gourrich

Attached you will find a memorandum accompanying the minimum list of standards; also, an explanatory note to examiners; and, finally, a maximum list. Originally I had on my minimum list many more items, but I sifted them down to but a few, in order to make a start with which I considered the least harmful to the legitimate investment market, or, rather, not harmful at all, except for one type of issue which in reality does not contribute anything to the capital market, but, at the same time, may do harm to investors. This is the small issue which is not underwritten but is peddled around, and which our follow-up definitely shows results in a situation which is almost tragic, as there is no protective escrow agreement in effect. Hence, the escrow agreement requirement, which naturally is a restrictive influence, will restrict something which can well afford to be restricted.

So far I have not talked to other people in the S.E.C. who may have profitable ideas; nor have I talked, as I think I should, to one or two men in the investment banking business, in whose judgment and friendliness I have confidence. When you are ready to proceed with these things, I shall be glad to talk it over with a few outside persons.

Attachments: 4

CC to Judge Healy

Gourrich/Buckley & Sameth/jws

MEMORANDUM

Section 8 (a) of the Securities Act of 1933 gives the Commission the right, in its discretion, either to accelerate amendments or to let each amendment extend the examination period to a date twenty days from the date of the amendment. This subsection, therefore, imposes very serious duties upon the S.E.C. in its use of the discretionary power. The philosophy of the waiting period is to afford the Commission ample opportunity to acquaint itself with all the phases of the registrant's corporate life, in order to determine whether or not there has been an untrue statement of a material fact or an omission of any necessary material fact. Amendments to the registration statement always present new facts or changes in data previously given, so that new questions are brought into relief, and new light is thrown on the registrant's corporate life, requiring detailed re-examination of the registration statement as a whole. The simpler the general picture of the company; the more orthodox its make-up; the more its activities are in line with the standards of the better class of companies; the less difficult is the examination or

re-examination of its statement; --i.e., less effort and scrutiny is required from the examining persons, and less concern is felt about a slip-up in examination. For example, it is obvious that the simpler the corporate set-up; the less need there is for prolonged and detailed examination. But, where there are corporate set-ups or practices which are not in line with the best standards of issuance, it may be suspected that beneath the surface and the obvious there may be hidden situations of significance to the investor. Hence, it becomes the duty of the examiner to move in his work with the greatest care and circumspection.

It is for this reason that the Commission has considered it advisable to enumerate those practices and set-ups which, because of their very nature, make it impractical for the Commission to reduce its time of examination of pre-effective amendments if the detailed and time-consuming work called for by the situation for the protection of investors is to be carried on. However, some such practices or situations may be readily corrected if the registrant is aware of the Commission's position. The statement of these practices and situations at this time may afford prospective registrants an opportunity to bring about such corrections, thereby putting themselves in a position where they may benefit from accelerative action if other conditions are satisfied.

The Commission may, from time to time, announce changes, additions, or eliminations of the standards set forth in the attached list. As these standards become universally recognized throughout corporate bodies, the process of registration will be performed more expeditiously. At the same time, the enunciation of these standards may tend to limit the periphery of practices and situations which may be in conflict with quick and accurate revelation of all material facts as called for under the 1933 Act for the protection of the investors.

MINIMUM LIST

1. If in connection with money being raised by a new enterprise there is no adequate escrow agreement providing:

(a) That substantially all monies paid in (after deduction of reasonable expenses for registration and sale of the issue) will be returned to the investors who bought part of the issue if the entire amount required is not raised.

(b) That if money which has been raised for a specific purpose cannot be used for that purpose, an immediate stockholders' vote will be taken to determine the disposition of the funds.

2. If reports to stockholders are submitted less frequently than once each year or later than four months after the close of the fiscal year.

3. If a holding company is about to issue a new security which will further complicate its set-up, or if a new holding company is being organized with a complicated set-up or which creates a complicated system-situation. A complicated holding company set-up will be understood to mean a holding company with a complex capital structure. A complicated system-situation will be understood to be one extending beyond one tier.

4. If (1) a company is being organized with two classes of common stock having equal rights except that one class has no voting power (A and B stock set-up) or if (2) an existing company with two classes of common stock attempts to raise new capital without first endeavoring to consolidate the two issues into a single issue. (Provided, of course, that control of the voting issue is held by insiders. This may be difficult to establish, and may make it necessary to put Item 2 in the maximum list.)

5. If a new issue of bonds or debentures is set up without the usual protective provisions, such as limitations of the total amount of the issue in relation to the total capital and surplus; restriction on substitution of security unless notice is given to security holders; restriction on changing provisions of the indenture without concurrence by at least a majority of the security holders; provision that the trustee must act in cases of default when directed by a stated percentage of the security holders; etc., etc.

6. If (1) a new issue of preferred stock does not have the usual protective clauses, such as the assumption of voting power and control in case dividend arrearage equals the amount of dividends for one year, or if (2) new capital is being raised when there already exists a preferred issue without these protective clauses, and a bona fide effort is not made to change the faulty provisions when insiders are definitely in control. (It may be difficult to establish the extent of control exercised by insiders, in which case Item 2 would have to be placed in the maximum list.)

7. If a new issue of common stock does not have preemptive rights, or if new capital is being raised when there already exists a common stock without preemptive rights, and a bona fide effort is not made to give the issue preemptive rights.

8. If the registrant makes loans or advances of officers or directors which are outside the normal course of its business.

9. If the registrant pays income taxes for any of its officers or employees.

10. If the registrant offers a new security with a misleading name, such as an “income bond” which is really a preferred stock; a “preferred” stock which is really junior to one or more issues of senior preferred, senior to one or more junior common, and, in reality, a hybrid with complicated provisions as to earnings or dividends; or a security bearing the title of “guaranteed” where the guaranty is perfunctory and frequently misleading.

11. If a new enterprise's financial set-up includes warrants.

NOTE FOR THE S.E.C. EXAMINERS

Undesirable practices and situations which should prompt us to go slowly and examine carefully registration statements under the Securities Act of 1933 and amendments thereto, and which offer us an opportunity to discuss remedial action with registrants if acceleration is desired. This minimum list has been selected with the view of causing the least disturbance to the legitimate capital market.

MAXIMUM LIST

1. If any officer or director of the registrant, or any promoter named in the registration statement, or any chief officer or partner of a principal underwriter has been convicted of fraudulent activities in securities or larcenies of property within the past ten years. (This is probably the most desirable minimum requirement, but may prove the most onerous to underwriters and registrants on a purely technical basis.)

2. If the issuer does not provide, by such means as are legally effective, that the holders of the securities specified in paragraphs (a), (b) and (c) below shall not

(1) dispose of any such securities, or

(2) be entitled to any distribution upon liquidation whether voluntary or involuntary, unless the holders of all securities who paid cash therefore shall have been repaid an amount equal to the net amount received by the issuer from the sale of such securities,

until the issuer shall have earned a net profit from operations for a period of one year; securities to be so provided for being:

(a) Securities issued within one year to any promoter or organizer for services rendered in excess of the actual expenses of such promoter or organizer.

(b) Securities issued to any promoter or organizer for property in excess of the cash outlay for such property, if such property was acquired by such promoter or organizer within one year prior to the offering herein exempted.

(c) Securities issued to any promoter or organizer for property, if such property was not acquired by such promoter or organizer within one year prior to the offering herein exempted, in excess of the fair cash value of such property, provided, and to the extent, that such promoter or organizer still holds the beneficial ownership of such securities.

3. If the company's corporate name is misleading.

4. If voting trust certificates are being registered which are not the outgrowth of a reorganization or are brought out to harmonize factional conflicts.

5. If certificates of deposit are being registered where the independence of the committees is not definitely established, or where there are exculpatory clauses permitting the committee members to trade in the securities of the company or in certificates of deposit for its securities.

6. If the trustee of a bond or debenture issue is known to have a conflicting interest, or to be "impecunious or irresponsible".

7. If a new issue of securities is being registered while faulty protective provisions on company's outstanding issues remain uncured, unless the company shall have already made a bona fide attempt to effect such cure.

8. If a new issue of non-cumulative preferred does not provide that the dividend must be paid when earned.

9. If there is no provision for the regular representation of each class of stock on the Board of Directors by at least one director.

10. If there exists between the registrant and another company circular ownership sufficiently large to give each working control of the other, unless there is set forth a definite program to break up this circular ownership.

11. If the registrant has been buying and selling its own common stock in the market, within the past twelve months.

12. If a company does not supply, in its annual reports to stockholders, substantially the same information as appears in the annual reports to the Commission: - salaries of officers; ownership of stock by officers, directors, and ten-percent owners; revaluations of property; depreciation rates; complete balance sheets, profit and loss statements, and reconciliations of surplus.

14. If the company has changed its auditing firm, and it is established that the reason for such change was that the previous auditing firm would not countenance certain objectionable accounting practices.

15. If the accountant's certificate has a list of uncommon qualifying notes which clearly indicate the accountant's disapproval of the corporation's accounting policies.

16. If there are indemnifying agreements signed by the registrant for the underwriters, experts, officers, and directors.

17. If, in the event of a stand-off agreement, there is no provision automatically permitting the parties to the agreement to sell as much stock as they wish, at a price not less than the public offering, once the stock has risen x points above such public offering price.

18. If the underwriting contract includes a market clause permitting cancellation after the date of public offering.

19. If the underwriters are known to have a continuous relationship to the company as bankers while at the same time being represented on the Board of Directors. (?)

20. If a company has issued options to favored persons, especially when such options have been granted after the company has reacquired stock from the stockholders for the purpose of granting such stock to its officers.

21. If a company purchases property from or sells property to officers and directors, unless such relations are approved by stockholders' vote.

22. If there exist bonus or profit-sharing agreements which have not been clearly and definitely made known to stockholders through annual report or other communications, and for which specific and separate approval of stockholders has not been secured.

23. If increases in officers' salaries (other than represented by bonuses and profit sharings) have been voted by the Board of Directors without having been submitted for the approval of stockholders.

24. If the registrant's output is sold to persons over whom the officers or directors have control or in whom they are beneficially interested, or if the company sells to, gives concessions to, or enters into other business agreements with persons in whom the officers and directors are beneficially interested or to whom they are related. (While this attacks a very fundamental vice in American business, probably few companies are free from it, and certainly a long time will be required to put this over. Particularly it must be remembered that many a director becomes a director just because of these special favors, not otherwise receiving more than nominal compensation.)

25. If statistical data of a dependable agency (like Department of Commerce) informed in the registrant's industry, establish (a) that the industry's production for a period of several years has annually increased more than 25%, and (b) that the capacity of the industry has shown a comparable rate of increase, thus indicating little economic justification for additional capital in the industry. (This is a difficult but very important standard, but if dependable information were available, some standard could be worked out.)

26. If the securities being registered result from a merger whose economic value has been seriously and meritoriously challenged by dissenting minorities of substance. (Another very fundamental but difficult standard.)

27. If the company's capital set-up, as regards bonds, preferred stock, common stock, and surplus is definitely out of line with even extreme cases in its particular industry (A

desirable but difficult standard, due to the lack of information on which to base judgments.)

28. If there has been a reorganization, readjustment, or merger, and the Commission, under the Holding Company Act or other act, or in any circumstance, has questioned the fairness of the terms of exchange of securities or the general soundness of the plan.

29. If the salaries of officers appear to be excessive. (It may be possible in the future to establish what is reasonably fair compensation from statistics now being accumulated, but it is impossible to do so now.)

30. If compensation to underwriters or salesmen of securities appears to be excessive. (It may be possible in the future to establish what is reasonably fair compensation to underwriters and salesmen, but it is impossible to do so now.)

31. If a company having apparently eligible securities does not make an effort to have its securities listed on a registered exchange.

32. If a person who has made an appraisal which is included as a part of the registration statement holds any substantial interest in the registrant or affiliate, or expects to become an officer of the company, or has received a bonus in the form of stock or other compensation which can be definitely established to be excessive and unwarranted. (Not an easy standard to determine.)

33. If a State Security Commission has refused to Blue Sky this or any other issue of the registrant, and the S. E. C. is satisfied that the reasons for such refusal warrant further study for the protection of the investor. (Again, not an easy standard.)

34. If depreciation rates shown in the registration statement have changed radically with adequate justification, or if they differ greatly from the most extreme cases in the industry. (This standard is very difficult to establish, due to the lack of data on which to base judgment.)