DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

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Subject: The Securities Act of 1933

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MR. BLACKSTONE: I think it appropriate in this training course to start with a bird's-eye view of the first of the Federal securities laws, the Securities Act of 1933. This Act is sometimes called "the truth in securities" Act.

There are two basic purposes of that Act: one is to prevent and make illegal fraudulent activities in the sale of any security where the mails have been used or the means and instrumentalities of interstate commerce have been used; the second major objective of the Act is to provide for registration, with the Commission, of an initial public offering of a security by an issuer.

The purpose of requiring registration is to make sure that the investing public will be given sufficient business and financial facts about the issuer of a new security so that it can make an informed decision whether to buy the security or not. In that connection, we have always had the problem of educating the public as to what the responsibility of the Commission is. I think that many people labor under the delusion that the Commission "passes upon" the merits of a security, or "approves" a security. Section 23 of the Securities Act makes it unlawful for anyone to represent that the Commission has passed upon the merits of a security or has approved a particular security, and a statement negating any such possible inference must appear in bold-face type on the front cover of a prospectus, as all of you are aware. Nevertheless, it remains a difficult proflem to educate fully the public to the fact that a registration statement, filed and declared effective, does not have the endorsement of the Securities and Exchange Commission. Passing upon the merits of a security is not the purpose of the Act. The purpose of the Act is to get the information to the public. Whether it is a speculative or gilt-edged security makes no difference to the Commission. It is rather a matter of letting the investor himself decide, after weighing the available facts, whether or not to buy the security.

In the Division of Corporation Finance we become so familiar with various forms of registration statements and with processing the items called for by the prospectus or in the second part of the registration statement that we may lose sight of the fact that these requirements for full information are not just matters dreamed up by the Commission itself. These required items of information in a registration statement are

specified by Congress in Schedule A of the Securities Act. I think it would be a good thing for all of us from time to time to re-read Schedule A of the Securities Act. When you do so, you will find 32 separate items of information, or documents, that Congress has said must be included in a registration statement. Schedule B of the Securities Act sets forth the information that must be included in a registration statement for securities offered by a foreign government, or a political subdivision of a foreign government.

If you refer to Section 7 of the Securities Act, you will find that Congress anticipated that all of the items of information in Schedules A and B may not be needed in a particular type of offering or for a particular type of issuer. For that reason the Commission is authorized by Section 7 to cut down the amount of information or documents to be included in a registration statement.

On the other hand, Congress recognized that there might be some types of issuers or securities where even more information should be included in the registration statement than is specified by Schedule A. So the Commission is also authorized by Section 7 to increase the informational requirements required to be set forth in a registration statement. Acting under this section the Commission has adopted various forms of registration for different types of issuers and different types of securities.

The statute also makes it clear that the registration statement shall be composed of two parts. The part that is of greatest importance to the public is the prospectus. That is the selling document that under Section 5 of the Act has to be delivered to a purchaser of a registered offering at least by the time the security itself is delivered to him. But, of course, it can be delivered to the purchaser at any time prior to the actual delivery of the security.

The statute again sets forth the information that has to be contained in a prospectus. Congress specified that all of the information -- all the items set forth in Schedule A -- must be in the prospectus, except the following documents: the underwriting agreement, the opinion of counsel in respect to the legality of the issue, material contracts, articles of incorporation, and some of the basic corporate documents and underlying agreements or indentures relating to the rights of the securities being offered. Here again the Commission has the power under the statute to modify the requirements as to what shall go into the prospectus.

Why has Congress specified that certain information be included in a registration statement? What bearing does such information have on the investor's decision to buy or not to buy a particular security? If you can answer these questions to your own satisfaction it should be an aid to your understanding of what we mean by "full and fair disclosure."

Why should Congress require to be shown the amount of the commission that underwriters are going to receive in distributing the issue? Why should that fact make any difference to the public?

What is the reason for requiring that the salaries and other compensation to officers and directors be shown?

Why does Congress insist upon certified financial statements?

If you look down the list of items in Schedule A, the reasons for requiring disclosure of some of the information should be quite apparent. But it may be that some of the other required informational items do not at first blush strike you as being the kind of information the public investor needs to know. Congress, however, did have sound reasons for each of those items. It might be interesting for each of you, if you have any question about these items, to puzzle it out yourself, and talk about it with other people. That would take you away from a purely mechanical approach to these matters and cause you to think about what we are doing and what Congress has specified that we do. Information for information's sake makes little sense. The information required to be set forth in a registration statement should be the kind which will have a practical effect upon the judgment of a purchaser whether or not to buy a security.

In applying the Act, the first basic question is, what is a security? The definitions of terms used in the Act are given in Section 2 of the statute. There is not much point in memorizing the precise definitions, for copies of the Act are easily available. A security is defined in Section 2(1) very broadly, and includes those obvious things that people think of as a security -- stock, bonds and notes. But it also includes "investment contracts." There are nice questions presented to us every day by lawyers and members of the public as to whether a particular arrangement is a security or not, within the meaning of the Act.

Generally we take the view that a security is involved in connection with any kind of an arrangement whereby one person is giving consideration, money or property, to somebody else to manage with the expectation that a profit will be derived, from the handling of that fund, by the person to whom it is given. Where the Commission has taken the position that a security is involved, that position, to the best of my knowledge, has always been sustained by the courts where the position has been challenged.

Of course the power of Congress to legislate in this entire field derives from the constitutional power of Congress to regulate the use of the mails and interstate commerce. Hence, securities offered without the use of the mails or without the use of the means and instrumentalities of interstate commerce are not encompassed by the Act. However, it is extremely difficult as a practical matter in this day and age for securities to be offered and sold to any sizable group of people without the use of the mails or some instrumentalities of interstate commerce.

Assuming that you have a security and a public offering that will involve the jurisdictional facilities, there still may be an exemption from the registration provisions of the Act under Section 3. I don't believe that I need to pause for any length of time on the particular securities exempted, but just run through then briefly.

Exempt securities include the following under Sections 3(a)(2) to 3(a)(8): government securities or securities of a state; securities issued by national banks; short-term notes, the proceeds from which are used to finance current transactions; securities issued by a charitable non-profit institution, by a building and loan association or by a receiver or trustee in bankruptcy; and annuity and insurance policies. Why should the latter be exempt from registration? Is an insurance policy a security? Certainly. You are giving your money to an insurance company with the expectation of a return from the premiums which you pay. That has all of the elements of a security as defined in the Act. So, without the express exemption in Section 3, insurance and annuity policies would be covered by the Act.

An exchange of securities by an issuer with its own security holders is exempt if the issuer does not pay commissions to those who solicit the exchange. That exemption is in Section 3(a)(9). Under Section 3(a)(10) an exchange of securities, either a security for a new security, or a security for property or cash, is exempt if the terms of the exchange have been approved and passed upon as being fair by a court of competent jurisdiction, or by a state or regulatory agency that has power to pass upon the fairness of such a plan.

That brings us to the exemption in Section 3(a)(11) which exempts securities issued in a wholly intrastate transaction. This last exemption gives the Commission a great deal of difficulty from an enforcement point of view. The exemption is very carefully worded. It applies only if two conditions are met: that the offering is limited to persons who are bona fide residents of the state where the issuer is domiciled and that the issuer is doing business in that state. We take a very dim view of the availability of this exemption where a company proposes to issue a million or two million dollars worth of securities, particularly if they are issued in small units of $10, $25, or $50 per share. We have some hesitancy in agreeing with an issuer that an offering of that magnitude really can be limited to bona fide residents of a state, and we very rarely go out on a limb in a request for an interpretative opinion on an offering of that kind and say that the Commission will take no action if the offering is made in reliance on that exemption.

We also have a problem under the intrastate exemption with the question of what is "doing business" within a state for purposes of the exemption. For example there was a company in California that was organized really for the purpose of building a gambling casino and resort in Las Vegas, Nevada. That company, organized by a few insiders, purchased a little company in Los Angeles that was engaged in the fruitcake business -- a seasonal business -- making a few fruitcakes each year at Christmas time, and that business was carried on in California. The net worth of that particular Los Angeles company was perhaps $50,000. They then proposed to offer solely to the residents of California $2,000,000 worth of stock, the proceeds of which would be used to finance a fancy hacienda in Las Vegas. If you read the exemption literally, it is available to that company because it was doing business in its state of incorporation and the offering was limited to bona fide residents of the state. The Commission took no action but it strikes me that that is stretching the exemption as far as it can be stretched. Here the company really intended to engage in a Nevada business and its California fruitcake business was "the tail of the dog." It would

seem that Congress did not have in mind providing an exemption in that type of situation in which the proceeds from the sale of stock do not finance a truly local business. We struggle with these problems of interpretation and generally we do not lean over backward to acquiesce in the claimed exemption under the intrastate provision. In our view it was designed to help a local business and was not intended to help finance a large venture outside the state of incorporation where the offering is made.

Section 3(b) of the Act provides a conditional exemption from registration for offerings of securities that do not exceed $300,000 in amount. That exemption is subject to whatever rules and regulations the Commission may adopt. The Commission could decide not to permit any exemption for small issues if it concluded that the public interest or the protection of investors did not warrant such an exemption. The Commission, as you know, has in effect Regulation A under this section of the Act, and Regulation A does lay down terms and conditions under which an exemption from registration is available to an issuer of securities not exceeding $300,000 in amount. I shall not go into Regulation A now because we have scheduled a full session on that subject and it is quite important that sufficient time be given to it so that you will all feel that you have a certain working knowledge of it.

Those are the securities that are exempt. We come now to Section 4 of the Act which exempts certain transactions.

First of all, there is a sweeping exemption for any transactions in securities not involving an issuer, underwriter or dealer. That immediately would exempt those transactions in stock that is already issued and outstanding, where it is not the issuer himself involved or where there is no underwriter who, by definition, is a person taking shares from an issuer or a controlling person of an issuer for resale. Furthermore, dealers' transactions in a security are exempted after a waiting period following the initial public offering of that security.

Also in Section 4 of the Act there is an exemption for any transaction not involving a public offering. The Commission has studiously avoided defining what constitutes a public offering for the purpose of Section 4(1) of the Act. It is felt wise not to attempt to pin down what is and what is not a public offering except on a case to case basis. The Supreme Court in the <u>Ralston-Purina</u> case made it clear that all of the facts in each case have to be examined in order to decide whether or not there is really a public offering.

You may hear a lot about a rule of thumb in the Commission to the effect that any offering of securities to 25 or less people is automatically a private offering and exempt from registration. That may be convenient to use as a first test, but the Commission would not want to limit itself to a strict numbers test. In most cases one might readily conclude that if there are only 25 or less persons being solicited by an issue, that does not reach the magnitude of a public offering.

One of the important criteria is the extent to which the offerees need the protection of a Securities Act prospectus and the information that would

be contained therein. If the offer is made solely to a group of top management people of the issuer, all of whom have access to the financial records of the company and are familiar with its operations, it would be a little absurd for the Commission to insist in that case that the securities be registered. Those people do not need the protection of the Securities Act. However, in a case where the offerees are wholly lacking in information about the issuer, we would generally resolve doubts in favor of its being a public offering, even though the number of offerees is relatively small. The only result of such a position is that the issuer has to register, and that is no very serious hardship.

Section 4(2) of the Act exempts brokerage transactions which are unsolicited. That exemption has given a great deal of trouble to the Commission, to the Bar, and to brokers. We have adopted Rule 154 to give more certainty to this area. If a person owns ten shares of General Motors, calls up his broker and asks the broker to sell the shares for him, there is no problem. That is clearly an unsolicited brokerage transaction. It would not require registration. I shudder to think what would happen if we had to register all such transactions. We would need more employees than there are brokers. But the problem does present itself to the broker when a person in control of a corporation wants to sell some of his shares. He calls up a broker and asks him to sell some of his shares. That is a brokerage transaction and is unsolicited by definition; but under Section 2(11) of the Securities Act a controlling person who is selling his shares through a broker will be deemed to be an "issuer," and the person arranging to take the shares from him for resale would be an "underwriter." That would result in an "underwriting" transaction requiring registration and would not be exempted as a "brokerage" transaction. For that reason it was difficult for brokers to know to what extent they could sell shares for a controlling person without registration.

The Commission has attempted to clarify such instances in Rule 154 by which it permits the exemption to be available, in a brokerage transaction, for the sale of shares by a controlling person where the total amount of shares being sold by the controlling person, counting all the sales he has made for the past six months period and including the shares he is offering through the broker, does not exceed 1% of the outstanding stock of the corporation; or if the stock happens to be listed on a national securities exchange, whichever is the lower of 1% of the outstanding stock or the volume of trading during one out of the past four weeks. That clarifies, somewhat, a particular type of situation often confronting a broker-dealer. He can now rely on exemption from registration -- when selling stock for a controlling person -- if the amount of the stock under the test does not exceed either the 1%, as computed in accordance with the rule, or the volume of one week's trading on an exchange during the past four weeks.

Let us assume now that in a particular offering the mails are to be used, or the means and instrumentalities of interstate commerce are to be used; it is not the type of security that is exempt by Section 3; the amount exceeds $300,000 so Regulation A is not available; and it is not a transaction exempt under Section 4. Registration will be required.

Section 6 of the Act sets forth the filing procedure. The registration statement must be filed in triplicate. Who must sign the registration statement? It has to be signed by the issuer, the chief executive, The principal financial officer, the controller and a majority of the board of directors. A filing fee of 1/100 of 1% of the aggregate offering price has to be paid at the time the registration statement is filed.

The wording of the statute and its interpretation by the Commission makes it applicable only to a security that is presently intended for offering. It would not make much sense to permit a registration statement to be filed today to cover a security that is intended to be offered next year, simply because time moves on and financial situations change. The information would be obsolete by the time the security is actually offered.

Next, the question arises as to why the Commission has a staff of more than 100 professional people to review and process registration statements. There is no specific section in the Act that gives the Commission any authority to review registration statements and send out deficiency letters. Where does the Commission find authority for taking upon itself that function? Isn't that inconsistent with the prohibition of Section 23 of the Act that says the Commission does not "pass upon" the merits of a security or the accuracy of the registration statement?

I think the authority for the processing procedure comes from Section 8 of the Act. Under Section 8(a) a registration statement becomes effective automatically 20 days after it is filed unless the Commission accelerates the effective date. Under that section, however, the Commission, in exercising its power to accelerate the effective date, is directed to take into account the adequacy of the information about the issuer which is available to the public, the facility with which the nature of the securities and their relationship to the capital structure of the issuer and the rights of the security holder can be understood, and the public interest and the protection of investors. To follow out that directive in the exercise of the power to accelerate the effective date, the Commission has to know something about the registration statement. It has to know something about the issuer. It has to be convinced that the public interest and the protection of investors will be wholly satisfied by accelerating the effective date. Consequently, it is necessary for some one on the staff to review these statements to advise the Commission whether the statutory tests for acceleration are met. That is one fairly clear justification for the Division of Corporation Finance to review and analyze a registration statement.

What difference does it make whether acceleration is granted? Why don't people just wait out the 20 days until the statement automatically becomes effective? The facts of life are such in the field of underwriting and distribution of securities that, in most cases, the underwriter who is going to sell the securities does not want to fix the price to the public or the price that he is going to pay the issuer until the very last minute -- until the statement is actually to become effective, and he can immediately begin to consummate sales of the securities. If the underwriter at the very first moment that the registration statement is filed

agreed to take the security at $20 per share and resell it at $20.50, the market condition in the next 20 days might substantially change so that that security would be selling on the market at $18, $17 or $16 and he would be stuck with an agreement to take the security at a price far above the market. He would stand to lose a considerable sum of money. So, in most cases, a registration statement when first filed lists no offering price; and that is not fixed until the very last moment by the so-called price amendment to the statement. But in filing such an amendment at the last moment to fix the offering price, the automatic timing provisions of Section 8(a) are brought into play. The amendment is deemed to start the 20 day waiting period running all over again. Thus the underwriter would not be able to commence selling when the price is fixed unless he can get the Commission actually to accelerate the effective date on the day the issuer files the price amendment.

The power of the Commission to accelerate is therefore extremely important. More registrations than not require acceleration because of the last minute pricing arrangement with the underwriters. Some securities, however, have no underwriters involved other than the officers and directors of the new company, in which case acceleration is of little actual importance.

The other justification for staff review and analysis comes from the stop-order provision of Sections 8(b) and 8(d). There, the duty is placed upon the Commission in appropriate cases to institute an administrative proceeding to determine whether to issue what is called a "stop order." Such an order will prevent the sale of the securities until the registration statement has been amended in accordance with the stop order. A stop-order proceeding will be instigated if the Commission has reason to believe that the statement is false or misleading, or omits to state a material fact necessary to make the entire statement truthful. Now the Commission obviously would be in no position to begin a stop-order proceeding unless its staff reviewed carefully all the registration statements filed and then, based on such review, recommended stop-order proceedings, where appropriate.

Thus, there are two duties of the Commission which can only be exercised if the staff of the Commission does, in fact, review and analyze registration statements: first, the acceleration power of the Commission could not be properly performed unless the staff analyzed the statements; and second, the stop-order provisions of the Act could not be properly carried out unless the staff carefully reviewed and analyzed the registration statements.

I have mentioned generally the test laid down by the statute for acceleration. The Commission has supplemented the statutory test by certain rules. Rule 461 provides that a registrant who desires acceleration must make a request therefor in writing and shall state the date upon which it is desired that the registration statement shall become effective. If it is desired that the statement become effective at a particular hour of the day, advice to that effect must reach the Commission not later than the second day before the day on which it is desired.

Rule 460 announces that the Commission, in passing upon a request for acceleration, will require a showing that there has been a reasonable distribution, to each underwriter and dealer who is going to participate in the sale of the security, of sufficient copies of a preliminary prospectus a reasonable time in advance of the anticipated effective date. The purpose of this rule is to carry out the acceleration test of Section 8(a) of the Act that there has been adequate information about the issuer already made available to the public. One way to test whether such information has been made available is to require a showing that a preliminary prospectus has been distributed among the underwriters and dealers who are going to participate in the distribution.

The Commission also under Rule 460 will consider whether or not there has been a bona fide effort to make the prospectus reasonably concise and readable. That is sometimes a nice decision to make, particularly if you are dealing with an issuer which has an extremely complicated corporate structure. Generally we try not to present to the Commission a registration statement for acceleration where the prospectus is ambiguous. We attempt to work out this problem through our deficiency letters and conferences, if need be.

I think it is of interest for you to be aware of the announcement last year of a proposal by the Commission to adopt a statement of policy setting forth what criteria guide the Commission in granting or denying acceleration. This proposed statement of policy, to be in the form of a note to Rule 460, has not yet been adopted and there may possibly be some changes or revisions before the Commission finally adopts it. The proposal attempts to codify the situations in which acceleration had been denied in the past. For example, the Commission has consistently taken the position that where officers, directors, or controlling persons of an issuer are indemnified against the civil liabilities of the Securities Act, that registration statement will not be accelerated unless those officers, directors, or controlling persons who are to be indemnified against their own liability waive such indemnification, or they at least agree to submit the question of the validity of that indemnification agreement to a court of competent jurisdiction for a determination. To my knowledge there has never been such a test.

Also, if the Commission finds there has been "gun-jumping," that is, sales made in the pre-effective period between the time the registration statement is filed and the time it becomes effective, that is a basis for denying acceleration.

Where a preferred stock is offered which has a par value substantially less than its liquidating preference and there is no agreement to restrict surplus as necessary to insure payment of such preference, the Commission in the past has refused acceleration. There has been some suggestion that that type of acceleration policy gets into the area of "blue-sky" regulation, that is, passing on the merits of the security rather than carrying out the disclosure philosophy of the Act. But again, one should refer to the provisions of Section 8(a) which make acceleration a privilege and not a right and under which the Commission must take into account the

public interest and the protection of investors. That certainly suggests that the Commission can go far into the area which might otherwise be thought of as the blue-sky area in deciding whether or not acceleration should be granted. The Commission, however, has been reluctant to go very far in the direction of passing on the merits in exercising its acceleration power.

Another basis for denying acceleration is found in this type of situation: Let us assume that an underwriter has a firm commitment to take the security being offered. If he does not have sufficient capital to carry out the commitment without violating what is called the "net capital" rule of the Commission, applicable to brokers and dealers, acceleration has been denied. There will be a leter session on the intricacies of the net capital rule -- very important to our work because of the position the Commission has taken as to its effect on acceleration.

If controlling persons are selling their own stock and the proceeds do not go to the corporation itself but simply to the controlling persons, the Commission in the past has taken the stand that these selling security holders should pay their fair share of the cost of the "bail out" including the cost of registration. If the company itself is paying most of those expenses without receiving any of the proceeds from the sale, the Commission has denied acceleration even though that fact is stated in the prospectus.

Again, if there have been any prior transactions in stock by persons connected with the offering which tend to artifically raise the market price of the stock being offered, that has been a basis for denying acceleration.

The next question that we might explore for a few minutes is: what can be done in the way of selling activities between the filing of the registration statement and the time that it becomes effective? Under Section 5 of the Securities Act, as amended in 1954, it is now permissible to offer securities for sale in the pre-effective period, but it is illegal in such period to consummate a sale or to accept an offer to buy the security. After the registration statement becomes effective, the final prospectus must be delivered to the purchaser at least at the time the security is delivered to him. In the pre-effective period, any written offer to sell the securities being offered would have to be made through a form of preliminary prospectus that basically complies with Section 10(a) of the Act, or a summary prospectus which complies with Section 10(b) of the Act. Very recently the Commission has adopted a summary prospectus rule, and we have had three or four summary prospectuses filed with the Commission to date. I think this technique will be used more and more, for it is something the underwriting industry itself requested.

It is actually possible for a summary prospectus to be done in excellent form with only four pages as contrasted with the 18 to 30 pages a full prospectus requires. The summary prospectus is inexpensive to send all clients, and perhaps the clients themselves will be more inclined to read short summaries in making some preliminary decision about the security than they would to wade through a full prospectus. Of course, the final prospectus still has to be used.

If no registration statement has been filed at all, and a security is required to be registered, any offer to sell or sale is illegal under Section 5 and there are criminal penalties imposed (up to five years in jail, or $5,000, or both).

In closing I should call your attention to some of the other penalties provided for by the Securities Act. The most effective provision of the Securities Act in getting full disclosure in registration statements is Section 11, which imposes a strict civil liability, not only on the issuer, but on everyone who signs the registration statement, on all the directors, on every expert who is named in the statement with his consent as having prepared a particular statement and on the underwriters. Any purchaser can sue a person named in Section 11 of the Act for damages for any false statement in the prospectus or in the registration statement. He does not have to show that he relied on it. He does not have to show anything other than that the statement is false and that he purchased the security. The person he is suing is then liable for damages unless he can carry the burden of proof that he made reasonable investigation of the facts and he reasonably believed after such investigation that the facts as stated were true.

Section 12 gives a civil right of action to a purchaser to rescind against a seller who has sold a security in violation of Section 5, which means the purchaser can recover the purchase price paid for the security. The same remedy is available to a purchaser where there has been material misrepresentation either orally or in a prospectus in the sale of a security. This applies to both registered and non-registered offerings.