CHAPTER VIII.

SMALL OFFERINGS EXEMPT UNDER SECTION 3(b) OF THE '33 ACT

A. Introduction

B. Regulation A should be amended in various respects, particularly to permit its use in certain secondary offerings without affecting its full availability to the issuer.

1. Sales by control persons and persons who have purchased in private placements need not be integrated with those of the issuer under a "single issue" concept, except under limited circumstances.

2. The provisions for computing the aggregate offering price of securities of companies with a recent history of losses (Rule 253(a)(2)) are unnecessarily restrictive, and interfere with the usefulness of Regulation A as a disclosure tool.

3. Offer and sale of securities without an offering circular (Rule 257) is inconsistent with good disclosure policy. Rule 257 should be rescinded.

4. The duration of disqualifications from use of Regulation A (Rule 252(c) and (d)) and other procedural rules should be altered to avoid hardship and inconsistency.

5. Various changes in Form 1A (the "notification") and Schedule 1 (the "offering circular") would improve disclosure and codify existing administrative interpretations.

(a) The notification.

(b) The offering circular.

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A. Introduction

It is desirable once again to emphasize that the various recommendations in this Report are parts of a coordinated whole. Thus, the recommendations of this Chapter VIII for an appropriate relaxation of existing restrictions on the use of Regulation A are keyed to the recommended rule changes dealing with secondary offerings found in Chapter VI. Those rule changes will enhance the importance of Regulation A as a vehicle for the public sale, with appropriate disclosures, of limited amounts of securities, particularly securities of non-reporting companies. It has been the Study's aim to improve the usefulness of Regulation A for this purpose.

Consistent with its orientation toward rule changes within the Commission's existing powers, the Study does not submit a recommendation on the proposals which have been made to increase the present $300,000 limit of Section 3(b). However, as will be seen, the Study's suggestions would permit some secondary sales to take place under Regulation A during the same twelve-month period in which the issuer has sold a full $300,000 of securities under the regulation. Hence, in a given year, well over $300,000 of securities of the same issuer might be sold in reliance on Section 3(b). There is no magic to a one year period under the statute. The regulations giving effect to the exemption could

have used a six month, or a two year, period. The concept of a single "issue" of securities is central, and has been maintained. The one year period merely provides a rough guide as to what constitutes a single issue.

A recurring subject for debate in conference of the Commission's Regional Administrators is the question whether certified financial statements (including at least a balance sheet and an earnings statement for the latest year) should be required under Regulation A.

A requirement for certification would provide a check on an issuer's financial disclosures performed by an independent party at least in some measure responsible both to the Commission (under its standards for practice before it) and to the public purchasers. The principal objection is one of cost, together with the fact that such a requirements would narrow the gap between what is designed to be an exemption from registration, and the registration process under Regulations C and S-X. The Study requested and obtained the considered opinions of each of the Regional Administrators on this subject. By and large, the strong sentiment was against requiring certification. If certification was to be required, suggestions included: (a) requiring it for offerings (individually or cumulatively) exceeding $100,000; (b) requiring it as a condition to a waiver of Rule 253; (c) requiring it where the issuer has an operating history, as opposed to an issuer in

the purely promotional stage; and (d) requiring it at the discretion of the Commission.

The Study concluded that it would be unwise, in the context of its total package of recommendations, to urge certification of financial statements in Regulation A offerings.[1/]

In the time available, and because of its small size, the Study was unable to make a careful inquiry into disclosure problems under Regulation B (exemption for fractional individual interests in oil and gas rights). E (exemption for SBIC's), and F (exemption relating to assessable stock), or Rules 234 (exemption for first lien notes), 235 (exemption for securities of cooperative housing corporations), and 236 (exemption for shares sold to provide funds for distribution to shareholders in lieu of issuing fractional shares). As the Commission is aware, the volume of offerings under Regulation B has increased substantially.[2/] The Study understands that the Division of Corporation Finance is reviewing a series of recommended changes in that regulation preparatory to their submission to the Commission.

1/ A number of states require that certified financial statements be included in offering circulars under Regulation A used to offer securities within their borders; such states include, for example, Texas, Oklahoma and New York.

2/ There were 254 Regulation B filings in the second half of 1968 as against 212 in the corresponding period in 1967, and 126 in the corresponding period in 1966.

B. Regulation A should be amended in various respects, particularly to permit its use in certain secondary offerings without affecting its full availability to the issuer.

1. Sales by control persons and persons who have purchased in private placements need not be integrated with those of the issuer under a "single issue" concept, except under limited circumstances.

At present, under Rule 254, securities sold in secondary offerings under Regulation A by persons in control of an issuer or by persons acquiring securities from an issuer in private transactions are "integrated" with sales under that regulation made on the issuer's behalf. Sales made by the issuer and all such persons in any period of one year may not in the aggregate exceed $300,000. Thus, if several persons utilize Regulation A for secondary offerings amounting to a total of $250,000, the issuer is thereby prevented (for one year) from making use of the regulation for a sale exceeding $50,000. Conversely, if the issuer uses the entire $300,000, no secondary sales can thereafter be made under the regulation for one year.

The Study sees no need for so rigid a pattern of restriction. Neither authority nor logic compels the Commission to classify the separate secondary offerings of individual shareholders as amounting to a single "issue" of securities within the meaning of that term in Section 3(b) of the Act. No greater reason is apparent for

classifying all secondary sales and those made on behalf of the issuer as part of the same "issue."

A limited expansion of the availability of Regulation A within the present dollar limitation of Section 3(b) would assist controlling persons and statutory underwriters—particularly those of non-reporting companies—who wish to dispose of a portion of their holdings, while not neglecting the need for appropriate disclosures.

It would be unwise, of course, to carry this proposition too far. If an issuer could sell securities privately to a number of individual purchasers, each of whom could promptly resell $300,000 of such securities under Regulation A, an obvious evasion of the registration requirements of the Act would occur. Accordingly, the Study would retain the present maximum amount of $100,000 which can be sold within any one year by any one person other than the issuer.[3/]

Moreover, the concept employed by the Study in developing the rules recommended in Chapter VI[4/] provides a ready analogy. A person who takes securities privately from an issuer and resells within a short time is, in effect, a conduit for the issuer. To guard against this possibility and to provide certainty, under those

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3/ There is also a provision permitting a maximum of $300,000 to be sold by the estate of deceased person in any one year within 2 years after the death of such person. The Study would retain this exception.

4/ See pp. 199-200 supra.

rules the private purchaser who resells publicly within one year is deemed an underwriter. Similarly, it is suggested that this aspect of the integration concept properly applies under Regulation A to sales made directly by the issuer and sales made within one year of purchase by private purchasers from the issuer.

As to controlling persons, it appears appropriate to tie together (1) the issuer and (2) those who have become its controlling persons in the immediate past. By contrast, the controlling person who has occupied that status for over one year should be permitted to make use of Regulation A without adversely affecting the amount otherwise available to the issuer.

Accordingly, the Study recommends amendment of Rule 254 [5/] to establish the following standards:

(a) $300 shall constitute the maximum aggregate offering price within any one year for securities offered under Regulation A by (i) the issuer, (ii) its predecessors (as defined in Rule 251), (iii) all of its corporate affiliates which were incorporated or organized, or became affiliates within the past two years, (iv) holders of restricted securities of the issuer (as defined in proposed Rule 161, Appendix VI-1) outstanding less than one year, and (v) (individual) holders of non-restricted securities of the issuer who have been

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5/ The precise language of the recommended amendment has not as yet been drafted.

affiliates (i.e., controlling persons) of the issuer for less than one year.

(b) Any person other than a person described in (a) above may sell under Regulation A securities with an aggregate offering price of $100,000 in any one year.[6/]

2. The provisions for computing the aggregate offering price of securities of companies with a recent history of losses (Rule 253(a)(2)) are unnecessarily restrictive, and interfere with the usefulness of Regulation A as a disclosure tool.

The Study debated long and hard over Rule 253. It consulted with members of the Commission's staff and in particular with Regional Administrators of long experience. A number of suggested changes in the rule were considered. It was the Study's ultimate conclusion that, while the issue is not free from doubt, Rule 253 should be modified to apply only to issuers with less than one full year of operating history.

If an issuer is newly formed and has just commenced business, it makes sense to restrict the resale of its securities to the public on behalf of promoters, controlling persons and underwriters under a

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6/ The exception for sales by estates of deceased persons referred to in n. 3 on p. 302, should be retained.

statutory exemption. The issuer itself (under the terms of Rule 253) remains able to use Regulation A for primary financing purposes.

However, clause (a)(2) of the present rule draws a fine distinction between companies which have had two recent unprofitable years and companies with only one loss year out of the last two. The restrictions of Rule 253 limiting secondary sales apply to the first category of companies but not to the second. The anomalous results which might flow from that provision are readily apparent. Thus, for example, there would be no restriction on secondary sales of the stock of a company with a bare two year operating history, and gross sales of less than $1,000,000 per year, which made a $5,000 net profit in its first year and suffered a $250,000 net loss in its second. However, secondary sales under Regulation A would be forbidden if a company in existence for many years, with gross sales of $10,000,000 suffered a small operating loss in each of its last two years.

The Study doubts that the distinction drawn by Rule 253(a)(2) effectively protects the public interest. To the contrary, the Study has been advised by several of the experienced Regional Administrators that when Regulation A is denied for secondary sales, the result is often an intrastate offering which may take place without disclosure and involves substantial risk of violation of the ’33 Act.

It is no answer to say that full registration under the ’33 Act is always available in such circumstances. For the small secondary offering, full registration would be impracticable. The Study believes it should be the Commission’s objective to provide an appropriate vehicle, whenever possible, for public sales to take place with disclosures suited to the occasion.

For these reasons, the Study recommends that Rule 253 be amended to:

(a) delete clause (a)(2), and

(b) change clause (a) to read:

> “(a) the following provisions of this rule shall apply to any offering under this regulation of the securities of any issuer which has had less than one full year of continuous operations immediately prior to the filing of the notification.”

3. Offer and sale of securities without an offering circular (Rule 257) is inconsistent with good disclosure policy. Rule 257 should be rescinded.

Rule 257 provides that, with certain exceptions, an offering circular need not be used if the aggregate offering price of all securities offered without the use of such a circular during any one year by the issuer, its predecessors and affiliates does not exceed $50,000.

Somewhat strangely, the rule provides that although an offering circular need not be given to public purchasers of the stock, all of the information required in an offering circular (except financial statements) must be furnished to the Commission as an exhibit to the usual notification. Thus, with the single exception of financial statements, all of the disclosures required by Regulation A must be prepared and given—but not to the public.

Moreover, the exception for financial statements is more apparent than real. Rule 257 may not be used by companies of the character specified in Rule 253(a). In order to determine whether or not a company is ineligible under this standard, the Commission's staff asks for and analyzes the appropriate financial statements of the issuer.

It makes little sense, in the Study's judgment, to require disclosures which will not be disseminated. Accordingly, little additional burden would seem to be involved for a user of Regulation A otherwise entitled to the benefits of Rule 257 if he must duplicate and deliver the offering circular. No other means of dissemination for the disclosures filed with the Commission is readily available. These documents are not, and in all probability will not be, included among the materials available on microfiche (see Chapter IX).

The Study therefore recommends rescission of Rule 257.

4. The duration of disqualifications from use of Regulation A (Rule 252(c) and (d)) and other procedural rules should be altered to avoid hardship and inconsistency.

Rule 252(c)(2) presently provides that Regulation A shall be unavailable if the issuer is subject to a suspension order under Rule 261 entered in the previous five years. Under Rule 261, an order temporarily suspending the exemption may be entered if the Commission has reason to believe that (among other things) (1) any sales literature used in the offering is misleading; or (2) the offering is being made in violation of Section 17 of the ’33 Act; or (3) any terms or conditions of Regulation A have not been complied with; or (4) any underwriter of the offering has been indicted for any crime (within a certain category) or is subject to an injunctive proceeding (of a designated character) or has failed to cooperate in any investigation of the offering by the Commission. After notice and opportunity for hearing, the Commission may enter a permanent suspension order on any of the foregoing grounds.

The happening of any of the foregoing occurrences may be due entirely to the actions of an underwriter of a Regulation A offering, the issuer being entirely innocent. Yet for five years thereafter, the issuer (or any person holding the issuer’s securities) is barred from the use of Regulation A, unless the Commission takes affirmative action (under Rule 252(f)) to lift the bar. This procedure seems

unnecessary. If a suspension order does not charge the issuer with action which is a ground for suspension, the order should be no bar to any future use of Regulation A by the issuer or by any person not so charged. Rule 252(c) should be amended accordingly.

Under Rules 252(c) and (d), Regulation A may not be used as to the securities of any issuer if

(1) the issuer, any predecessor, or any affiliated issuer is subject to a postal fraud order, or

(2) any director, officer, principal security holder, promoter, underwriter, or officer, director, or partner of such underwriter, of the issuer is subject to an injunctive order (of a certain category), is subject to a Commission order (of a certain designated kind) has been expelled from an exchange (American or Canadian) or the NASD, or is subject to a postal fraud order.

Other types of conduct on the part of the foregoing persons, <u>including criminal conviction</u>, operate to bar the use of Regulation A for a five or a ten year period only.

The rules should be amended to provide that Regulation A is barred for a maximum period not to exceed five or ten years, whichever is appropriate, absent relief granted by the Commission under Rule 252(f).

Under existing doctrine, a technical violation of the terms and conditions—for example, failure to file a report of the termination of an offering on time—results in loss of the Section 3(b) exemption for the entire transaction. The Study believes that the more appropriate result of such technical violations would be loss of the exemption prospectively.

5. Various changes in Form 1A (the "Notification") and Schedule 1 (the "Offering Circular") would improve disclosure and codify existing administrative interpretations.

The Study has made no attempt to draft revisions of the notification and offering circular required by Regulation A. However, a number of suggestions have been made which, in the opinion of the Study, would improve the disclosure elicited by those documents and codify existing administrative interpretations.

(a) The notification.

Minor alterations should be made in the notification to codify existing practices of the regional offices and to require disclosures not now called for (such as the address of the issuer.)

(b) The offering circular.

(i) General instructions analogous to those in ’33 Act registration forms should be provided for the offering circular.

(ii) Various items of disclosure should be revised to codify existing review practices in the regional offices and to clarify certain items. For example, the disclosure of intended use of proceeds could be made more meaningful, and a statement added that consolidated financial statements are required, where appropriate.