NEWS

SECURITIES AND EXCHANGE COMMISSION
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REGULATION D: MORE PROGRESS IN REDUCING GOVERNMENT REGULATION

Address by

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"The New Rules for Private Placements"
Sponsored by:
The Housing & Development Reporter, BNA
and
The Institute for Professional and Executive Development, Inc.
Washington, D.C.
June 3, 1982

I appreciate the opportunity to speak to you for a few minutes today at the beginning of this conference dealing with the new rules for private placements. This program provides an opportunity for you to hear several speakers explore the technical differences between Regulation D and Rules 146, 240 and 242, the old rules governing private placements. I feel sure that when you have become familiar with the intricacies of the new rules, you will find them to be more understandable and easier to use than the old ones. Other speakers will discuss the details of Regulation D. I have been asked to comment on the background and origins of the change in rules and the legislative and administrative concern with the capital formation process.

I believe it is important to understand that the concern of Congress and the Commission about the impact of SEC regulation on small business is not of recent origin. One of the priorities of William O. Douglas, an early Commission Chairman and proponent of economic deconcentration, was to find an effective way to equalize capital raising opportunities for small and large businesses. In 1937, an SEC study found that the relative cost of raising capital was significantly higher for small businesses. For instance, statistics showed that issuing costs accounted for about 15 percent of common stock issues of $1 million to $5 million, whereas about 22 percent was required for issues of $250,000 or less. The differences in the cost of selling preferred stock ranged from less than 4 percent for issues between $5-10 million to over 17 percent for those of $250,000. Debt issues showed a similar degree of disparity. In early 1937, President Roosevelt asked, "that the Securities and Exchange Commission consider such simplification of regulations as will assist and expedite the financing . . . of small business enterprises." Soon thereafter, the Commission expanded the exemptions for issues under $100,000 and provided a new simplified form for issues of less than $5 million.

Following other periodic changes designed to reduce capital raising costs, in the 1970's the SEC adopted what we sometimes call the 140 series of Commission rules. These rules provided a more objective and workable regulatory framework by removing some of the uncertainty for those who desire to issue securities and engage in securities transactions pursuant to exemptions from registration requirements under the Securities Act. Rule 144 dealt with public resales of securities acquired in private transactions; Rule 145 dealt with registration of securities issued in connection with mergers, acquisitions and reclassifications; Rule 146 dealt with transactions that are exempted from registration by

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Section 4(2); and Rule 147 dealt with intra-state offerings under Section 3(a)(11). When adopted, these rules were considered to be significant changes that would assist businesses to raise capital in a manner consistent with the protection of investors.

During the middle to late 1970's, small business problems continued to receive considerable attention. At least three different Congressional subcommittees held hearings in 1976 and 1977, and a number of studies of small business problems were commissioned. These hearings and studies generally indicated that the obstacles faced by small business are rooted in our economic system, and are affected by tax and regulatory policies that are beyond the scope of the federal securities laws. There were, however, suggestions that the Commission's requirements for registration of securities, as well as the periodic reporting requirements, were excessively burdensome for small issuers.

At about the same time, in 1977, the Report of the Commission's Advisory Committee on Corporate Disclosure recommended that public hearings be held to consider a lessening of reporting requirements for small companies, and to identify what characteristics would qualify a company as being "small." The Report recognized that it might be difficult at times to reconcile the objective of protecting investors through the disclosure of all material information needed to make an investment or corporate governance decision, with the objective of removing certain reporting requirements for small businesses. Nevertheless, the Report concluded that with respect to small companies, it might be possible to lessen some of the costs borne by such businesses by reducing some existing disclosure obligations without adversely effecting investor protection.

In December of 1977, the Commission announced that it would hold public hearings on the ability of small businesses to raise capital and the impact of the disclosure requirements of the Securities Act of 1933 on such businesses. These Hearings also responded to the Advisory Committee's recommendation to evaluate potential reductions in the periodic reporting requirements of small companies. The staff prepared a list of 75 questions for which answers would be sought. These questions focused on issues involving Rule 146, Rule 240, Regulation A, Section 4(2), and Exchange Act rules on disclosure, in an attempt to develop a better understanding of the effect these provisions have on to small business financing. We held hearings here in Washington, as well as in Denver, Boston, Los Angeles, Chicago and Atlanta. In 21 days of hearings, we received 55 written submissions and testimony from 140 witnesses. From the approximately 4,500 pages of testimony, the staff developed a summary of comments, which has been used since that time as our "data base" in the small business area.

The first tangible result from these efforts was the adoption of Form S-18, which, as most of you know, is a simplified registration form available for certain companies making their first registered, public offering. The form was adopted as an innovation for small businesses on an experimental basis, and, thus its use was restricted initially to certain corporations not engaged in, among other things, mining or oil and gas operations. The staff has monitored the use of this form to evaluate its effectiveness and to detect potential problems. In 1981, the Commission made Form S-18 available to mining operations, and later this morning, the Commission will be considering adoption of amendments that would permit the form to be used by limited partnerships, oil and gas ventures and other entities to which it is not presently available.

Another significant development following the public hearings was the formulation of Rule 242, which was published for comment in September 1979, and adopted in early 1980. This Rule was developed in response to many comments at the hearings complaining about the difficulties of using Rule 146 to raise capital. Although the amount of money that could be raised under the Rule was limited to $2 million in a six month period, two aspects of the Rule were precedent setting. First, sales could be made to an unlimited number of persons that qualified as "accredited investors", a term that is incorporated into Regulation D and one that you will undoubtedly hear more about later today, and second, sales could be made to 35 other persons, a major departure from the requirements of Rule 146. Although Rule 242 has now been rescinded with the adoption of Regulation D, you will recognize many of its provisions in Regulation D.

While the Commission was holding hearings and developing Rule 242, Congress was considering legislative initiatives to respond to the problems and needs of small businesses. Ultimately, Congress adopted the Small Business Investment Incentive Act of 1980, which, among other things, created a category of "business development company" for purposes of the Investment Company Act of 1940, and raised the ceiling for offerings under Section 3(b) of the Securities Act from $500,000 to $5 million. Perhaps more importantly for our purposes today, the Act created Section 4(6) which provides a new exemption from the registration provisions of the Securities Act for offerings made only to "accredited investors." As the Report of the Senate Committee on Banking, Housing and Urban Affairs stated, Section 4(6) "is intended to give small businesses greater access to financial institutions and other sophisticated investors without the costs associated with the registration requirements." Also, the Act authorized the Commission to work with state securities associations in the development of a uniform exemption from registration for small issuers and to adopt an exemption that was agreed upon by the states and the federal government.

The Commission responded to the legislative changes by seeking public comment on the interrelationship of the various private placement rules, noting that certain rules, and the new legislation, were designed primarily to assist small businesses in raising capital, while other rules could be used by even the largest companies. The Commission sought comments because we have found over the years that some of the best suggestions for changes in regulation come from those who are subject to the regulation and those who act as their professional advisers. Although particular suggestions are not always adopted, thoughtful and detailed comments from the private bar and other interested members of the public can have a significant influence on our rulemaking process.

The SEC staff reviewed the comments that were received, and devoted many hours of hard work to formulating the rules now known as Regulation D. Both before and after it was published for comment, the Commission staff worked closely with a subcommittee of the North American Securities Administrators Association ("NASAA") in order to develop uniform federal-state exemptions from registration. Lewis Brothers, Director of the Securities Division of the Virginia State Corporation Commission, who is with us here today, was an active and influental member of that subcommittee.

During the development of Regulation D, many persons sought changes in the details of the proposal ranging from the definitions of accredited investors and purchaser representatives to the information requirements for limited partnerships and Exchange Act reporting companies to the number of purchasers permitted in the offering. Although there are still disagreements with regard to particular provisions of Regulation D, I believe that a reasonable balance has been achieved between encouraging the development of small business and the necessary protection of investors.

As I am sure you realize, the concerns and policies of the several states do not always coincide with each other or with those of the Commission. Thus, it was necessary for the Commission and NASAA to seek reasonable compromises on certain elements of the proposed regulation. Despite the good faith efforts of the Commission and NASAA to work out disagreements and achieve uniform exemptions, you will find that there are some differences between Regulation D and the Uniform Limited Offering Exemption endorsed by the membership of NASAA. Regardless of the inability to achieve a complete consensus, the substantial agreements which were reached represent an important milestone. This process was the first cooperative effort between the Commission and NASAA in the rulemaking area and it was significant not only for what it accomplished in Regulation D but because it set the stage for further cooperation in the future.

The ultimate success of these efforts to achieve substantial uniformity, however, depends upon legislative and administrative action by the states. The Small Business Investment Incentive Act of 1980 specifically provides that the Commission can not preempt the states in its attempt to develop uniform exemptions. Thus, the Commission is limited to its powers of persuasion in encouraging the states to implement changes. Similarly, the endorsement of a Uniform Limited Offering Exemption by the membership of NASAA is not binding on states. Perhaps through participation in bar associations and other organizations, each of you may be instrumental in the development of exemptions at the State level which parallel those contained in Regulation D.

Finally, I want you to know that the recently adopted new rules governing the periodic reporting requirements for small companies, Regulation D, and the rule changes we will likely approve later today, do not signal the end of the Commission's efforts to reduce the cost of raising capital by small businesses anymore than did the rules adopted during earlier periods of the Commission's history. We will continue to make changes as we have in the past. Even now, the Commission is working with other government agencies and private sector organizations to make preparations for an annual Government-Business Forum to review the current status of problems and programs relating to small business capital formation. You may recall that the Small Business Investment Incentive Act of 1980 directs the Commission to conduct such a forum annually. An executive committee, comprised of persons from several federal agencies and private sector organizations at its first planning meeting in April, approved a questionnaire which was sent to a sample of small businesses throughout the country, divided itself into task forces to deal with various categories of issues, and determined the format to be used for the Forum. This Forum, which is scheduled for September, will consider not only securities law requirements, but also difficulties encountered by small business in taxation, extension of credit and access to financial institutions. With the help of the Executive Committee, experts chosen by the task force, and of all who participate in the Forum, we expect to develop another agenda of problems facing small business and to seek solutions to those problems.

Thank you.