EFFECT OF THE SECURITIES ACT OF 1933 UPON THE FINANCIAL NEEDS OF SMALL INDUSTRY

The provisions of the Securities Act of 1933* involved in the present question are those intended to provide full disclosure of the character of new offerings of securities.

The Act also contains provisions relating to the prevention of fraud or misrepresentation in the sale of securities, whether old or new, but these provisions are to a large extent devoted to making explicit, and subjecting to Federal prosecution, offenses which are already covered in a general way by the common law or statute law of most States. These provisions do not seriously concern either large or small businesses and may be disregarded for present purposes.

Disclosure of the character of new offerings of securities is accomplished through two methods: (1) a registration statement must be filed with the Securities and Exchange Commission disclosing certain details regarding the new issue of securities, and (2) each security sold from such an issue must be accompanied or preceded by a prospectus containing information similar to that required in the registration statement.

Because of the nature of Federal jurisdiction, these requirements are made effective by requiring that they be complied with before interstate commerce or the mails may be used to distribute the security.

The Commission does not approve or disapprove any securities. Any securities, no matter how worthless, may be registered upon the filing of a registration statement containing the necessary information; but the Commission may terminate the effectiveness of a registration statement (and hence the selling of the securities) because of omissions or misstatements in the registration statement.

There are criminal penalties for filing false, incomplete or misleading registration statements.

Probably of even more importance is the fact that any person who purchases a security for which such a false, incomplete or misleading registration statement has been filed may recover certain damages from the underwriter or from various other persons connected with the issue. These civil liabilities are, at least

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* Not to be confused with the Securities Exchange Act of 1934 that regulates exchange trading, margin requirements, etc.

potentially, quite severe.

Exemptions from the Act

Section 3 of the Act exempts certain securities from the registration requirements. Most of these exemptions are not of particular interest here, for example, the exemption of Government securities, commercial paper, securities of religious and charitable organizations, securities whose issue is controlled by the Interstate Commerce Commission, securities of building and loan associations, and securities exchanged by the issuer with its existing security holders exclusively where no commission or remuneration is given.

Intrastate distribution. - Of more interest for present purposes is the exemption in section 3 of securities which are a part of an issue sold only to persons resident within a single State, where the issuer of the security is resident and doing business within the State or incorporated and doing business therein. It will be noted that this does not exempt a corporation's securities unless it is incorporated in the State to which the distribution is confined, as well as doing business in the State.

Exemptions by Commission. - Section 3 also authorizes the Commission to exempt securities by regulation, but it cannot exempt issues that exceed $100,000. The $100,000 restriction in the Act prevents widespread use of this power of exemption.

"Private offerings". - Section 4 of the Act exempts certain transactions from the registration requirements. These are similar in effect to highly restricted exemptions of securities. The most important of these exemptions for present purposes is the exemption of "transactions by an issuer not involving any public offering". A rather detailed analysis of the Act is necessary for an understanding of this exemption.

Since the exemption specifies only "transactions by an issuer", it might be supposed that any transactions by an intermediary, such as an investment banking firm arranging the details of the private offering, would not be exempt. Other provisions of the Act, however, have a bearing here.

Section 4 exempts all transactions "by any person other than an issuer, underwriter, or dealer". Hence only "underwriters" and "dealers" need be considered further.

The term "underwriter" is given a particular definition. It is defined in section 2(11) to mean

> "any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking * * *." (Underscoring supplied).

Thus, by definition, a person is not an "underwriter" with respect to a particular issue unless there is a "distribution" of the issue. In other words, the arrangements which an investment banking firm may make in connection with a strictly private offering would not make the firm an "underwriter" of the issue for the purposes of the Act even though the firm might be popularly thought of as an "underwriter".

"Dealers" transactions are covered by the exemption in section 4 of all

> "transactions by a dealer * * *, except transactions within one year after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter * * *, and except transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter." (Underscoring supplied).

It will be noted that transactions of dealers are exempted if there has been no "distribution", because the one-year period during which a dealer's transactions are subject to the Act does not begin to run until "the first date upon which the security was bona fide offered to the public". So long as there is no such public offering, the period does not begin to run and the dealers' transactions remain exempted.

Thus, it will be seen that by one provision or another all transactions are effectively exempted if there is no "distribution".

The importance that attaches to there being no "distribution" in connection with so-called private offerings is indicated by the following excerpt from S.E.C. Release No. 285 of January 24, 1935, discussing a proposed private offering:

> "any dealer who might subsequently purchase from an initial purchaser the securities which you propose to offer, would be required to satisfy himself that the initial purchaser had not purchased with a view to distribution. If the initial purchaser had purchased with this intent, he would be an underwriter, and sales by a dealer of securities bought by him from such an initial purchaser would, as a general rule, not be exempt until at least a year after the purchase of the securities by the dealer. The sale of unregistered securities to a limited number of initial purchasers, therefore, leads to a practical situation in which such initial purchasers may have difficulty in disposing of the securities purchased by them."

These restrictions will be seen to follow from the definition of underwriter and the one-year period during which dealers' transactions are subject to the Act, as discussed above.

The Act does not define "distribution", or its correlative "public offering", and the Commission's discussion of the term has been guarded. Although an offering to a rough maximum of 25 offerees has been suggested as sufficiently insignificant to fall outside the concept of "public offering", it has been recognized that such a figure does not afford an absolute test and that equal importance must attach to other factors, such as the relationship of the offerees to each other and to the issuer, the number and character of units offered, and the size and amount of the offering. It also seems that in so far as a numerical test is employed it is the number of offerees rather than the number of purchasers which is material.

Since the exemptions relating to private offerings apply to all securities, whether of large businesses or small, such exemptions are not of peculiar interest to small industry. The caution of the Commission in discussing the term "distribution" on which such exemptions depend is not surprizing in view of this universality. Therefore, unless it is intended to relax the application of the Act generally, it would seem to be more logical to seek relief for small businesses by working out exemptions confined to such businesses, rather than by giving attention to general exemptions such as those relating to private offerings.

Effect of Comptroller's Regulation. - There have been many large private offerings and apparently the Securities Act has caused little difficulty. It is possible that the Securities Act was not an important reason for some of these issues being placed privately, since some of them were subsequently registered.

Almost all the private offerings, however, have been purchased by insurance companies. The press has recently commented on the fact that banks are obtaining practically none of such securities. In this connection, the effect of the regulations of the Comptroller of the Currency regarding the purchase of investment securities by member banks should not be overlooked. These regulations, in effect, require securities purchased by member banks to have a public distribution, or be available for such distribution.

Registration under the Securities Act, or exemption of the security under section 3 (not exemption of transactions under section 4), is necessary for such distribution. It will be seen, therefore, that even though registration under the Securities Act may be avoided by placing securities privately, member banks could not participate in such financing under the present regulations of the Comptroller. The obstacle would be the Comptroller's regulations, however, rather than the Securities Act.

Since the Comptroller's regulations are based throughout on requirements of "liquidity", it might be necessary to make considerable changes in these regulations, in addition to eliminating the requirements specifically relating to the Securities Act, before member banks could freely purchase the type of securities that small businesses are likely to issue.

Increased expense of issuing securities.

General expenses. - A nominal charge of only one 1/100th of one per cent of the offering price of the securities must be paid the Commission as a fee for registering an issue; but there are expenses of printing the registration statement and prospectus, fees of counsel and accountants, and other expenditures in connection with the preparation of the statement.

However, only certain of these expenses have been increased by the Securities Act registration requirements, and it is not easy to isolate or appraise the items of additional expense. All the information required by the Act should be readily available to the issuer, and much of it probably would have to be made available to the underwriter regardless of the Securities Act, although possibly it could be presented in less expensive form.

The following excerpt from an article by R. W. Goldschmidt, Senior Financial Economist of the Securities and Exchange Commission, in the January 1937 issue of Duke University's "Law and Contemporary Problems" (pp.18, 27) is of interest:

> "In view of the numerous discussions of the additional cost of registration it may be of interest that various rather careful estimates made on the basis of registration statements filed with the Commission indicate that such additional costs are on the average below 1/2% of gross proceeds for issues above $1,000,000 and probably do not amount to even 1/4% at the present time."

It will be noted that this estimate is for issues above $1,000,000. The expense necessary to distribute an issue of securities is to a large extent a lump sum that does not vary greatly with the size of the issue. Thus, the cost per unit increases rapidly as the size of the issue decreases, as indicated in the following tabulation of the total costs of certain issues during 1936 and the first half of 1937:

(In thousands)	Under $250	$250-499	$500-749	$750-999	$1,000-4,999	$5,000-9,999	$10,000-24,999	$25,000 or more
Number of issues...	11	8	6	6	50	11	37	35
Commission and discount(per cent)..	6.4	6.2	5.2	4.2	3.4	2.3	2.2	2.1
Other expenses(per cent)............	2.2	2.0	2.5	2.0	1.4	1.1	0.9	0.6
Total(per cent)	8.6	8.2	7.7	6.2	4.8	3.4	3.1	2.7

This difference in per unit costs is, of course, a fact that is not a result of the Securities Act. But to the extent that the Act increases the cost of issuing securities, it increases the burden on small business to a greater extent than on large business. It is admitted at page 27 of the Goldschmidt article, supra, that any additional costs due to the Securities Act "are, of course, relatively heavier for small issues, but the same relationship between costs of issuance and size of issue obtained before the Securities Act became effective".

The Commission has improved the various forms for registration of different securities and thus has reduced the cost of registration. It also has made certain rules regarding material in the registration statement that may be omitted from the prospectus. It has broader powers with respect to the prospectus than with respect to simplifying the registration statement or granting outright exemptions of securities, and conceivably it might drastically reduce the prospectus requirements for certain issues of small businesses.

Underwriting Commissions.- It will be noted from the tabulation above that underwriting commissions, like general expenses of distribution, tend to increase in per unit cost as the size of issue decreases. It might be supposed that the possibility of civil liability under the Securities Act would cause underwriters to charge higher underwriting commissions. If so, this would bear more heavily on small businesses on a per unit basis.

In an article published at page 44 of the January 1937 issue of Duke University's "Law and Contemporary Problems", however, Mr. Paul P. Gourrich, Director of the Research Division of the Securities and Exchange Commission, claims that the Act reduces underwriting commissions.

He admits (p. 70) that this decrease in spreads "may be traceable to the fact that present issues have been of higher quality, mostly for refunding purposes, and with lower coupon rates". Whether or not the Securities Act actually reduces underwriting commissions, however, these data would at least seem to offer some rebuttal against any arguments that the Act increases such charges.

Discouragement of "nongilt edge" issues

The civil liabilities for false, incomplete or misleading registration statements may give rise to an intangible factor affecting small businesses. Some claim that the fear of such liability tends to cause both underwriters and issuers to confine themselves to the highest type of issues, that is, to issues that will not be very substantially affected by general adverse economic conditions. This would be on the theory that they would thus be more likely to avoid being sued by disgruntled investors. Such litigation might be troublesome and expensive even if finally won by the defendants. While there is still some talk to this effect, it was considerably reduced by the 1934 amendments that somewhat relaxed the civil penalties.

If the civil penalties connected with registration statements do tend to discourage all issues that are not of the highest grades, they not only are eliminating many unsound or fraudulent issues but also are eliminating many issues that merely might be subject to fluctuations. If the penalties have this effect, it means that they tend to freeze so-called "venture money" and to limit new issues to "gilt edge" securities. Whether or not it is due to such penalties, it does seem to be a fact that the few security issues of the past several years have been largely of the "gilt edge" variety.

Large businesses are usually in a better position to offer "gilt edge" bonds or relatively "gilt edge" preferred stock than are small businesses. Therefore, it may be that the civil liability provisions place small businesses at a disadvantage in this respect entirely aside from any mere differences in per unit costs for large and small issues. The exact extent of any such disadvantage--if indeed it actually exists at all--is quite problematical, however, particularly since the relaxation of the civil penalties as effected by the 1934 amendments to the Act.

<u>Conclusions</u>

1. The Securities Act has somewhat increased the cost of issuing securities, but the available evidence indicates that the additional cost has not been a substantial burden to small industry. The increased cost, however, is difficult to appraise and does affect small industries more than large, because any such increase results in a greater per unit increase for a small issue than a large issue.

2. The Commission might be able to reduce somewhat the cost of issuing securities by simplifying the requirements under the Act, particularly those for prospectuses, but there may be some question as to just how much could be accomplished along this line.

3. Some claim that the civil liabilities connected with registration statements make underwriters and issuers reluctant to distribute "nongilt edge" issues. To the extent that this is correct, it would particularly affect small businesses since they are usually not in a position to issue "gilt edge" securities; but this matter is quite problematical, particularly since the relaxation of the civil liabilities in 1934. By amendment to the law, however, such civil liabilities could be modified or eliminated for all or certain types of securities. (Of course, exemptions granted in

other ways would, in the sphere in which they operate, amount to exemptions from such civil liabilities.)

4. While the exemption of "private offerings" is not as clear as it might be, the ambiguity on this point probably affects small industry less than does the investment security regulation of the Comptroller of the Currency which, in effect, forbids member banks to invest in securities which are privately placed. Thus, the Comptroller's regulation, rather than the Securities Act, bars such private offerings to member banks, and such offerings are absorbed almost exclusively by insurance companies. Moreover, private offerings are of general interest to all issuers, rather than of peculiar interest to small industry.

5. The exemption of issues distributed within a single State is not as effective as it might be for present purposes because it applies to a corporation's securities only if it is incorporated in the State of distribution, as well as doing business there. By amendment to the law, this exemption could be extended to any corporation doing business (or having its principal place of business) in the State of distribution, even though incorporated elsewhere.

6. The Commission's power of exemption is not as effective as it might be for present purposes because the Act confines it to issues under $100,000. By amendment to the law, the Commission's power of exemption could be broadened, either by raising the $100,000 limitation to a substantially higher figure or by removing a dollar limitation altogether and substituting other standards.

Since the enactment of the Securities Act of 1933, its effects upon the capital market and upon the financial needs of various types of businesses have been the subject of much discussion and analysis, both by the Securities and Exchange Commission and others, with conflicting conclusions.

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