

January 19, 1938

The Small Corporation and the Capital Market

Has the small corporation adequate credit facilities? As to short time commercial loans, yes. As to medium or long-term credit, no.

The following are the difficulties that confront the small corporation:

1. The undistributed profits tax prevents the use of earnings for capital expansion or debt payment except under heavy penalties. An exemption from the surtax for small corporations would be beneficial.
2. The local bank will not lend to the small industrial corporation for capital purposes. Such "capital loans" have always been criticized by bank examiners and while there is less basis for criticism today, the attitude of the examiners and the banker is still hostile toward such loans.
3. Can the small corporation get an industrial loan from the Federal reserve bank? Yes, in some cases, but the statute is quite restrictive since it limits the purpose to "working capital" and requires the loan to be made on a "sound and satisfactory" basis which has been interpreted by the reserve banks to mean a high class risk. A re-vamping of the whole industrial loan mechanism would be desirable.
4. Having failed to procure a capital loan from a local bank and from a reserve bank, can the small corporation go to the capital market? No, since the cost is prohibitive and the restrictions in the Securities Act of 1933 and in the Comptroller of the Currency's Regulation on Investment Securities practically make it impossible.
  - (a) As to the cost, the fee paid to the SEC for registration is nominal but there are heavy expenses in order to accomplish the registration. These include legal, auditing, printing, engraving, trustees' fees, underwriters' expenses (in addition to his "spread"), travel, long distance telephone and telegraph, the aggregate being extremely heavy when the security issue is small. Even moderate sized issues encounter an unreasonably heavy burden. A recent issue of \$3½ million of equipment trust certificates issued by a west coast transit corporation cost approximately \$47,000 for expenses plus the underwriters' commission of \$105,000, a total of \$152,000 or roughly 4.5 percent additional burden on top of the interest.

(b) Can these excessive costs be avoided by short circuiting the registration requirement? No, except in a very few cases. The statute does provide for certain exemptions but they are unduly restrictive and do not afford any substantial relief to a small corporation. These exemptions are as follows:

(1) Securities which are part of an issue sold only to persons residing in the State where the corporation was incorporated and in which it is doing business. Many small and medium sized corporations are incorporated under the laws of a State other than where they do business.

(2) An exemption as to "transactions by an issuer . . . not involving any public offering." This would afford relief if the issuer had a staff with sufficient technical and financial experience to handle all the details of an issue of securities. This is not a simple matter since it involves the entire mechanics of drawing the obligation itself, negotiating with the trustee, as well as the actual selling of the securities. In other words, it would require that the small corporation should be virtually as experienced in the issuing and distribution of securities as is the typical underwriter. Why can't the underwriter serve the small corporation in this situation? Here the restrictions in the statute raise grave doubts, since the exemption under discussion relates only to transactions "by an issuer" and the underwriter and dealer is effectively barred from participation since he cannot use the mails or telephone or telegraph communications across a State line to market unregistered issues. This situation would indicate that without sacrificing the general principle of protecting the public against fraud by the registration requirement, the exemption above noted might be extended so as to permit a small issue of securities to be purchased by a local underwriter, including a member bank, for private distribution to member banks only.

(c) A broadening of the exemption as to private offerings suggested above would have to be accompanied by an amendment to the Comptroller's Regulation on Investment Securities. This regulation as now drawn prevents member banks from investing in any security which is not "readily marketable" and which is "predominately speculative in character." In defining "readily marketable" emphasis is placed upon ratings and upon wide distribution and frequent transactions in the market. This

obviously eliminates local issues since such issues cannot get a rating in the first place and furthermore their smallness prevents wide distribution and frequent transactions.

#### Summary

The small corporation today is seriously handicapped for additional capital and a continuation of the existing situation will accelerate the trend toward bigness in industry. A program to combat this trend and to afford needed relief to small corporations would require:

- (1) The exemption from surtax of say \$15,000 of the net earnings of any corporation.
- (2) The encouragement of capital loans by banks with savings accounts and the creation of a new agency for industrial loans free from the present restrictions in section 13(b) of the Federal Reserve Act.
- (3) A broadening of the exemptions in the SEC statute as to registration and distribution of local securities purchased privately by member banks.
- (4) Concurrently with (3) above, an amendment to the Comptroller's Regulation on Investment Securities.