ADVANCE - For Release On Delivery

"Small Issues and the Public Interest"

An Address by

Hon. Harry A. McDonald
Commissioner
Securities and Exchange Commission

before the

Thirty-Second Annual Convention

National Association of Securities Administrators

Richmond, Virginia

July 11, 1949

I am surely enjoying my visit to this historic and lovely old city of Richmond. The natural beauty of Virginia, the pleasent company, the interesting things to see and, above all, the genial hospitality of our hosts make this an auspicious occasion.

I am also happy of this chance to meet with those who are in the business of regulation and to personalize the effective cooperation which has developed through the years between the State Commissions and the S. E. C.

We ought not restrict that cooperation to the formal channels of written communications. The ambiguity of the printed word was brought home to me after a recent talk I made in Philadelphia. Discussing the hazards of market prognostication and my inability to tell what the market was going to do next, I remarked facetiously that the S. E. C. has 1137 registered investment advisers, and that I was not one of them. This talk was publicized. Within a few days I received a letter from a Congressman on behalf of one of his indignant constituents wanting to know what the Securities and Exchange Commission needed with all those investment advisers!

A meeting of this sort helps to clarify the problems we confront together.

It seems to me that ours is a dual task. We must stop fraud in the sale of securities. We must also facilitate the flow of capital to legitimate business enterprise. Sometimes it is like being a circus performer riding two horses threatening to take off in separate directions. But as we gather experience in the characteristics of each steed, we shall in time find the balance which best suits the public interest.

One subject we can discuss to advantage is regulating the sale of securities under the Securities Act of 1933 to raise small amounts of capital. Both you and I know - this is a perennial. Nevertheless, we are acquiring a good deal of experience in this field of seemingly contradictory objectives. While we cannot hope to solve all of the problems tonight, perhaps we can make some progress.

How can we balance the different and at times conflicting interests of the issuer, the investor, and the general public? Where does the public interest lie?

The phrase "in the public interest and for the protection of investors" appears repeatedly in the Federal securities acts. It is found in many of the State blue sky laws. Basically, "the public interest" in the ultimate touchstone of all we do in the regulatory field. Of course it has meaning only through application. Different men will employ it differently, each according to his nature, his experience, and his personal outlook.

Securities regulation has come a long way in the last two decades. The State blue sky laws and the Federal securities acts, combined with the mail fraud statute, have substantially lessened the possibility that the investor will be defrauded. The stock swindler's field of activity has been drastically circumscribed by this pattern of regulation. But he has not been completely eliminated. It is generally recognized that today small issues are a favorite vehicle for fraudulent activity. Investors also stand to lose in small businesses that sell stock to the public although their financial condition may be poor, or before their market or their product is adequately tested.

One doesn't have to look far for the reason. Small issues are not regulated as carefully or as completely as the larger ones.

This has always been a country of small beginnings, of individuals starting in a new endeavor, building and working to better things. Our national philosophy favors individual enterprise, particularly what has come to be called "small business." The Congress has expressed this favor historically in the form of special benefits to small business such as tax exemptions, contract preferences, and special loan facilities. They expressed the same philosophy in the Securities Act of 1933 by giving the S. E. C. authority to exempt securities from registration where the small amount involved or the limited character of the public offering makes registration not necessary -- and here the phrase reappears -- "in the public interest and for the protection of investors." Initially, the limit of this exemption was $100,000. In 1945 the Congress raised the amount to $300,000.

The S. E. C. has proceeded cautiously in opening this exemption. Every relaxation is at the price of investor protection. Undoubtedly, many going businesses, needing a small amount of additional capital, have been able to use to advantage the exemption for small issues known as Regulation A. Generally speaking, issuers of this type have dealt fairly with investors and have provided sufficient information to them. But there are some which have not dealt fairly. Consequently, there are those who feel that the protective standards have been relaxed too far, and that more information than the present Regulation A provides should be required. There is some merit in this contention, as we shall see.

Regulation A has an interesting history. Early versions required the use of a simplified prospectus in certain situations. In 1940 the regulations were completely revised. In place of the attempt at required, though limited, disclosure, emphasis was shifted to supervision and policing.

I am not going to enter into a technical discussion of the terms and conditions of Regulation A. Basically, it provides that, with certain exceptions, issues up to $300,000 in any one year are exempt from the registration requirements of the Securities Act if the issuer files what is called a Letter of Notification with the local regional office of the S. E. C. There is no charge for this as you know. It must also file copies of any selling literature it proposes to use.

The letter of notification is extremely simple. It identifies the issuer. It names the officers and directors. It names the underwriters. It names those on whose behalf the offering is to be made. There is a brief description of the securities to be offered, and the amount, together with underwriting discounts and commissions. If the sale is on behalf of the issuer, the proposed use of the proceeds is given. It also lists the states in which it is proposed to offer the securities.

Although the letter of notification is a public record, it need not be given to investors and, in fact, rarely is. Even if it were, the information is too scanty to be of much use. It does not require balance sheets or operating statements; the capital structure is not given; the terms of other outstanding securities are not described; the business of the issuer is not described; selling literature need not be used; and there are missing other items of information an investor would need for an informed appraisal of the security.

The purpose of the letter of notification, as its name indicates, is to notify the S. E. C. that securities of the type described are about to be offered for sale.

What do we do with this information? The regional office reviews the filing for completeness, and determines on the basis of the information presented, whether the exemption is available. The selling literature is also looked over. The issuer is notified of any apparent misrepresentations or omissions which may be found. Generally correction is made before the offering begins.

Meanwhile a copy of the filing has been sent to the main office in Washington. A check is made to see whether the $300,000 limit for the year is being exceeded and on the basis of available information, whether the other conditions for exemption are satisfied. The names of the principals are compared with the master securities violations file we maintain. Regulation A, as you know, is not available if the issuer or a promoter connected with it, or any person in a control capacity has been convicted within five years of a crime involving the sale of securities or is subject to an injunction. The selling literature is reviewed, and the expert staff of the Commission consulted on technical problems. The Washington office also prepares a weekly report of all letters filed, and extracts information which is distributed to our regional offices and to the State Commissions. This informs them of issues likely to be offered in their territories. Most of you are familiar with this report.

As you can see, these procedures are aimed at protecting the investor by assisting the law enforcement agencies to be on the lookout for fraud. They do not give the investor the type of information which the Securities Act makes available for registered issues. To this extent, investor protection is being sacrificed in the process of facilitating the financing of small issues.

I know from my own experience of the danger inherent in such a situation. As a young man working my way through the university, one of the first things I did was to sell stock in a tire and rubber company which was at that time being organized. It was strictly a promotion, but I was too inexperienced to realize it. The company never attained a competitive position, although it may have produced a few tires. The point is, that I was not required to be licensed by the state, nor was I supervised in any way whatsoever. I was just told to go out and sell stock. But before going out I had myself been sold - completely - by the promoters on what seemed to be the marvelous prospects of the company. I even put some of my own earnings into that stock. When the company subsequently failed, my customers suffered a complete loss. I was deeply shocked, but I had learned a very valuable lesson.

In the intervening years I have bought and sold a great many securities. Some have turned out well: some have turned out bad. I believe firmly that no state should allow the selling of securities to unsophisticated investors without regulation. I also believe that legitimate business ventures and honest dealers in securities have nothing to fear from intelligent regulation, but have much to gain. Every dollar taken in a stock swindle is a dollar that could have gone into a legitimate investment. Both are in competition for the investor's savings. Securities regulation is not simply a matter of enforcing rules of fair competition between the two opposing

groups. Its primary objective is to drive swindlers entirely out of business. To achieve that objective, the legitimate issuer and honest security dealer must submit to a certain amount of regulation and inconvenience. That is where the interest of the general public lies.

We at the Commission are well aware that in balancing investor interest against easy financing for small business, Regulation A has tipped the scales in favor of the latter. We have accordingly kept close tab on the way Regulation A is working out. Several studies have been made of its operation. They point the way to increased investor protection.

First of all, we find that the effectiveness of regulation varies a good deal in different parts of the country. Although the S. E. C. has broad powers to prevent and punish fraud, Regulation A, as it is now set up, depends heavily on the State commissions and our local regional administrators for results. Regulation A only makes available basic information to these policing agencies. The actual prevention of fraud is up to them. I need not remind you of the substantial differences in the laws under which you state commissioners operate. The most effective protection for investors is to prevent the fraud before it occurs by carefully screening new promotions and the persons connected with them.

This reliance on the State commissions is deliberate policy. The Securities Acts were never designed to supercede the State blue sky laws. The S. E. C. was established to supplement state regulation at the national level. Small issues are usually local issues. Local law enforcement agencies are on the spot, familiar with the people and the businesses involved, and is the best position to act quickly and effectively when a bad situation presents itself. Our regional offices are ready to assist in any way they can, particularly when the scheme begins to cross state lines.

The second thing our studies show is that only a portion of the almost $250,000,000 of securities filed each year under Regulation A are ever actually sold. Some issues never reach the offering stage. Others are offered, fail, and are withdrawn. In many cases, only part of the issue is sold. Where that happens, only a few states protect investors through an escrow or similar arrangement against wastage in an inadequately capitalized enterprise.

A defect which has been observed in our present procedure is that we have no sure way of knowing how much of an issue has been sold. A letter of notification, once filed, is good forever. We do follow up filings with a questionnaire on the results of the offering, and where nothing has been sold urge that the letter be withdrawn. However, there is no assurance that it will be. Consequently, we never know when someone will begin to offer stock under a filing that has been inactive for some time. In contrast, a registration statement, although it likewise remains in effect indefinitely unless withdrawn or subject to stop-order, permits securities to be sold only on the basis of recent information. The effect is that the registration must be brought up to date from time to time in order to continue offering the security. Perhaps a similar limitation should apply to Regulation A, requiring renewals periodically if further sales are contemplated.

Approximately twenty-five or thirty percent of the Regulation A offerings use the services of an underwriter. Most of the successful offerings have underwriters. This should tend to indicate that the underwriter, with a

reputation at stake, is selective of the issues which he offers to his customers, even when he takes on a best-efforts basis.

Today, when we hear so much about the need for assisting small business, it would greatly aid business enterprise in this country if sound, well-known investment houses would apply their prestige and distributing ability to the financing of going, proven businesses even though they may be small. The local investment banker, as I see it, has a civic responsibility to assume a sponsoring interest in the growing businesses of his particular community. There is a point in the growth of nearly every successful enterprise when internal and personal funds are not sufficient to finance its expansion possibilities, and it is therefore desirable to seek capital from the public. It is at this point that deserving businesses need the sound advice of an investment banker. Because of the size of the business and the risk involved, most investment houses much prefer not to have anything to do with this type of underwriting. We at the Commission, however, feel that the investment banker would more nearly perform his required function were he to assist in the financing of meritorious small enterprises.

The underwriter, or the investment banker, also has another very salutary influence. He usually insists on using selling literature. We find that successful offerings almost always employ some type of written sales material. The quality of this sales literature varies considerably. Some is fairly informative and on rare occasions may approximate a regular statutory prospectus. Frequently it is just a colorful sales pamphlet, expensively gotten up, but inadequate.

The highly significant fact is that most issuers under Regulation A are voluntarily undergoing the expense of laying out and printing sales literature. Those who advocate easy regulation for small issues tell us that they should not be put to the expense and inconvenience of the registration process. They also argue that the expense of making written disclosure to prospective investors discourages small business from selling securities to the public. Yet we find that when it comes right down to actual sales practice, over two-thirds of them resort to printed materials. Why should not the materials contain specified information and serve a positive, construction purpose? Furthermore, since a substantial proportion of the written materials as originally filed requires amendment to prevent it from being misleading, one can only wonder what is being done in those issues where no writing is used!

What type of information would be helpful to investors? There are many items of information readily available to the issuer which the investor should have. A description of the business is one example. Financial statements are another. Every going business has a reasonably current balance sheet available. It can be added to the selling literature without any significant expense. An accountant's certification would not be required, although any connection between the person preparing the reports and the issuer should be shown. I consider financial statements essential to informed investment. It is irrelevant to argue, as some do, that most people cannot read a balance sheet or profit and loss statement: -- there are many who can. At least, there would be no concealment of insolvency or poor operating results such as occurs under the present regulation. Most important, required disclosure will discourage many unsound ventures from going to market, as our present registration experience shows.

Another important item, readily available to the issuer, is its capital structure and the terms of other outstanding securities. Buying a stock without knowing what is senior is like blindly buying real estate in a swamp. If you are lucky, your tract may have some dry land.

These items give you an idea of what I have in mind. No bank or credit institution would lend money on the meager information some companies furnish prospective investors. The interest of investors can, I believe, be reconciled with the desire of small businessmen to be free of unnecessary restraints in raising capital. Requirements of the type I have in mind would be but a slight burden to legitimate persons seeking to sell legitimate securities. They could be of great benefit to the investing public.

Going to the public for money, while it is a right of legitimate enterprise, carries the obligation of a very sacred trust. Because of the corporate vehicle some individuals have regarded this trust lightly. I have always felt that one who acts irresponsibly in the sale of securities is as criminal as one who proceeds on the highway with a gun. Going to the public for money is a privilege that should be available only for those who can justify public participation through honesty of purpose and honesty in the conduct of the affairs of the enterprise.

These thoughts on how we can best serve the public interest in connection with small issues are preliminary ones. While the regulation of small issues is important to investors, and therefore to the Commission, other matters of higher priority -- particularly the Section 5 amendment program, have necessarily occupied the Commission's attention. Personally, I have always believed that an important function of the S.E.C. is to facilitate the flow of the nation's savings into business and industry. The ideas I have put forth this evening on how this objective may be better achieved in small issues still require a good deal of analysis and refinement. We recognize that this is a highly controversial field. Your suggestions would be most welcome.

Working together, as we have done so successfully in other matters, we will and must find the solution.