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# The prospectus and offering circular as sources of investment information

Bernard L. Webb

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THE PROSPECTUS AND OFFERING CIRCULAR AS  
SOURCES OF INVESTMENT INFORMATION

by

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Thesis

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## CHAPTER I

### SCOPE AND PURPOSE

The purpose of this study is to determine the adequacy and reliability of information contained in the prospectus or offering circular issued in connection with new issues of common stocks. The study will be limited to issues of corporations that are just "going public." That is, the first public offering of securities by corporations that have previously been privately owned.

The study will be made from the viewpoint of the purchaser or prospective purchaser of such securities. Since most of the firms concerned in such issues are relatively new and untried, most purchasers are seeking price appreciation rather than income. To that extent, we are concerned with "investment information" only if investment is considered in the broad sense of being any purchase of securities for profit. Certainly few of these issues could qualify as "investment" securities under more stringent definitions of investment. For example,

Graham and Dodd define an investment operation as, " . . . one which, upon thorough analysis, promises safety of principal and satisfactory return."<sup>1</sup> In purchasing first public offerings one must usually forego maximum safety in search of maximum profits. If this narrow definition of investment is accepted, this study will be concerned primarily with the use of the prospectus or offering circular as a source of "speculative information," with speculation being defined here as the purchase of securities in the hope of profiting through price appreciation.

#### Method of Evaluation

The first step in the study will be the preparation of a list of information which should be included in a prospectus or offering circular, and the checking of this list against the information required by the Securities and Exchange Commission. A group of prospectuses and offering circulars will then be analyzed to determine the extent to which they include this information. The reliability of the information will be determined on the basis of the enforcement activities of the Securities and Exchange Commission. Finally, the author's conclusions will be stated and suggestions for improvement will be offered.

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<sup>1</sup>Benjamin Graham and David L. Dodd, Security Analysis Principles and Techniques (3rd ed., New York: McGraw-Hill Book Co., 1951), p. 43.

### Definitions of Prospectus and Offering Circular

The Securities Act of 1933, U. S. Code, Title 15, defines a prospectus rather broadly as any communication with the public regarding a securities offering, unless such communication is accompanied by a printed prospectus. This definition is broad enough to include oral as well as written communications. Securities and Exchange Commission regulations have relaxed this definition to permit publication of very simple advertisements, sometimes called "tombstone advertisements" because of their brevity, stating a very minimum of information.<sup>2</sup> For the purposes of this study a much more limited definition will be used. The word prospectus, as used herein, will refer to the printed brochure bearing that title and issued in connection with a stock issue, when such issue has not been granted an exemption under Securities and Exchange Commission Regulation A.

An offering circular is a similar document issued in connection with a stock offering which has been granted an exemption under Regulation A. This regulation permits the exemption from certain formalities of a securities

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<sup>2</sup>Securities and Exchange Commission, General Rules and Regulations under the Securities Act of 1933 (Washington: U. S. Government Printing Office, 1962), p. 3.

issue for which the total proceeds will be less than \$300,000. Primarily it permits the issuer to avoid the completion of the very extensive Registration Statement required of other issues, and it permits the use of an offering circular instead of the much longer prospectus.

#### Legal Requirements for a Prospectus

The Securities Act of 1933 requires a prospectus to include the following information:<sup>3</sup>

1. name of issuer,
2. state of incorporation,
3. location of principal business office,
4. name and address of officers, directors and promoter of the corporation,
5. name and address of the underwriters,
6. name and address of persons owning of record or beneficially more than 10% of any class of stock of the corporation,
7. amount of securities of issuer owned by any person in 4 through 6 above including securities included under the current prospectus,
8. general character of the business of the issuer,
9. statement of capitalization of the issuer,

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<sup>3</sup>U.S., United States Code, Title 15, Section 77j and 77aa.



10. statement of securities, if any, subject to outstanding options, with names and addresses of persons holding such options,
11. the amount of capital stock of each class issues or included in shares to be issued,
12. statement of bonded debt outstanding or to be created by securities to be offered with details as to maturity, etc.,
13. the specific purposes in detail, and approximate amounts to be devoted to such purposes, for which securities will be issued,
14. statement of remuneration to officers and directors if such remuneration exceeds \$25,000 per year,
15. estimated net proceeds from offering,
16. proposed offering price,
17. all commissions or discounts to underwriters, including cash, securities, or other values,
18. itemized listing of other expenses of issuer,
19. net proceeds of any securities sold by issuer in the two years preceeding, with offering date, price and name of underwriters,
20. amount paid or to be paid to promoters during past two years and the consideration for such payment,

21. names and addresses of vendors and purchase price of good will to be purchased with proceeds of the offering,
22. full particulars of any interest of officers, directors or major stockholders in any property acquired within two years of the offering,
23. name and address of counsel who passed on the legality of the offering,
24. dates and parties and general effect of any material contracts entered into within two years or to be entered into after the registration of the offering, including contracts for management services, bonuses or profit sharing, material patent rights, or for furnishing of technical services,
25. balance sheet of issuer, with proper certification,
26. profit and loss statement of issuer, with certification.

The Securities Act of 1933 authorizes the Securities and Exchange Commission to permit the issuer to omit any of the above information which The Commission considers not in the public interest. The Act also authorizes The Commission to require such additional information as

The Commission may consider necessary. It appears, therefore, that The Commission has the authority to require any additional information deemed necessary without additional legislation.

Legal Requirements for an Offering Circular

The offering circular used in connection with an offering under Regulation A may contain somewhat less detail. The Securities and Exchange Commission regulations require only that it contain:<sup>4</sup>

1. name, address, state of incorporation and date of incorporation of the issuer,
2. offering price, underwriting discount or commission, and proceeds to issuer for the offering,
3. description of the methods to be used to distribute the securities,
4. a reasonably itemized statement of the purposes for which the proceeds will be used,
5. a brief statement of the securities to be offered: in the case of common stock the par or stated value,
6. nature of issuer's present or proposed product or services, the principal market thereof, and

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<sup>4</sup>Securities and Exchange Commission, General Rules and Regulations under the Securities Act of 1933 (Washington: U. S. Government Printing Office, 1962), pp. 18, 64.

the length of time the issuer has been in business,

7. location and general character of plants or other physical properties held or to be acquired,
8. details of any new invention or process which the issuer plans to exploit including patent information, if any,
9. full names and residence addresses of all directors, officers and controlling stockholders of issuers and promoters if incorporated less than three years, along with aggregate annual remuneration of above and individual remuneration of three highest paid,
10. all direct or indirect interest of those above in securities of the issuer or affiliates, and any material transaction with them in past two years,
11. appropriate financial statements of issuer prepared in acceptable accounting form but not necessarily certified,
12. a description of all options or warrants presently outstanding or proposed to be issued.

Since all prospectuses and offering circulars must be approved by the Securities and Exchange Commission

before use, it may be assumed that all of the information above is contained therein. However, the detail in which it is treated will vary rather widely among issues. Some issuers and brokers apparently furnish only the minimum information required by the Commission staff, while others apparently attempt to furnish adequate information for a reasonable investment decision.

## CHAPTER II

### FORMULATION OF STANDARDS

There are occasional new issues of high grade investment securities, such as Ford Motor Company, or Upjohn Company. Such issues are exceptional, however. The large majority of new issues are floated by small companies, many of them very thinly financed. The securities of these small companies are usually purchased by persons who expect to profit through price appreciation.

Price appreciation usually depends largely on increases in the firm's per share earnings. It follows, therefore, that a potential investor in such securities is interested in obtaining information which will indicate the probable trend of per-share earnings. This trend is determined by the trend of total earnings and the trend of the number of shares outstanding. Consequently, the prospective investor needs any information which will indicate the probable trend of either total earnings or future capital requirements. He is also interested in any outstanding contracts under which the firm can be required to issue additional shares upon the demand of others.

In addition, the prospective investor should have information concerning the current status of the securities

market and its probable future trends. However, such market information cannot be provided in a prospectus or offering circular because of the rapid change in market conditions and the length of time required to prepare a prospectus or offering circular. The investor must find and weigh such information for himself. The study of market trends will not be discussed further herein. This thesis will be limited to a discussion of information which is needed by an informed investor, and can be provided adequately in a prospectus or offering circular.

#### Information Required by Investors

The purpose of prospectuses and offering circulars is to provide prospective investors with adequate information about the offeror to enable them to make an informed investment decision. It follows then that these documents should contain the information which an intelligent and informed investor would need concerning the company and its environment. The following paragraphs will discuss the information which is essential for a well informed decision.

#### Management

The prospective investor should know the names and addresses of management personnel, their past and present business associations, positions held, and stockholdings of management personnel. This information is necessary for

two reasons. First, the past and present business associations of management personnel are the best available indications of their qualifications to manage the firm. If they have no past business experience, or if their experience is in a different kind of business, their qualifications would be open to considerable question. A long record of successful employment in a responsible position in the issuing firm or a similar business would be a favorable factor in the investment decision.

Secondly, the information as to securities held by management is an indication of the interest that management will have in the success of the company. Management that holds large quantities of company stock will naturally have a greater interest in promoting the interests of the company. On the other hand, if the stockholdings of management are out of proportion to their contributions to the company, it may well indicate an effort by management to enhance their own fortunes at the expense of the other stockholders. The contributions of management referred to above may be in the form of labor, patents, and similar intangibles, as well as money. Management remuneration in excess of their free market value may also indicate an effort to take advantage of other stockholders.



## Financial Factors

The investor should have certified balance sheets and profit and loss statements for at least the most recent three years.

A single balance sheet shows only the estimated financial condition of the firm on a given date. It gives no indication as to trend. Similarly a single profit and loss statement shows the results of a single year. The operating results of one year may not be typical. If such statements are furnished for three or more years, the prospective investor can form a reasonable opinion as to the probable future trends. For example, the balance sheet for a given year may indicate that the firm is adequately financed, or will be after issue of the proposed stock. However, a study of trends may show that inventories or accounts receivable, or both, are growing at a much faster rate than sales. If accounts receivable are growing faster than sales the firm probably is following very liberal, and possibly unsound, credit policies. Continuation of such policies will result in a need for additional funds to finance the accounts. This trend may also indicate that the firm has a large amount of uncollectible accounts which have not yet been written off. In either case, there is a strong

possibility that future profit trends will be affected unfavorably, either through the write-off of bad accounts or by the need for additional funds to finance the accounts.

The need for statements for more than one year is recognized by many underwriters. For example, the well known firm Carl M. Loeb, Rhoades & Co. requires statements for five years for issues underwritten by them.<sup>5</sup>

Inventory may be growing faster than sales because of poor inventory control or because the firm is unable to dispose of obsolete materials. If inventory is obsolete future profits will be diminished by write-offs. If the unfavorable trend is due to poor inventory control, future profits will be affected unfavorably because of increased need for funds to carry the larger inventory.

A careful analysis of changes in consecutive balance sheets may show that earnings have not been accurately stated in the profit and loss statement. The firm, for example, may have written off obsolete inventories or bad accounts directly against surplus, thus overstating earnings. Excessive amounts of research expenses may have

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<sup>5</sup>Securities and Exchange Commission, Report of Special Study of Securities Markets, Part 1, (Washington, U. S. Government Printing Office, 1963), p. 513.

been capitalized, again increasing stated earnings. For example, Dunn Engineering Corp. was able to conceal its substantial operating losses, and its insolvency, by deferral and capitalization of substantial research expenses, among other accounting devices.<sup>6</sup>

The factors discussed above cannot be discovered by scanning a single balance sheet. They become apparent only upon careful analysis of balance sheet trends, and comparison of such trends with operating results as stated in the profit and loss statements.

Of course, a great many other data can be discovered from analysis of financial statements. Among them are earnings per share, earnings on invested capital, current ratio, inventory turnover, acid test ratio, and others. It is not the author's purpose here to write a text on the analysis of financial statements, but merely to point out the necessity for more than one balance sheet and profit and loss statement in the formulation of an informed investment decision.

The prospective investor should also have a complete statement of the capital structure of the firm. This

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<sup>6</sup>Ibid., p. 335.

statement should include details as to the amount and terms of all stock, bonds, options and loans outstanding. Without such information the prospective investor cannot accurately estimate the future per share earnings, or appraise the soundness of the firm's financial structure. The firm may be dangerously overburdened with debt. Large amounts of outstanding warrants or convertible debentures may result, by conversion, in lower per share earnings, even while total earnings are growing. In any case, large amounts of such convertible securities tend to hold stock prices down.

The purposes for which the proceeds of the proposed stock offering will be used is also important information for the prospective investor. For example, other data in the prospectus may indicate that the firm's current plant is operating near capacity. If the proceeds are to be used in part for new plant, there is a possibility that new funds will not be needed in the near future. However, if the proceeds are to be used for some other purpose it is apparent that the company cannot grow appreciably without obtaining additional funds for new production facilities. Such additional funds will adversely affect per share earnings, either through debt service expense, or by increasing the amount of stock outstanding. Also, of course, a statement of the use of the proceeds may indicate some unwise or even frivolous plans for the future.

## The Product

The prospectus or offering circular should contain a detailed description of all major products. The description should include a statement of the competitive advantages or disadvantages of the product, as compared to major competitors. The existence of, or lack of, patent protection should be indicated. If the company is earning a substantial profit on an unpatented product, it is very likely that increased competition can be expected. This increased competition will probably reduce the company's earnings, and the chances of rapid price appreciation. This is the classic pattern of product development. One company develops a new product and earns a substantial profit on it. This profit attracts competition. Soon the production capacity of the industry exceeds the buying capacity of the market. Consequently, profits shrink or disappear completely. This pattern has been followed by many products in recent years. Among the most prominent are semiconductors, plastic boats, and a number of major plastics. The high profit stage of this development pattern can be prolonged somewhat by patent protection.

The absence of patent protection places greater emphasis on the research facilities of the company. Without patent protection a company can maintain high level earnings

only if it develops new products to replace the old ones when profits from the old products begin to shrink.

The prospectus or offering circular should also indicate, at least in a general way, the relationship of the company's prices to the prices charged by competitors. If direct price comparisons cannot be given, there should at least be a statement that the company's prices are comparable to those charged by competitors, or are higher or lower, as the case may be.

#### Marketing

Efficient marketing is as important as the product. He who invents a better mousetrap must also beat a path to the world's door. Consequently, the prospective investor must be in a position to evaluate the marketing methods used by the security issuer.

The prospective investor is interested primarily in the answers to three questions concerning the marketing program. First, can the present or proposed marketing system distribute the issuers products effectively and economically? Secondly, is the present or proposed marketing system within the financial ability of the issuer? Finally, what is the extent of and the probable trend in the market?

To answer these questions the prospective investor needs reasonably complete information as to the marketing channels being used or to be used. The various channels which can be used include:

1. direct sales to consumer through company branches or direct by mail,
2. through independent wholesalers and retailers, and
3. from company direct to retailer.

There are, of course, numerous variations. The most advantageous channels will vary with the product and the size and financial condition of the company. For example, a large manufacturer of crackers may find it possible to sell directly to the retailer, because of high volume, broad product line, and wide geographical distribution. A smaller cracker producer may find it necessary to sell through jobbers because he lacks the financial strength, product variety and geographical distribution to support an owned distribution system. A similar situation exists in the capital goods industries. They can distribute directly to the user, or through jobbers, manufacturer's agents or similar outlets.

To form an opinion as to the adequacy and appropriateness of the distribution system used the investor

will need to know:

1. the type of person or firm who buys the product,
2. the distribution channels used and the number and location of distribution centers, jobbers, or other similar units, and
3. probable extent of and future trends in the market.

The type of buyer is frequently self-evident from the product, and need not be discussed in detail in the prospectus. Some of the more technical products do require more detailed discussion.

Information as to distribution channels used, territorial distribution, and number of units should be readily available to management from company records.

Information as to the extent of the probable future trend of the market is usually available to management from trade associations, trade journals, governmental sources, and private market studies. These sources can usually provide reasonably accurate information as to the present extent of the market. Their predictions of future trends are likely to be less accurate than their historical statistics, but better than the investor can prepare for himself. Information is usually available to management



from all of the sources listed. The investor will find it more difficult to obtain such information for himself.

If management does not have the marketing information mentioned above, the prospectus should be required to include a statement to that effect. The lack of such information on the part of management is, in itself, important investment information. It is evidence that management is either incompetent or negligent.

#### Production Facilities

Even the best marketing facilities are useless unless the company can produce or buy the products to sell. The investor is, therefore, interested in the ability of the issuing company to obtain the products.

The investor will need to know whether present production capacity is sufficient to meet the present and prospective needs of the company. If production facilities are not sufficient for future needs the company will need funds for expansion as sales grow. These funds will have to be obtained from one of three sources: (1)retained earnings, (2)debt financing, or (3)equity financing.

If expansion is to be financed from retained earnings, the growth of the company will probably be

retarded while funds are accumulated. If growth is financed through debt securities the earnings may be adversely affected by debt service costs. If growth is financed through equity securities, the earnings per share may be adversely affected. Any of these three results will result in slower price appreciation for the company's securities.

The company's labor relations experience is also important to the investor. The very best physical plant is useless if it is frequently idled by labor troubles. Frequent strikes will have an adverse effect on earnings, and, consequently, on security prices.

#### Research

Research activities have become an important element in the valuation of securities in recent years. The effect of research on security prices has been carefully documented by a number of financial analysts.

For example, Gregor Lazarcik, Research Associate at Columbia University, found a direct relationship between the amount spent on research and the rate of increase of security prices.<sup>7</sup> During the period 1957-60 the prices of

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<sup>7</sup>Gregor Lazarcik, "Scientific Research and Its Relation to Earnings and Stock Prices," Financial Analysts Journal, XVIII (January-February, 1962), 49 et seq.

the 425 stocks in Standard & Poor's Industrial Index increased by twenty-five percent. These companies spent 3% of sales on research. During the same period, stocks of ten of the companies increased 520% in price. These companies had spent 8.5% of sales for research. Mr. Lazarcik cited other statistics in the same vein.

There is no completely acceptable measure of the effectiveness of a company's research efforts. However, certain quantitative information could be given to assist the investor in his appraisal of the company.

The percentage of sales spent on research is the most frequently used measure of research activities. While this is an accurate measure of management emphasis on research, it does not measure its effectiveness. This information is useful to the investor, however, and should be included in the prospectus or offering circular.

Effectiveness of research activities is indicated by the new products developed. This is usually measured by the percentage of company sales which resulted from new products developed during some specified period, frequently the preceding five years. This measure cannot be used, of course, by a new company.

The final indication of research effectiveness is the qualification of the research staff. For the smaller company this could be indicated by listing the research staff, or at least the more prominent members thereof, with details as to education, past accomplishments, and past positions held. A larger company would probably not be able to provide such detail because of their larger research staffs. However, these details are less important for the larger company, since such companies usually have a longer history by which their research effectiveness can be measured.

The prospectus or offering circular should also contain details of research in progress to the extent that such information can be disclosed without producing adverse competitive effects. Such information will assist the investor in his appraisal of the probable future progress of the company.

It must be realized, of course, that research is more important to some industries than it is to others. Research is of very limited application, for example, to retail store operations.

#### Miscellaneous Information

In addition to the data indicated under the various

headings above, there is certain additional information which should be included in the prospectus or offering circular.

Details of any proposed mergers or acquisitions should be included. None of the offering circulars, and only eight of the prospectuses, examined mentioned any possibility of merger with or acquisition of other firms. Yet the author is aware of several mergers and acquisitions involving the issuing firms. Another study indicates that prospective mergers or acquisitions were major motives for as many as 20% of first issues, though not frequently mentioned in the related prospectus or offering circulars.<sup>8</sup>

Certainly a prospective part owner of the firm should be informed of any impending changes of such importance. Of course, such mergers must be approved by the stockholders before they can be consummated. However, this requirement offers little protection to the purchaser of stock, since the original stockholders usually retain voting control of the corporation.

Details should be given of any loans or other

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<sup>8</sup> Salomon J. Flink, Equity Financing of Small Manufacturing Companies in New Jersey, (Trenton, N.J., New Jersey Department of Conservation and Economic Development, 1962), pp. 48, 52.

financial arrangements under consideration. This information is important as an indication of debt service costs to be incurred, and the effect of such costs on earnings. It is also important as an indication of the availability of sufficient financial resources to support future growth of the company.

Details should be shown for any major contracts outstanding or under consideration. Many small firms are heavily dependent on a single customer or a small number of customers. This is particularly true of a number of applied science companies which derive most of their income from government contracts. Excessive dependence on one or a few customers tends to cause instability, a factor which may have an adverse affect on stock prices.

The prospectus or offering circular should also include information regarding any dealings of the company with its officers, directors, or companies controlled by them. This information is necessary primarily to protect the stock purchaser against fraudulent or unethical dealings designed to unjustly enrich insiders at the expense of the public stockholders.

Any litigation in progress which may affect the company should be discussed in full, along with a

statement by counsel as to the probable outcome. The importance of litigation is clearly illustrated by one of the offering circulars in our sample. The issuing company, C. F. Kirk Laboratories, Inc., was the defendant in a civil suit alleging damages in an amount more than double the total assets of the company.<sup>9</sup> For reasons that are readily apparent, the company and its legal counsel may be reluctant to express an opinion as to the outcome of litigation in progress. If such is the case, the stock issue should be delayed until the litigation has been terminated. Issues could also be delayed during negotiation of mergers or major contracts if management does not wish to disclose details during the negotiation.

Certain necessary data have not been discussed above due to the fact that The Securities and Exchange Commission require their inclusion in the prospectus or offering circular, and mere mention of them is adequate. Among these are the name of the company, its principal office address, state of incorporation, offering price of securities, and similar data.

#### Summary

The purpose of the prospectus or offering circular

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<sup>9</sup>C. F. Kirk Laboratories, Inc., Offering Circular, (New York, Schrifver & Co., 1960), p. 8.

is to provide the prospective investor with adequate information to enable him to make an intelligent investment decision.

The essential information for such a decision is as follows:

1. Management

- a. names and addresses of management personnel
- b. past and present business associations and positions held
- c. management's holdings of securities and options issued by the company
- d. remuneration of management

2. Financial

- a. reasonably detailed and certified balance sheet and profit and loss statement, preferably for a period of at least three years to permit trend analysis
- b. a complete statement of the capital structure including details as to amounts and rights of all classes of stock, debt securities and options, and term loans, including all securities covered by the prospectus
- c. purposes for which the proceeds of the offering will be used



3. The product

- a. a detailed description of all major products and their uses, including new products ready for marketing
- b. a statement of the advantages and disadvantages of the company's products as compared to the products of major competitors
- c. details of patent protection available
- d. relationship of the company's prices to those of competitors

4. Marketing

- a. a statement of the marketing techniques and channels now used and any changes contemplated
- b. territory covered
- c. share of market
- d. major competitors
- e. size and trend of total market

5. Production

- a. physical production facilities available and contemplated changes
- b. relationship of current production to plant capacity
- c. labor relations situation

6. Research

- a. details as to staff and physical equipment of research department, if any
- b. amount of research expenditures
- c. reasonable details as to products developed in the past and major projects in progress

7. Miscellaneous

- a. details of any merger or company acquisitions planned or under consideration
- b. details of any loans or other financial arrangements under consideration
- c. details of any major contracts outstanding or under consideration
- d. details of any dealings with officers or directors, or other companies controlled by them, other than dealings within the normal scope of their duties
- e. details of any litigation in progress or expected.

It is recognized, of course, that there are times when it is not expedient to disclose certain of the information indicated above. This may be because of adverse effect on the company's competitive situation, or for fear of adverse effect on litigation. However, it is

essential that the information be disclosed if negotiation with prospective stockholders, the future part owners of the company, are to be conducted in good faith.

If management is not willing to make adequate public disclosure, they should resort to private placement of stock or some form of private debt financing until such time as adequate public disclosure is possible.

Chapter III will measure the extent to which prospectuses and offering circulars in our sample complied with the standards of adequacy set forth above.

### CHAPTER III

#### EVALUATION OF CONTENTS OF SELECTED PROSPECTUSES AND OFFERING CIRCULARS

In an effort to determine the extent to which prospectuses and offering circulars comply with the requirements stated in Chapter II, the author has carefully examined and evaluated 31 prospectuses and 38 offering circulars. These prospectuses and offering circulars were not chosen specifically for this study, but were obtained by the author in connection with possible investments in the issuing companies. The author believes that the documents studied are typical of those issued during the past few years. All of these documents had been approved by the U. S. Securities and Exchange Commission. Tables I and II show the results of this analysis. While the evaluations are necessarily subjective, examples of adequate and inadequate treatment of various points are quoted below to permit the reader to judge the correctness of the author's evaluation.

#### Limitations of Evaluation Process

Certain qualifications should be noted with regard to the evaluation process. First, there was no effort to determine the accuracy of the statements in the documents examined. They were evaluated purely on their

apparent adequacy. Funds and facilities were not available to the author to investigate the reliability of the data contained in these specific documents. A later chapter will evaluate the reliability of prospectuses and offering circulars with reference to the enforcement activities of the Securities and Exchange Commission.

Also, there was no effort to evaluate the data with regard to whether they were favorable or unfavorable from an investment standpoint. It is not the purpose of this study to evaluate new issues as investment vehicles, or to evaluate the specific issues in the sample. Its sole purpose is to appraise the adequacy of the prospectus and offering circular as sources of investment information.

Some factors were marked as adequately treated when, in fact, they were not mentioned. This practice was followed in those cases where the factor was not applicable to a given business. For example, patents are not a material factor in life insurance company operations. On the other hand, they would be a very important consideration in the operation of some of the science-oriented companies. It follows that those items classed as not mentioned are only the ones that were not mentioned, but, in the opinion of the author, should have been.

TABLE I

EVALUATION OF INFORMATION CONTAINED IN 31 PROSPECTUSES

	ADEQUATE		INADEQUATE		NOT MENTIONED	
	Number	Percent	Number	Percent	Number	Percent
<b>MANAGEMENT</b>						
1. Name and address	31	100	0		0	
2. Past associations	26	84	5	16	0	
3. Security holdings	31	100	0		0	
4. Remuneration	29	93	2	7		
<b>FINANCIAL</b>						
1. Statements	4	13	27	87	0	
2. Capital structure	31	100	0		0	
3. Use of proceeds	31	100	0		0	
<b>PRODUCT</b>						
1. Description	30	97	1	3	0	
2. Price	10	32	9	29	12	39
3. Patents	20	64	3	10	8	26
<b>MARKETING</b>						
1. Techniques	29	93	2	7	0	
2. Territory	31	100	0		0	
3. Share	18	58	9	29	4	13
4. Competition	24	78	6	19	1	3
5. Size & trend	5	16	7	23	19	61
<b>PRODUCTION</b>						
1. Physical plant	31	100	0		0	
2. Operating rate	12	39	9	29	10	32
3. Labor conditions	26	84	1	3	4	13
<b>RESEARCH</b>						
1. Staff & physical plant	14	45	3	10	14	45
2. Budget	12	39	4	13	15	48
3. New products	13	42	4	13	14	45
4. Current projects	11	35	4	13	16	52
<b>MISCELLANEOUS</b>						
1. Mergers contemplated	8	26	0		23	74
2. Loans contemplated	3	10	0		28	90
3. Material contracts contemplated	0		0		31	100
4. Dealings with insiders	21	68	0		10	32
5. Litigation in progress	14	45	0		17	55

TABLE II

EVALUATION OF DATA CONTAINED IN 38 OFFERING CIRCULARS

	ADEQUATE		INADEQUATE		NOT MENTIONED	
	Number	Percent	Number	Percent	Number	Percent
<b>MANAGEMENT</b>						
1. Name and address	38	100	0		0	
2. Past associations	34	90	2	5	2	5
3. Security holdings	38	100	0		0	
4. Remuneration	37	97	0		1	3
<b>FINANCIAL</b>						
1. Statements	10	26	28	74	0	
2. Capital structure	38	100	0		0	
3. Use of proceeds	38	100	0		0	
<b>PRODUCT</b>						
1. Description	38	100	0		0	
2. Price	10	26	4	10	24	64
3. Patents	18	47	0		20	53
<b>MARKETING</b>						
1. Techniques	27	71	5	13	6	16
2. Territory	37	97	0		1	3
3. Share	9	24	3	8	26	68
4. Competition	27	71	0		11	29
5. Size & trend	4	11	5	13	29	76
<b>PRODUCTION</b>						
1. Physical plant	32	84	3	8	3	8
2. Operating rate	17	45	1	2	20	53
3. Labor conditions	25	66	0		13	34
<b>RESEARCH</b>						
1. Staff & physical plant	10	26	5	13	23	61
2. Budget	6	16	2	5	30	79
3. New products	18	47	1	3	19	50
4. Current projects	12	32	0		26	68
<b>MISCELLANEOUS</b>						
1. Mergers contemplated	0		0		38	100
2. Loans contemplated	1	3	0		37	97
3. Material contracts contemplated	2	5	0		36	95
4. Dealings with insiders	25	66	0		13	34
5. Litigation in progress	19	50	0		19	50

### Inadequacy of Financial Statements

Perhaps the greatest shortcoming in prospectuses is the inadequacy of financial statements. Only 13% of the prospectuses and 26% of the offering circulars contained adequate financial statements. The superiority of the offering circulars in this respect is more apparent than real, as will be explained later.

The major shortcoming of the financial statements is the failure to include balance sheets for more than one year. Only one document examined, an offering circular, contained balance sheets for two years. None contained more. Balance sheets are essential to determine the trend of working capital, inventories, accounts payable and receivable and other similar data. They can also be used to confirm changes in surplus as shown on the profit and loss statements. The trends indicated are essential in the evaluation of an investment to determine the adequacy of current financing, and the adequacy of management control. A company which may appear to have adequate working capital on the basis of a single balance sheet may be shown to be approaching inadequacy due to poor control of inventories and accounts receivable. The increased demand for funds resulting from excessive increase in inventory or accounts



receivable may require additional financing, either equity or debt. An analysis, over a period of years, of the relationship of inventories and accounts receivable to sales will usually disclose any unfavorable trend which exists. A single year's statement will give no indication of trend. Poor control of inventory and accounts receivable has been a severe problem with small science oriented companies managed by persons skilled in science and technology but with little or no experience in business management. Companies whose stock prices have been adversely affected by poor control of inventories or credit include Aeronautical Electronics, Texas Instrument, Transitron, Dorsett Laboratories, and others.

A few of the documents also contained inadequate information on depreciation methods and inventory valuation.

The offering circulars appeared superior to the prospectuses with regard to financial statements only because the companies concerned were newer. The inclusion of one balance sheet was obviously adequate for a company that had been in business for only one year or less. The author believes that balance sheets for at least the most recent three years should be

included for older companies, in order to permit trend analysis.

The lack of certification was a cause of inadequacy of financial statements in some of the offering circulars examined.

#### Treatment of Research and Development

The second greatest failure of the documents as sources of investment information was the completely inadequate treatment of research and development operations. This, of course, does not apply to certain companies examined, such as bowling alleys, insurance companies, and some others. However, new and improved products are the lifeblood of the small technology company. They must have a steady stream of new products in order to keep ahead of their competitors.

The disclosure of research information cannot be complete, of course, due to the necessity of withholding some information from competitors. Even with this limitation, however, there is still room for improvement. The vast majority of the documents examined did not give sufficient detail to enable the prospective investor to evaluate this phase of company operations.

### Marketing

The marketing function was also slighted in the prospectuses and circulars examined. This was particularly true as to the size and trend of the potential market, the market share of the company and the comparison of the company's pricing to that of the competition. In most cases where the potential market was mentioned it was merely stated that it was "large and growing," or some similar general statement. Only a few companies cited statistical evidence as to the size and trend of their market. Generally speaking, the documents that contained adequate information in this area were the most adequate in other areas also, probably because they were prepared by the more competent underwriters.

### Physical Plant

The majority of the documents examined contained no statement as to the adequacy of their present physical plant. A few stated that the plant was adequate for foreseeable needs, and one stated that its plant was adequate for operations at three times their current level. This is obviously an important factor in an investment for capital appreciation. Capital appreciation is dependent largely on growth without dilution

of equity. If the plant is not adequate for increased business the company will have to find additional capital for expansion. This will result in either additional debt service expenses or dilution of per-share earnings. In either case it will considerably lessen the potential for appreciation in stock prices.

In order to permit the reader to evaluate the author's standards of adequacy, a few examples of adequate and inadequate statements follow.

#### Examples Illustrative of Evaluation Process

An inadequate statement of the qualifications of management: "Clinton F. Backner, Vice President-Sales, has been associated with Allegheny and its predecessor in a sales capacity for the last 31 years."<sup>10</sup> This statement was considered inadequate because of the general statement "in a sales capacity." This statement might encompass any position from routeman's helper to vice president for sales. Without further detail it does not give an adequate indication of his past experience or qualifications.

An adequate statement of management qualifications:

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<sup>10</sup>Allegheny Pepsi-Cola Bottling Company, Prospectus, (Philadelphia, Pa., Suplee, Yeatmen, Mosley Co., Inc., 1962), p. 14.

Albert A. Dusseault, Executive Vice President and Director, has been associated with the Company since its inception in 1953 and is responsible for the execution of management policies and active supervision of its operations. From 1955 to 1958, Mr. Dusseault served in a management capacity with Hillsborough Investment Corporation and its subsidiaries, with executive offices at 839 Elm Street, Manchester, N.H. He has been active in the consumer finance industry for the past sixteen years since his discharge from the service in 1945. Mr. Dusseault has been active in the New Hampshire State Association of Small Loan Companies for the past ten years and has served as Treasurer, Vice President and President of the Association at varying times. He also serves as Vice President and Director of McCown Motor Hotels, Inc. and Jubilee Travel Service, Inc.<sup>11</sup>

**An adequate statement of market position:**

According to statistics published by Swimming Pool Age, a trade publication, swimming pool installations in the United States have shown a continual increase. The number of pools, during the past decade, have increased from 11,000 in 1948, to an estimated 255,000 currently. In 1958 an estimated 51,200 swimming pools were installed in the United States, and in 1959, an estimated 70,000 pools were installed. It is estimated that this year swimming pool installations will continue to increase appreciably.

This company's business is highly competitive, as there are many firms throughout the United States engaged in substantially similar types of businesses. Although its sales were confined to the eastern and midwestern parts of the United States, in 1959 the company supplied approximately 34% of the filters used in the entire country.<sup>12</sup>

**Inadequate statement of competition:**

While there are other companies engaged in metal fabrication in the Miami area, the machinery and

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<sup>11</sup>Coastal Acceptance Corporation, Prospectus, (Manchester, N.H., Eastern Investment Corporation, 1962), p. 14.

<sup>12</sup>Major Pool Equipment Corp., Offering Circular, (New York, Hill, Thompson & Co., Inc., 1960), p. 4.

equipment of Dwyer-Baker makes it uniquely equipped to handle a large variety of varied machine work. The Company is believed to have the largest and heaviest brake presses and precision shears in Florida. The brake press has a 320 ton capacity for heavy gauge work, and the shears can handle metal up to 12 feet in length.<sup>13</sup>

**Inadequate statement of market position:**

The Company encounters substantial competition with other companies who sell the same or related products as the Company. Its principal competitors in the Diazo-type white-printing equipment field have gross assets and sales which are substantially larger than those of the Company. The office type photo copy machine business is highly competitive and most of the Company's competitors in this field have gross assets and sales which are substantially larger than those of the Company. Other sources of competition are a number of companies which are expanding their activities in the photo-copying field or have recently entered the field for the first time. Many competitors lease or rent photo-copying equipment, as does the Company, in addition to the sale thereof.<sup>14</sup>

This statement is considered inadequate because it fails to identify the competitors, indicate their sales volume in competitive products, or state product advantages or the competitive price situation.

**An adequate statement on research:**

These research and development activities ripened into products the sale of which account for the Company's profits during the first three quarters of its 1949 fiscal year. In its new field, the Company first developed what is now a standard filter used in glide slope receivers on commercial aircraft. The Company has also developed, for a leading missile manufacturer, a magnetic amplifier, miniaturized to about one third its former size. One of the Company's

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<sup>13</sup>Dwyer-Baker Electronics Corp., Offering Circular, (Palm Beach, Florida, Frank B. Bateman, Ltd., 1960) p. 7.

<sup>14</sup>Copymation, Inc., Prospectus, (New York, Kennet Kass, 1962), p. 12.

principal activities has been the development and manufacture of a subminiature transformer, a basic component, which enabled hearing aid manufacturers to reduce the size of their products.<sup>15</sup>

The research budget was given in connection with the financial statements and statement of use of proceeds. The size of the research staff, but not their qualifications, is stated elsewhere in the circular. However, their qualifications are indicated by the successful development of marketable products.

An inadequate statement on research:

The Manager of the Engineering Department is Mr. C. G. Davis who received a B. S. degree in electronic engineering from Texas Technological College. Mr. Davis was formerly employed by Texas Instruments, Inc. in the Transformer Engineering Department. While at Texas Instruments, Mr. Davis authored a design manual on solid state power conversion equipment that was used throughout the Company as a basis for design of computers.<sup>16</sup>

While this statement gives a fairly complete indication of the capability of the research manager, it gives no indication of the research budget, projects in process or planned, size of research staff, or past successes. This information is not shown elsewhere in the circular.

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<sup>15</sup>Johnson Electronics, Inc., Offering Circular, (Winter Park, Florida, Security Associates, Inc., 1960), p. 4.

<sup>16</sup>Saturn Electronics Corporation, Offering Circular, (New York, Reese, Scheftel & Co., Inc., 1962), p. 5.

The offering circular of Vol-Air, Inc. is completely inadequate with regard to marketing channels.<sup>17</sup> It fails to make any mention whatever of distribution channels to be employed for the Company's line of air conditioning equipment.

An adequate statement on marketing:

Sales of the Company's products are made primarily through manufacturers' representatives on a commission basis. Such representatives are required to agree not to handle microwave components of other manufacturers which are directly in competition with those of the Company. The Company now has sixteen such representatives operating in the United States and Canada. Occasionally sales of products for use in military equipment are made directly to the United States Government by the Company

The Company sells to approximately seventy-five customers, sales to one of whom accounted for 30% of total sales for the fiscal year ended November 30, 1959. In that year the sales to the seven largest customers represented approximately 75% of the total sales of the company. The amount of sales to any particular customer fluctuates considerably from time to time, depending upon the requirements of such customer for microwave components in any specified period. Since November 30, 1959, approximately 90% of the total sales of the Company has been with seven customers, two of whom were not in the group of seven customers referred to above for the preceding period. All except a very minor portion of the Company's sales are made pursuant to specific orders received from customers rather than pursuant to contracts made with such customers.

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During the year ended November 30, 1959, 85% of the Company's sales were to customers for use directly or indirectly, by the Government. Approximately 95% of Premier's sales were to customers engaged in

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<sup>17</sup>Vol-Air, Inc., Offering Circular, (New York, Glass & Ross, Inc., 1961).



military contract work in two general categories: electronic companies and aircraft companies. In the same year more than 90% of Portchester's production consisted of non-military items which are used in microwave link systems for telephone and television transmission, and industrial communications systems. During said year, Premier's sales represented 92% of the consolidated aggregate sales.<sup>18</sup>

### Summary

There is much room for improvement in the information contained in prospectuses and offering circulars, particularly in the latter. Improvement is particularly desirable in the financial statements, and discussion of research activities, production facilities, and marketing operations.

The offering circulars were noticeably less adequate than the prospectuses. This deficiency is evident in several of the categories, and is particularly applicable to the financial statements, because of their frequent lack of certification.

No effort was made to evaluate the accuracy of the data in the documents examined. The accuracy of prospectus and offering circular data will be discussed in Chapter IV.

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<sup>18</sup> Premier Microwave Corporation, Prospectus, (New York, Van Alstyne, Noel & Co., 1960), pp. 8 & 9.

## CHAPTER IV

### RELIABILITY OF THE DATA

The reliability of investment information is at least as important as its apparent adequacy. Unfortunately the author does not have adequate facilities to check the accuracy of each prospectus or circular examined. The only other source of information as to reliability is the records of the Securities and Exchange Commission regarding stop orders issued against security registrants and suspension orders against companies issuing securities under Regulation A. Both types of orders require the issuer of securities to stop selling those securities either permanently or temporarily until some change is made. Practically all such orders arise from false or fraudulent statements in prospectuses or offering circulars. These data are summarized in Tables III for prospectuses and Table IV for offering circulars, and were obtained from the Annual Reports of the Securities and Exchange Commission for the years 1957, 1958, 1959 and 1960.

#### Securities and Exchange Commission Enforcement Statistics

For the four years shown, less than one percent of all registrations approved (not including Regulation A exemptions) were involved in stop order proceedings.

TABLE III

STOP ORDERS ISSUED BY THE SECURITIES AND EXCHANGE COMMISSION  
AGAINST ISSUERS OF SECURITIES UNDER PROSPECTUSES

	<u>NUMBER OF PROSPECTUSES APPROVED</u>	<u>STOP ORDERS ISSUED</u>	<u>PERCENT</u>
1957	884	8	.9
1958	810	5	.6
1959	1048	9	.8
1960	<u>1422</u>	<u>9</u>	<u>.6</u>
Totals	4164	31	.74

TABLE IV

SUSPENSION ORDERS ISSUED BY THE SECURITIES AND EXCHANGE COMMISSION  
AGAINST ISSUERS OF SECURITIES UNDER REGULATION A

	<u>NUMBER OF EXEMPTIONS GRANTED</u>	<u>SUSPENSION ORDERS ISSUED</u>	<u>PERCENT</u>
1957	919	128	13.9
1958	732	88	12.0
1959	854	87	10.0
1960	<u>1049</u>	<u>75</u>	<u>7.0</u>
Totals	3554	378	11.0

Since the Securities Act of 1933 was adopted, and prior to June 30, 1960, a total of 15,280 registrations were approved, of which 207, or 1.3% were involved in stop order proceedings. Of course, there were undoubtedly other cases of false or fraudulent statements which were not detected or could not be proved. However, it would appear that information contained in prospectuses is at least 95% accurate and dependable for investment purposes.

For the years shown in Table IV approximately 11% of all security issues under Regulation A were involved in suspension order proceedings. Comparable data were not available to the author for prior years. An examination of the Securities and Exchange Commission Annual Reports indicate that a large percentage of the suspension orders seems to involve speculative mining and oil exploration companies, though no exact percentage figures can be given. This higher violation rate of Regulation A issues is probably because such companies are usually new and small, and because the Commission requires so much less advance information concerning such issues. This limited information makes it more difficult for the Commission staff to detect false and fraudulent statements. It appears from the above that

information contained in offering circulars is probably not more than 80% accurate.

### Illustrative Fraudulent Statements

Horton Aircraft Corporation. -- This registrant, a Nevada Corporation, was organized for the purpose of manufacturing and selling a so-called Horton wingless Airplane. The company filed two registration statements with the Commission. The first statement, filed in 1955, covered a proposed offering of 500,000 shares of no par value common stock of which 400,000 shares were to be offered by the registrant and 100,000 shares by the president, William E. Horton, at \$1.00 per share or the market price, whichever was higher. The other registration statement, filed in 1956, covered 100,000 shares of common stock of the registrant held by Horton which was to be offered at \$25.00 per share. A consolidated hearing was held as to both registration statements and the Commission issued a stop order suspending the effectiveness of both statements.

The Commission found the registration statements false and misleading in the following material respects, among others.

The representation in the registration statements that Horton had assigned to the registrant a patent with respect to the wingless airplane was materially misleading in view of the fact that Horton had previously assigned all of his right, title and interest in his 'invention' to another person. The description in the registration statements of the Horton Wingless Airplane, the aeronautical principles involved, and the coverage of the patent obtained by Horton, was also materially false and misleading. False and misleading statements were also made with respect to the performance of Horton's model of the wingless plane. The registration statements also contained false and misleading statements with respect to the use of the proceeds from the previous sale of unregistered securities, the price of the securities being registered and the proposed use of the proceeds therefrom.

In addition, the Commission found that while the second registration statement disclosed the entry of an injunction against registrant and Horton based on false and misleading claims and the return of an indictment against Horton based on fraud, registrant nevertheless omitted to disclose the nature of the false and misleading statements and the fraud involved.<sup>19</sup>

Columbia General Investment Corporation. -- The registrant, a Texas corporation organized for the purpose of engaging in the investment business, filed a registration statement covering 100,000 shares of its common stock, \$1 par value, to be offered to its stockholders at \$4.50 per share. The Commission, finding that the registration statement contained materially misleading statements, denied a request for withdrawal of such statement and issued a stop order.

The registration statement stated, among other things, that 42,000 shares of the common stock of Columbia General Life Insurance Company, acquired from the promoters of the insurance company and registrant in exchange for 210,000 shares of registrant's common stock, and representing a substantial portion of registrant's assets, had an 'estimated fair value' of \$420,000. The \$420,000 value was stated to be based on the fact that at and prior to such acquisition, shares of such stock had been sold at prices of \$10 and more by the insurance company in the course of a public offering and by one of the promoters through a company established for the purpose of maintaining and stabilizing the market in that stock. However, the Commission held that the prices paid in such sales could not be considered a true reflection of the market or fair value of the stock at such time in view of the materially misleading statements employed in connection with the sales. The Commission found that the failure to disclose the facts surrounding the insurance company offering rendered the statements regarding the value of the 42,000 shares misleading.

The Commission further found that registrant had sold 53,059 of its own shares to stockholders

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<sup>19</sup>U.S., Securities and Exchange Commission, 24th Annual Report, 1958, p. 36.

of the insurance company at \$9 per share, and 10,077 shares to the general public at \$12 per share, without disclosing that such prices had been arbitrarily determined, that there had been recent sales of such stock at \$2 per share to insiders and others, and that registrant's capital and surplus figures included the misleading \$420,000 valuation attributed to the 42,000 shares of insurance company stock. As a result of such sales, the Commission ruled, a contingent liability to the purchasers was created which should have been disclosed in the registration statement.<sup>20</sup>

Microveer, Incorporated. -- The Commission's temporary suspension order alleged that the offering circular was misleading and contained untrue statements of material facts with respect to statements made concerning the physical properties of the issuer's product, a thin wood veneer, the existence of potential purchasers of the company's product and the amount of funds needed to equip the issuer's plant adequately with machinery. No hearing was requested and the suspension order became permanent.<sup>21</sup>

Wyoming Gulf-Sulphur Corporation. -- This corporation filed a registration statement with the Commission relating to a proposed public offering by the corporation of 700,000 shares for its own account and 226,000 shares for the account of two stockholders. After hearings the Commission issued an order pursuant to section 8 (d) of the Securities Act of 1933 suspending the effectiveness of the registration statement on the basis of findings that, among other things, the corporation failed to disclose in the registration statement the limited experience of management in marketing its product and the limited nature of the potential market for its product.

The Corporation proposed to produce and market 'soilaid,' which was obtained by treating the sulphur-bearing ores on the properties containing about 16 percent sulphur so as to increase the sulphur content to not less than 25 percent. This product can be used on certain soils in the

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<sup>20</sup> Ibid., p. 37.

<sup>21</sup> Ibid., p. 44.



western part of the United States for the purpose of causing them to become friable and permeable to water. Gypsum, in abundant supply in the west, is also used for this purpose. Although the corporation's stated plans were to produce 400 tons a day in one of its plants and 1,000 tons a day in a plant proposed to be constructed with part of the funds obtained from the proposed financing, only a very limited amount of sulphur-bearing ore had been treated and in the year 1954 only 18,221 tons of sulphur were used for soil-treatment purposes in the entire United States. This information and the fact that because of transportation costs it would be cheaper for a purchaser residing in the west to obtain sulphur from the Gulf Ports of Texas than to purchase the product from the corporation were either not disclosed in the registration statement or inadequately presented.

The Commission also found that the proposed method of distribution of the securities was misleading. Since the bid and asked price of the securities at the time the registration statement was filed was around \$1 and the proposed offering price was to be not less than \$2 a share, the Commission found that 'it seems clear that the stock could not be sold at \$2 a share except by misrepresentations or other fraudulent means, unless the market rose appreciably.' In this connection, the Commission cited the fact that a few days before the registration statement was filed with the Commission, a broker-dealer firm with which a vice president of the corporation was associated circulated a grossly false and misleading 'special report' recommending the purchase of the registrant's stock.

Other areas in which the corporation either failed to disclose material information or inadequately presented information, included the use of the proceeds from the offering, transactions with promoters, and the history of the unsuccessful operation of the properties.<sup>22</sup>

Arizona Aviation and Missile Corporation. --  
The issuer is an Arizona corporation formed in

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<sup>22</sup>U.S., Securities and Exchange Commission,  
23rd. Annual Report, 1957, p. 41.

1957 for the purpose of developing and manufacturing safety and electronic components for aircrafts and missiles. At the time of the issuer's offering under Regulation A, it had engaged in manufacturing only three items; a curtain rod, a machine for soldering electrical circuits, and an electrical display lighting device.

The issuer delivered to the underwriter for use in the offering copies of a reprint from a technical magazine, the use of which implied that the issuer was active in the field of aviation safety design. This reprint was not filed with the Commission as required by Regulation A. In addition, the issuer sponsored, and its president participated in, two television programs designed to further the sale of the issuer's stock. The issuer also failed to file copies of the scripts of these programs with the Commission as required by Regulation A.

In order to publicize and further the offering and sale of its stock the issuer caused to be published in a newspaper an article purporting to describe the issuer's business. This article contained misleading statements and included a photograph which was misleading in that it purported to show the operations of the issuer but in fact showed those of another company.

In view of the issuer's failure to comply with the terms and conditions of the regulation the Commission entered an order permanently suspending the exemption.<sup>23</sup>

Way-Do Manufacturing Co., Inc. -- The company was a New York corporation incorporated in 1955 for the purpose of merchandising a preparation claimed to be able to control dandruff and excessive hair loss. The notification stated that the securities would be offered for sale only in the State of New York whereas the offering was made in several other states as well. The notification also stated that no offering circular would be used in connection with the offering, although the use of an offering circular was required and one was filed as an exhibit to the notification.

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<sup>23</sup>U.S., Securities and Exchange Commission, 26th Annual Report, 1960, p. 49.

Way-Do admitted, and the Commission found, that the offering circular was deficient in that it failed to disclose the amount of expenses of the issuer in connection with the offering, the method by which the securities were to be offered, the remuneration of the company's officers and directors, the stock holdings and other interests of directors and officers, the percentage of outstanding securities to be held by directors, officers and promoters and by the public, assuming the entire issue were sold or the issuer's contingent liability for sales of unregistered stock during the previous year. The offering circular also failed to include an adequate statement of the purposes for which the proceeds of the offering would be used or to contain the required financial statements.

In view of the extensive and serious deficiencies the Commission refused to permit the withdrawal of the notification as requested by the issuer and entered an order permanently suspending the exemption.<sup>2+</sup>

Strategic Minerals Corporation of America. --- The registrant was organized under the laws of Delaware in 1955 for the purpose of developing and using a process, known as the Bruce Williams Process, for the beneficiation of low-grade ores. The registrant proposed to use such process to beneficiate low-grade manganese ores. It filed a registration statement covering a proposed offering of \$1 million principal amount of 6 percent first mortgage bonds at a price of 95 percent of the principal amount and 1,200,000 shares of common stock at \$3.00 per share. After the Commission instituted proceedings pursuant to Section 8(d) of the Act, the registrant entered into a stipulation of facts with our Division of Corporation Finance and consented to the entry of a stop order.

Among the deficiencies constituting the grounds for the issuance of the Commission's stop order were: (1) representations that the registrant's proposed production facilities were planned to be located near manganese ore

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<sup>2+</sup> Ibid., p. 53.

deposits, and stockpiles owned by the United States Government, in Texas, Arkansas, Arizona, and New Mexico, without disclosing that registrant had no assurance of obtaining any ores owned by the government for beneficiation, and that it had no assured source of raw materials and had not examined any stockpiles, mines or mining properties with a view to locating potential sources of raw material for its proposed plants; (2) representations concerning costs of constructing plant facilities and operating cost estimates, which the registrant conceded were inadequate and misleading; (3) the failure to disclose that the registrant had not conducted any market survey to determine whether any user of manganese ores would be interested in purchasing its upgraded product; (4) the failure to disclose the current world price of manganese ores, and that on the basis of available information and present world prices for manganese, the Bruce Williams Process is not economically feasible; (5) the failure to disclose that there was no market justification at that time for the construction of any beneficiating plants to upgrade manganese ores; and (6) the failure to disclose in a summary fashion in one place in the early part of the prospectus under an appropriate heading the speculative features of the registrant's business and securities. The Commission also found deficiencies, among others, with respect to the disclosures contained in the financial statements, and representations concerning the use of proceeds, securities proposed to be offered and the amount of securities outstanding, compensation to be paid to the underwriter and the underwriter's relationship to the registrant and the debt securities covered by the registration statement.<sup>25</sup>

In spite of the violations indicated above the author believes that information contained in prospectuses is more reliable than information usually

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<sup>25</sup> Ibid., p. 44.

available to the small investor in the form of corporate annual reports, broker-dealer advisory reports, and newspaper and financial journal reports. It would appear that even the information contained in offering circulars is at least as reliable as that contained in the sources mentioned above.

The unreliability of broker-dealer literature and news releases is attested to by responsible executives of investment firms. For example, Walter K. Gutman, highly regarded security analyst for the Wall Street firm of Stearns & Co., says, ". . . we professionals not only promote, we are promoted to, too. Just remember when you take a course in security analysis - if the professor doesn't tell you something about promotion, he's not telling you everything there is to tell."<sup>26</sup>

Philip A. Fisher, of the San Francisco firm of Fisher & Company says, "However, on the whole, I would feel the typical public printed brokerage bulletin available to everyone is not a fertile source. There is too much danger of inaccuracies in them."<sup>27</sup>

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<sup>26</sup> Walter K. Gutman, You Only Have to Get Rich Once (New York: E.P. Dutton & Co., 1962), pp. 127, 128.

<sup>27</sup> Philip A. Fisher, Common Stocks and Uncommon Profits (Revised ed.; New York: Harper & Bros., 1960), p. 151.

The inaccuracy of much information furnished by brokers and investment advisors was also noted by the Securities and Exchange Commission in its recent study of securities markets.<sup>28</sup>

Of course, a great deal of these inaccuracies can probably be traced to the fact that brokers are usually attempting to predict future events, primarily market conditions and profits. It seems likely, however, that some brokers take advantage of the situation to predict conditions which they cannot reasonably expect to occur.

#### Summary

It appears from an analysis of the Securities and Exchange Commission prosecution records that information contained in prospectuses is approximately 95% accurate. It is doubtful that greater accuracy can be attained without a detailed investigation of each filing company prior to approval. The cost of investigating every prospectus to prevent inaccuracies in 5% of them would seem exorbitant.

The data contained in offering circulars appears

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<sup>28</sup> Securities and Exchange Commission, Report of Special Study of Securities Markets, Part 1, (Washington, U. S. Government Printing Office, 1963), p. 330 et seq.

to be only about 80% accurate. The author believes that the Securities and Exchange Commission can and should take steps to improve the reliability of offering circular data. Specific corrective measures will be discussed in the next chapter.

## CHAPTER V

### CONCLUSIONS AND RECOMMENDATIONS

One commentator says,

While the S.E.C. 'full disclosure' rules have undoubtedly done much to protect the investor, it is probably also true that they are more exacting than they have to be (emphasis supplied) and that they deter many a company from trying to raise new money for expansion.

Furthermore, it can be argued that the individual investor doesn't really benefit as he should from the protection that is provided him. Most individuals who buy a new issue - and their number is few compared to those who buy securities already on the market - rarely examine the prospectus or understand it if they do.<sup>29</sup>

The author cannot agree that the Security and Exchange Commission regulations are too strict. Certainly any regulation cannot be too strict in which as many as 11% of potential violators are found guilty of one or more material violations. As indicated in Table III the Securities and Exchange Commission has reduced the violations by issuers to prospectuses substantially below this figure. It should certainly be possible to reduce violations by issuers of offering circulars to a level of 5% or less. As indicated in Chapter II, the author feels that present requirements for prospectuses and

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<sup>29</sup>Louis Engel, How to Buy Stocks, (New and enlarged ed., New York: Bantam Books, 1957), p. 31.



offering circulars is minimal, at best. Much additional information is required to enable the prospective investor or speculator to reach an intelligent decision. This information is frequently furnished by brokers to preferred customers orally at the time of the offering, thus placing these customers in a position to judge the security better than those who must rely on the prospectus or offering circular. This use of oral communication also opens the way for fraudulent claims with less chance of detection.

The author does agree with Mr. Engel's contention that most people who read a prospectus do not understand it. He does not agree that this is sufficient reason to deny this information to those who are qualified to use it.

Mr. Engel also observes that, "All told, preparing a new issue for sale can be a very expensive undertaking. The bill for preparing the necessary forms and printing a prospectus may run to \$15,000 or \$20,000, and it can run as high as \$100,000."<sup>30</sup>

However, the author does not consider this a valid reason for eliminating such documents. The

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<sup>30</sup>Ibid., p. 30.

expense is ultimately borne by the purchaser of the new stock, since the issue is usually priced to cover such expenses. The amount of such expenses is usually quite small in comparison to the potential loss from investing on the basis of inadequate or inaccurate information.

The author concludes then that the standards for prospectuses, and especially for offering circulars, should be much more exacting than they presently are. Specifically he would recommend that:

1. The document should contain in all cases balance sheets for the latest three years, or annually for the life of the company if it is less than three years, and that greater attention be given in the financial statements to depreciation policies, long term leases, inventory valuation, and treatment of development expenses. A great many companies follow the practice of carrying development expenses on their books as assets and amortizing them over a long period. This tends to overstate both assets and earnings.
2. Greater attention should be given to marketing functions and product pricing.

Each document should state the size and trend of the potential market, the nature and extent of competition, the company's position in the market, and whether or not the company's products are competitive in price. If such information is not available, the prospectus or circular should contain a statement to that effect. This would at least put the prospective investor on notice that management is probably not as knowledgeable as it should be.

3. Each document should contain a statement of the operating rate of the company, that is, the percent of capacity at which the plant is now operating. This is essential in estimating future capital needs.
4. Each document should contain adequate information as to the physical facilities, staff, budget, results and current projects of the company's research and development department, where this is applicable. We are living in a period when technology is often the key to a company's success. The potential investor should be placed in a position to judge this factor as accurately

as reasonably possible.

5. Each document should contain data concerning mergers, loans, and material contracts which the company is currently considering. If none are under consideration a statement to that effect should be required.
6. Consideration should be given to the elimination of Regulation A, regarding smaller issues. While the total amount of each such issue is relatively small, the loss they may cause to an individual investor is just as large as for the larger issues. Commission records indicate that most fraudulent issues are qualified under this regulation. If these issues were held to the same standards as other issues it appears likely that many such frauds could be prevented. As an alternative to the elimination of the regulation, it is possible that standards under the regulation could be tightened to provide adequate protection for the public. This would, of course, increase the expense of operating the Securities and Exchange Commission because of the need for expanding the staff to handle the additional work.

The author believes that such additional expense is justified. Regulation A was adopted and has been continued on the assumption that the simplified procedure would result in lower costs for small issues. However, information gathered by Flink fails to show any significant savings.<sup>31</sup>

In summary, it is the opinion of the author that information contained in prospectuses is as accurate as can reasonably be expected and meets minimum standards for adequacy. However, the prospectus would be much more useful to investors if greater detail were provided in the areas previously mentioned.

Offering circulars are somewhat less adequate, and much less accurate than prospectuses. The author recommends that Regulation A, under which offering circulars are issued, be withdrawn. All issues, regardless of size, would then be required to comply with the full registration procedure. The registration procedure provides much greater protection for the investor than that provided by the simpler requirements of Regulation A.

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<sup>31</sup>Salomon J. Flink, op. cit., p. 82.

APPENDIX I

ISSUERS OF PROSPECTUSES EXAMINED

Allegheny Pepsi-Cola Bottling Company  
Amacorp Industrial Leasing Co., Inc.  
American Bowla-Bowla Corporation  
Aqua-Chem, Inc.  
Automated Sports Centers, Inc.  
Bernan Leasing Company  
Coastal Leasing Corporation  
Constellation Life Insurance Company  
Copymation, Inc.  
Custom Components, Inc.  
Detroit Mobile Homes, Inc.  
Food Corporation of America, Inc.  
Gateway Sporting Goods Company  
General Shale Products Corp.  
Ginn and Company  
Great Lakes Bowling Corporation  
Kenrich Petrochemicals, Inc.  
Lowe's Companies, Inc.  
Major League Bowling & Recreation, Inc.  
Microdot, Inc.  
National Equipment Rental, Ltd.  
Park Electrochemical Corp.  
Pocket Books, Inc.  
Powertron Ultrasonics Corporation  
Premier Microwave Corporation  
Royal School Laboratories, Inc.  
Safecraft Corporation  
Southern Frontier Finance Company  
Technical Animations, Inc.  
Union Texas Natural Gas Corporation  
Variable Annuity Life Insurance Company of America

APPENDIX II

ISSUERS OF OFFERING CIRCULARS EXAMINED

American Alliance Life Insurance Company  
Automation Laboratories, Inc.  
Automation Systems, Inc.  
Brook Labs., Co., Inc.  
BTU Engineering Corporation  
Doak Pharmacal Co., Inc.  
Custom Craft Marins Co., Inc.  
C.W.S. Waveguide Corp.  
Dorsett Laboratories, Inc.  
Dwyer-Baker Electronics Corp.  
Equitable Standard Life Insurance Company  
General Computer/Electronics Corporation  
Geotechnics and Resources, Incorporated  
Glass Magic Boats, Inc.  
Guaranty National Insurance Company  
Harvey Boat Works, Inc.  
Highway Cruisers, Inc.  
Hydrocraft, Inc.  
Idaho Mining and Milling, Inc.  
Johnson Electronics, Inc.  
C. F. Kirk Laboratories, Inc.  
Le-Wood Homes, Inc.  
Liverpool Industries, Inc.  
Major Pool Equipment Corp.  
Mid-Eastern Electronics, Inc.  
Missile Components Corp.  
The Rabin Company  
Rising's Electro, Inc.  
Saber Boats, Inc.  
Saturn Electronics Corporation  
Spray-Bilt, Inc.  
Statmaster Corporation  
Transitor Specialties, Inc.  
Transitubes Electronics, Inc.  
Vol-Air, Inc.  
Wallson Associates, Inc.  
Western Semiconductors, Inc.

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