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SIGNIFICANT REVISIONS IN SEC REGULATIONS A & D

by

Arthur M. Magaldi*

The Depression of the 1930's and its traumatic effects had many ramifications in American society. Economists and those who have studied that period differ on the issue of the role of the stock market crash of 1929 as a cause or effect of the Depression. One view sees the market crash as the catalyst or start of the Depression. Another view sees the crash as a symptom of an overall economic decline. There is no doubt, however, that the stock market crash was an integral part of the severe economic decline that gripped the United States during the 1930's.

The suddenness of the precipitous market decline signalled the end of an era of prosperity and ushered in a time of economic hardship for millions. As the New York Times recorded in its October 30, 1929 edition, "Stock Prices collapsed yesterday, swept downward with gigantic losses in the most disastrous day in the stock market's history. Billions of dollars in open market values were wiped out as prices crumbled under the pressure of liquidation of securities which had to be sold at any price...Banking support, which would have been impressive and successful under ordinary circumstances, was swept violently aside, as block after block of stock, tremendous in proportions, deluged the market. Bid prices placed by bankers, industrial leaders and brokers trying to halt the decline were crashed through violently, their orders were filled, and quotations plunged downward in a day of disorganization, confusion and financial impotence."

The effects of the stock market crash were not limited to those who directly lost money from the falling prices of equities. The economic foundation of the United States was severely shaken. "From 1930 to 1933, prices of industrial stocks fell about 80 percent. Large numbers of banks had invested the money of their depositors in stocks. When stock values fell, many of these banks lost such money and had to close because they could not return it to the depositors.

Bank failures increased as the depression continued. About 1,350 banks failed during 1930. Approximately 2,300 more banks failed during 1931, and an additional 1,456 went under in 1932. The bank failures wiped out the savings of millions of people."[1]

As the most dramatic illustration of the economic malaise into which the United States had fallen, the stock market crash drew intense scrutiny. The analysis revealed that

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many schemes, frauds, and manipulations contributed to the problem. It became clear that investors of that time did not have available to them sufficient truthful information upon which to base investment decisions. Investors were therefore vulnerable to fraudulent schemes and manipulations and market excesses. The conclusion was reached that the integrity and effectiveness of the securities markets could only be assured by the introduction of new strict statutory safeguards. Exercising its power to regulate interstate commerce, the Securities Act of 1933[2] ("Securities Act") and the Securities Exchange Commission Act of 1934[3] ("Exchange Act") were passed to promote and insure the honesty and integrity of the securities markets. Both statutes are disclosure statutes with strong anti-fraud prohibitions.

New issues of securities to be sold in interstate commerce or by means of interstate commerce, e.g., the mails, are regulated by the Securities Act. The statute requires that any issue of securities that is being sold to the public for the first time, i.e., new issues, must be registered with the SEC and each purchaser of the new issue must be provided a prospectus before the sale or at the time of the sale. The registration statement, Form S-1, must contain extremely detailed and definite information about the issuer, the issuer's business, financial structure, relevant contracts, and officers. The filing must include an audited financial statement and any other information the SEC deems relevant. The prospectus which is generally part of the registration statement, contains in abbreviated form a substantial amount of the same information. In addition to the seventeen items specifically required in the registration statement, it is common for the SEC to call for additional disclosures and clarifications in the form of amendments. Unless the SEC extends the time frame, twenty days after filing the registration statement or twenty days after any mandated amendments, the registration statement is deemed effective and the securities may be sold.

It is, of course, a violation of the law to offer to sell or to sell unregistered securities unless the issue is the subject of a relevant exemption. Civil liability attaches to innocent or negligent violations and willful violations can be prosecuted as criminal offenses.

The provisions and enforcement of the Securities Act have been relatively successful in encouraging fair, accurate, and complete disclosure about new issues of securities; the securities markets have prospered to the point where it is not uncommon to see 300 million shares traded on the New York Stock Exchange on a single day.

One important difficulty with the detailed disclosure required by the Securities Act has been the substantial costs involved with compliance. "Due to the intricacy of the regulations, it is virtually impossible to achieve registration without the help of attorneys expert in the field. Accounting requirements and costs are likewise considerable. Substantial accounting and legal expenses and the accompanying "red tape" involved in compliance may discourage companies and entrepreneurs from going public."[4] The expenses involved in registering new issues have been particularly burdensome to smaller companies, especially companies with no established market for their securities.

Over the years the SEC has been mindful of the sometimes prohibitive costs of registering securities, and exercising its rule-making powers has passed rules exempting certain sales of securities from these requirements. The exemptions have applied where the SEC has determined that there existed no substantial danger to the public in the exempted sales. The purpose of this paper is to consider significant changes to two of the more important exemptions, Regulation A[5] and Regulation D, Rule 504.[6] In order to do this, some background on the Exchange Act is required.

Securities Exchange Commission Act

The Exchange Act created the SEC as a "securities watchdog." While the Securities Act regulates the issuance of new securities, the Exchange Act regulates the ongoing trading of securities.

The Exchange Act functions as a disclosure statute. It requires that corporations with 500 shareholders and $5 million in assets as well as any corporation traded on a national securities exchange file disclosure reports with the SEC.[7] These so-called reporting companies must file annual reports (Form 10-K), quarterly reports (Form 10-Q), and monthly reports (Form 8-K) for any month in which there is a material change in the affairs of the corporation.

The Exchange Act also condemns fraud and fraudulent activities in securities dealings. The famous Section 10b and Rule 10b-5 declare unlawful "any device, scheme or artifice to defraud." The rule makes it unlawful to make untrue or misleading statements or to omit to state material facts necessary to keep other facts from being misleading. Rule 10b-5 also declares illegal any act, practice or course of conduct which operates as a fraud upon anyone in regard to the sale or purchase of securities.

Rule 504

Prior to the revision of Rule 504, a non-reporting company, i.e., a small company which was not subject to the reporting provisions of the Exchange Act, could raise up to one-half million dollars in a twelve month period through the sale of a new issue of securities without the necessity of complying with the registration provisions of the Securities Act. The requirement that a prospectus be provided to purchasers was likewise dispensed with and the issuer of the securities was not required to make disclosure to the purchasers. Under the 504 exemption, the securities could be sold to any number of offerees or purchasers. The rationale for the Rule 504 exemption is that there is no substantial danger to the investment public where the total of the issue is a relatively modest $500,000. The intent of the Rule 504 exemption is to allow small issuers access to modest amounts of capital through the sale of a new issue without the expense of registration.

The Rule did not dispense with all investor safeguards; the anti-fraud provisions of the Act are not suspended. Moreover, the SEC has to be notified within fifteen days of the first sale of the securities.

There were many drawbacks to the use of Rule 504. To utilize the exemption, Rule 504 required a private placement, i.e., no advertising or general solicitation of the public was permitted. Further, purchasers of the securities under the exemption received "restricted securities," i.e., securities which were not available for resale without registration. It was the responsibility of the issuer to determine that the purchasers were purchasing the securities as an investment and the securities had to bear a legend indicating that they had not been registered and were therefore restricted as to resale.

Revised Rule 504

Newly revised Rule 504 makes three significant changes to the rule. Under the revision, the amount of securities which can be sold has been raised to $1 million[8] during a twelve month period. There is no longer any prohibition against advertising or solicitation of the public.[9] The issuer or underwriter may advertise in any medium deemed appropriate. Purchasers of securities under this exemption no longer receive restricted securities.[10] The securities purchased are fully transferable and can be re-sold immediately after purchase.

While the other provisions of Rule 504 outlined above remain substantially intact, the net result of the changes appears to be that an issuer which remains within the $1 million monetary guideline may, in effect, make a public offering of that amount without restrictions or registration.

Regulation A

Regulation A is a conditional small issues exemption from registration under the Securities Act. The Regulation A exemption may be considered a quasi-exemption inasmuch as the issuer must file with the SEC an offering statement[11] (Form 1-A) instead of a full registration statement. No securities may be offered for sale under Regulation A until an offering statement is filed with the SEC and no sales may be made until the Form 1-A offering statement has been deemed qualified by the SEC. Each purchaser of securities must be delivered a final offering circular[12] before or at the time of the confirmation of sale.

Regulation A has, in effect, substituted the offering statement and offering circular for the registration statement and prospectus of the traditional Securities Act registration. The value to the issuer is that the disclosure required to qualify for Regulation A exemption is somewhat less than that required for a full registration. Regulation A exemption can ouly be used by companies that are not required to report under the Exchange Act.

Revised Regulation A

Prior to revision, the monetary limit of $1.5 million of sales within a twelve month period was in effect. This monetary limitation effectively limited the exemption's usefulness to small companies because the costs of compliance with this modified registration, although reduced from the costs of full registration, are still burdensome. In many cases, there was little to gain from Regulation A transactions in light of the substantial expenses required to be incurred to qualify the offering statement and to prepare and distribute the offering circular. Moreover, many of the expenses had to be borne by the issuer before knowing whether there was a market for the securities because the first step in the Regulation A process is the filing of the offering circular. The SEC framed the problem in this manner, "..., one of the major impediments to a Regulation A financing for a small start-up company with no established market for its securities, is the cost of preparing the mandated offering statement. The full costs of compliance would be incurred without knowing whether there will be any investor interest in the company."[13]

The revisions enacted by the SEC retain the basic structure of Regulation A but change major portions of the regulation. The revisions recognize the need for small companies, those not subject to the reporting provisions of the Exchange Act, to have access to capital markets through the sale of limited amounts of securities with a lessened amount of red tape. The revised regulation raises the dollar limit of sales to $5 million during a twelve month period.[14] Equally important, revised Regulation A allows the issuer to circulate solicitation of interest documents prior to the filing of the offering statement.[15] This "testing of the waters" may also include radio or television advertising.[16] Such a solicitation of interest writing is specifically declared not to be an illegal prospectus. "Any written document under this section may include a coupon, returnable to the issuer indicating interest in a potential offering, revealing the name, address, and telephone number of the prospective investor."[17] This procedure allows the issuer to determine whether there is interest in the proposed issue and encourages an informed decision on the advisability of proceeding or terminating the proposed offering.

The written solicitation of interest document or script of the broadcast soliciting interest must be filed with the SEC at the time of first use. Following the submission, oral communications with prospective investors may take place. If the respouse to the test the waters solicitations of interest are positive, the issuer will then be able to proceed with the expense of the offering statement and offering circular which continue to be required before sales may take place.

An additional aid to small business issuers under Regulation A allows for good faith projections of future performance in the disclosure documents provided there is a reasonable basis for such projections. "The Commission's safe harbor provisions relating to forward looking information have been specifically made applicable to Regulation A. Therefore, good faith projections, with a reasonable basis, of revenues, income, earnings per share, capital expenditures, dividends, capital structure and other financial items may be made in Regulation A filings and the "test the water" submissions and fall within the protections of the Commission's safe harbor rules, ..."[18]

Conclusion

The liberalization of Regulation A and Regulation D, Rule 504, seems reasonable. It appears to be a worthwhile attempt to open capital markets to small businesses from which they had been unnecessarily excluded by stringent regulations. There appears to be little danger to the public since safeguards, notably the anti-fraud provisions, remain in effect. Raising dollar figures in the exemptions to more realistic amounts reflective of the 1990's seems to be an appropriate measure for the SEC. It is refreshing to learn of initiatives by a powerful regulatory body which encourage legitimate business activities without abandoning the public trust.

ENDNOTES

1. The World Book Encyclopedia (New York: World Book - Childcraft International, Inc.), Vol. G, p. 340, 1979.
2. 15 U.S.C. Sec. 77a *et seq.*
3. 15 U.S.C. Sec. 78a *et seq.*
4. The Legal Environment of Business (Cincinnati: South-Western Publishing Co.), p. 639, 1987.
5. 17 CFR 230.251-262.
6. 17 CFR 230.501-508.
7. *Supra* at 3.
8. 17 CFR 230.504(b)(2)(i).
9. 17 CFR 230.504(b)(2)(2).
10. 17 CFR 230.504(b)(2)(3).
11. 17 CFR 203.252.
12. 17 CFR 203.253.
13. 51 SEC Docket 2615.
14. 17 CFR 230.251(b).
15. 17 CFR 230.254(a).
16. *Id.*
17. *Supra* at 12.
18. 57 Fed. Reg., No. 157 at 36444.