CORPORATE FINANCING AND THE FEDERAL SECURITIES LAWS

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At the outset, it should be noted that the title of this article, "Corporate Financing and the Federal Securities Laws," is, to some extent at least, a misnomer and misleading inasmuch as this subject has so many facets that one could, if so inclined, write almost *ad infinitum* and still not cover all aspects of this matter. This article, for the most part, deals only with a limited phase of this broad general subject, namely, the raising of capital by small business enterprises through the issuance of securities and the registration requirements of the federal securities laws as applicable thereto, with particular emphasis upon certain exemptions from registration provided by these laws.

Before entering into a discussion of this limited aspect of federal regulation of securities, a brief statement concerning the "regulator" and the statutes it administers would appear to be in order.

The "regulator" is, of course, the Securities and Exchange Commission. This Commission, generally referred to as the SEC, was organized on July 2, 1934, having been created by an Act of Congress entitled the Securities Exchange Act of 1934,[1] and it is an independent, bipartisan, quasijudicial agency of the United States Government. The Commission consists of 5 members, or rather, Commissioners, not more than 3 of whom may be members of the same political party. The 5 Commissioners are appointed by the President, with the advice and consent of the Senate, and one of the Commissioners is designated Chairman by the President. The Commission's staff is composed of lawyers, accountants, engineers, security analysts, and administrative and clerical employees. This staff, numbering in the aggregate some 750 persons, is divided into divisions and offices in accordance with functional alignment and each division or office is in charge of an

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1. 48 STAT. 881, 15 U.S.C. § 78 (1934).

official appointed by the Commission.[2]

The statutes administered by the SEC relate generally to the field of securities and finance and are designed to provide, to the extent possible, protection for investors and the general public in their securities transactions. These laws include, in addition to the Securities Exchange Act, the Securities Act of 1933,[3] the Public Utility Holding Company Act of 1935,[4] the Trust Indenture Act of 1939,[5] the Investment Company Act of 1940,[6] and the Investment Advisers Act of 1940.[7] The Commission also serves as adviser to the federal courts in corporate reorganization proceedings under Chapter X of the National Bankruptcy Act.[8]

The Federal Securities Laws and the numerous rules and regulations promulgated by the Commission thereunder are complex because of the very nature of their subject matter.[9] Accordingly, anyone who attempts a broad summarization of the various statutes administered by the SEC must necessarily and inevitably over-simplify the statutes and the Commission's functions in connection therewith. However, subject to this *caveat* concerning summarizations and the inevitable over-simplification resulting therefrom, a concise summary of one of these statutes, the Securities Act of 1933, is here presented.

SECURITIES ACT OF 1933

The Securities Act of 1933,[10] often called the "truth in securities law," has two basic objectives: (1) to provide investors with material financial and other information concerning securities offered for public sale; and (b) to prohibit misrepresentation, deceit, and other fraudulent acts and practices in the sale of securities generally. Achievement of these objectives is sought through the registration and and antifraud provisions of the act.

In general, section 5 of the act makes it unlawful for anyone to offer, sell or deliver unregistered securities by use of the mails or

2. Included in these divisions and offices are nine regional offices, one of which is located in Atlanta, Georgia (350 Peachtree-Seventh Building). The Atlanta regional office serves a territory comprised of the states of Georgia, Florida, North Carolina, South Carolina, Tennessee, Alabama, Mississippi, and part of Louisiana.
3. 48 STAT. 74, 15 U.S.C. § 77 (1933).
4. 49 STAT. 838, 15 U.S.C. § 79 (1935).
5. 53 STAT. 1149, 15 U.S.C. § 77 aaa (1939).
6. 54 STAT. 789, 15 U.S.C. § 80a (1940).
7. 54 STAT. 847, 15 U.S.C. § 80b (1940).
8. 52 STAT. 883, 11 U.S.C. § 501 (1938).
9. Technically, offers are prohibited before the filing of the registration statement and sales are prohibited before the effective date of such statement.
10. See note 3, *supra*.

instrumentalities of interstate commerce, unless either the securities or the transactions in which they are involved are exempt from registration with the Commission. Section 17 of the act makes it unlawful for any person in the offer or sale of securities by use of the mails or instrumentalities of interstate commerce to employ any device, scheme or artifice to defraud or to obtain money or property by means of misrepresentations, either by making untrue statements of material facts or by omitting to state material facts necessary in order to make the statements made not misleading.

Securities are registered by filing with the Commission a registration statement containing the information and data specified by the Securities Act and the General Rules and Regulations promulgated thereunder.[11] It is important to note that compliance with the Securities Act does not obviate the necessity for complying also with applicable state law. Section 18 of the act expressly provides: "Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person."[12]

Not only does the Securities Act prohibit false and misleading statements in the sale of securities under penalty of fine or imprisonment but, in addition, section 12 of the act provides defrauded investors with important recovery rights, assuming, of course, that such investors can prove that there was incomplete or inaccurate disclosure of material facts. The rights provided defrauded investors arising under this section must, however, be asserted in an appropriate federal or state court and not before the Commission.

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11. It cannot be emphasized too strongly that, contrary to the belief held by a great many people, registration does not insure investors against loss nor does it indicate that the SEC has approved the security involved. The Commission does not approve securities, it does *not* have the power to disapprove securities for lack of merit, and section 23 of the act makes it unlawful to represent otherwise in the sale of the security. The only standard which must be met in the registration of securities is full disclosure of the material facts concerning the company and the securities it proposes to sell. The fairness of the price or other terms of the security the company's prospects for success, and other factors affecting the merits of the security have no bearing upon the question of whether securities may be registered. Assuming proper disclosure of all the salient facts, the Commission cannot deny any registration or otherwise bar the securities from sale.

12. In Georgia the Secretary of State acts as Commissioner of Securities. (Ga. Laws, Nov.-Dec. Sess. 1953, p. 423, GA. CODE ANN. § 97-102 (1955 Rev.)). Georgia has its own "registration" requirements and, in general, it is unlawful to sell securities within the state unless notice of intention to sell, together with a prospectus (selling circular) containing specified information has been filed with the Commissioner ofSecurities, unless the securities or transactions are exempt. (Ga. Laws Nov.-Dec. Sess. 1953, p. 423 GA. CODE ANN. § 97-103 (1955 Rev.)).

As noted at the beginning, the main theme of this article deals with the raising of capital by small business enterprises through the issuance of securities and the registration requirements of the Securities Act as applicable thereto, with particular emphasis upon certain exemptions from registration provided by this act. However, before discussing these exemptions, one fact should be made clear. The antifraud provisions of section 17, referred to above apply to all sales of securities in interstate commerce or by use of the mails, regardless of whether the securities are exempt from registration. Stated more concisely, there is no exemption from the antifraud provisions of the Securities Act.

In the preceding summary of the Securities Act it was pointed out that section 5 makes it unlawful to offer, sell or deliver unregistered securities by use of the mails or instrumentalities of interstate commerce, unless either the securities or the transactions in which they are involved are exempt from registration with the Commission. Obviously, a small business enterprise, either established or in the development stage, which desires to raise capital through the issuance and sale of securities, is subject to the provisions of section 5 and, in the absence of an exemption, must, prior to issuing and selling such securities, comply with the registration requirements thereof.

Section 3 of the Securities Act provides exemption for certain classes of securities and section 4 exempts certain transactions. In addition to the statutory exemptions, the Commission has adopted regulation A, which provides a conditional exemption from registration for issues not exceeding $300,000 in amount. The three exemptions which are of primary benefit to small businesses are those provided by section 3 (a) (11), regulation A, and, to a lesser extent, section 4 (1).[13] However, each of these exemptions has very definite limitations and an issuer who relies upon any one of them may find itself faced with serious problems unless the terms and conditions of the particular exemption relied upon are fully understood and strictly complied with.

SECTION 3 (a) (11)

Section 3 (a) (11) provides an exemption for "any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory."

13. Although these exemptions are of primary importance to small business enterprises, they are not necessarily limited to "small business" but are available to an issuer, large or small, who can comply with their provisions.

At first reading, compliance with the terms and conditions of section 3 (a) (11) would appear to be a relatively simple matter. Actually, as will be seen, an issuer contemplating the issuance and sale of securities in reliance upon this exemption would be well advised in certain cases to give serious consideration to the desirability of complying with the terms and conditions of regulation A and ignoring section 3 (a) (11) altogether.

This so-called "intrastate" exemption is available only where the *entire issue* of securities is offered and sold *exclusively* to *residents* of the state in which the issuer is incorporated and doing business. This exemption was designed to apply to distributions which are genuinely local in character and, in view of the requirement that the entire issue must be offered and sold exclusively to residents, any offers or sales to nonresidents, no matter how few and even though legal in themselves, preclude compliance with the terms and conditions of section 3 (a) (11) and cause the loss of the exemption, not only with respect to the securities sold to the nonresidents, but also with respect to the entire issue, including those sold to residents. Thus, an issue of securities may not be split so as to offer a part thereof under section 3 (a) (11) and the balance after registration with the Commission or under some other exemption, including the conditional exemption provided by regulation A.

It not infrequently happens that a company will commence an offering of stock under section 3 (a) (11) and thereafter decide to comply with the terms and conditions of regulation A so as to be able to offer and sell its stock outside the state. If the stock sold in reliance upon the intrastate exemption and that proposed to be sold under regulation A is of the same class, the question arises as to whether a single "issue" of securities is involved. If a single "issue" is involved, then any sale to a nonresident, even though made after compliance with regulation A, would destroy the exemption for all the stock sold under section 3 (a) (11), since the entire "issue" would not have been sold exclusively to residents, and the company would, in such, case, become contingently liable to all the purchasers of the stock sold under section 3 (a) (11).

Neither the Securities Act nor the General Rules and Regulations adopted thereunder contain a definition of the term "issue" but, generally speaking, an offering of securities of the same class as those previously sold and presently outstanding is not considered a new and distinct "issue" if the two offerings are significantly connected, as where the offering of the securities previously sold was made as a related part of a plan or program which contemplated the

present offering. The determination of whether securities are being offered as part of a single "issue" depends upon various factors, including the methods of sale and distribution employed to effect the offerings, the disposition and use of the proceeds, and the manner and terms of the distribution. Securities of the same class, offered on the same general terms to the public in an uninterrupted program of distribution, cannot be segregated into separate "issues" merely by claiming that such offerings represent separate plans of financing. The difference between the offerings must be distinct and substantial.[14]

In view of the above, if there is any likelihood that the company will be unable to dispose of its securities entirely to residents within the state, it should at the outset comply with the terms and conditions of regulation A and, by so doing, avoid this potential problem.

Moreover, the requirement that the entire issue be sold exclusively to residents contemplates that the resident purchasers will purchase the stock for the purpose of invesment and not with a view to resale. In other words, any sale to a nonresident, either directly or indirectly, will cause the loss of exemption under section 3 (a) (11) with respect to the entire issue and if an issuer offering securities in reliance upon the intrastate exemption should sell to a resident who purchases with a view to resale and who, in fact, does resell to a non-resident, such sale or sales by the resident to the nonresident could cause the loss of the exemption and, under such circumstances, the issuer might find himself subject to the penalties prescribed by the act.[15]

REGULATION A

The Commission, pursuant to authority contained in section 3 (b) of the Securities Act, has adopted regulation A, which provides a conditional exemption from registration for offerings of securities under certain conditions.[16] Regulation A is referred to as a "conditional exemption" for the reason that, unlike the exemption pro-

14. The terms "issue" and "class" are not synonomous, however, and two blocks of securities of the same calss may nevertheless represent separate "issues" if they represent separate plans of financing in point of time and circumstance.

15. As a measure of protection from this potential source of trouble, it is not an uncommon practice for issuers who offer their securities under section 3 (a) (11) to require a signed statement from each purchaser stating that such purchaser is a bona-fide resident and is purchasing for the purpose of investment and not for resale. Such a statement does not, of course, relieve the issuer from all liability should the exception be lost, since "good faith" and lack of "willfulness' does not relieve an issuer from civil liability arising under section 12 of the act.

16. Regulation A embraces rules 215 through 224 of the Geieral Rules and Regulations under the Securities Act. The provisions and an explanation of regulation A also may be found in Securities Act Release, Numbers 3466 and 3471, copies of which are available upon request.

vided by section 3(a) (11), it is not automatically available to the issuer but, instead, is available only after compliance with certain requirements, which include the filing with the appropriate regional office of certain prescribed information. However, compliance with the terms and conditions of regulation A is a relatively simple matter and this conditional exemption is widely used by small or newly organized companies.[17]

Briefly state, regulation A provides an exemption from registration for offerings by an issuer not exceeding $300,000 in amount in any twelve-month period. To secure this exemption it is necessary to file, in triplicate, a notification on form 1-A, together with an offering circular containing prescribed information, at least ten days prior to the date upon which the offering is to be commenced.[18]

Form 1-A is a very short form consisting of seven items which must be answered. In general, these items require that information be supplied with respect to such matters as the states in which it is proposed to offer the securities, contemplated additional offerings, sales of unregistered stock within the past year, and the names and addresses of predecessors, affiliates, officers, directors, and promoters of the issuer.

Rule 219 requires that an offering circular containing the information prescribed in subparagraph (c) thereof be filed with the notification and delivered to all persons to whom the securities are offered. In general, the offering circular must contain pertinent information with request to the issuer, such as the date and place of incorporation, the general type of its business and properties, the names and addresses of officers and directors and their interests in the company, the kind and amount of securities being offered, the amount of commissions or fees to be paid in connection with the sale of the securities, and for what purposes the net proceeds from the sale of the securities will be used. In addition, the offering circular must contain appropriate financial statements of the issuer, including a balance sheet as of a date within 90 days prior to the filing of the notification, and income and expense or profit and loss statements for the prescribed period.[19]

When a notification and offering circular are filed with the regional office, they are examined by an attorney and an accountant to deter-

17. In view of the problems which can arise under section 3(a) (11), many issuers offer and sell their securities under regulation A, even though they contemplate selling only within the state. By doing so, they eliminate the potential liability which may arise from inadvertent or indirect offers or sales to nonresidents.

18. An offering circular need not be filed or used where the aggregate amount of the offering does not exceed $50,000.

19. These financial statements need not be certified.

mine whether such material complies with the requirements of the regulation [20] In addition, such material is examined to determine whether appropriate disclosure of all the pertinent facts has been made and to determine whether any of the statements or information in the circular appear to have the tendency to be misleading.[21]

Where it appears that the notification and offering circular do not meet the requirements of the regulation, or where it appears that adequate disclosure of material facts has not been made, or that any of the information or data has the tendency to be misleading, an informal letter of comment pointing out wherein the material appears to fail to comply with the requirements of the regulation is sent to the issuer or its counsel so that appropriate revision of the notification and offering circular may be made, if necessary.[22]

Although from the above it might appear that compliance with the regulation is tedious and time-consuming, such is not the case. Regulation A filings are processed expeditiously and, in the majority of cases, the preparation and filing of the notification and offering circulars do not prove to be burdensome or expensive.[23]

SECTION 4 (1)

The second clause of section 4 (1) of the Securities Act exempts "transactions by an issuer not involving any public offering." The question of whether a particular offering is public or private within the purview of section 4 (1) is a question of fact which must be determined in the light of all the circumstances. Some of the factors which are considered in determining whether an offering is public or private include the number of persons to whom the securities are

20. Where oil, gas, or mining questions are involved, the material also is examined by engineers on the Commission staff.

21. The fact that such material has been filed and examined does not indicate that the Commission has passed upon the merits of the securities or th eaccuracy of the facts contained in such material. Rule 219 (c) requires that the offering circular contain on the cover page this statement: "These securities are offered pursuant to an exemption from registration with the Securities and Exchange Commission. The Commission does not pass upon the merits of any securities nor does it pass upon the accuracy or completeness of any offering circular or other selling literature." Also, rule 222 prohibits the use of any statements or language stating or implying that the Commission has passed upon the merits of, or given approval to, the securities, or has passed upon the merits of, or given approval to, the securities, or has made a finding that such material is accurate or complete.

22. Occasionally, differences of opinion arise between the staff and the issuer and its counsel as to whether full risclosure has been made and as to whether certain statements or information have a tendency to be fisleading. However, these differences can be, and are, amicably settled and, as a matter of practical fact, the comments which are furnished the issuer often result in the inclusion or deletion of information or data which, if not included or deleted, would subject the issuer to the penalties of the act, civil and criminal, prescribed for false and misleading statements.

23. In this connection, there is no fee for filing under regulation A.

offered, their relationship to each other and the issuer, the number of shares being offered, the amount of the offering, and the manner in which it is made. In determining this question, the scope of the offering would be more important than the number of ultimate purchasers.

There is no prescribed formula for determining whether an offering is public or private. Generally, where securities are offered solely to promoters and organizers of the issuer, such disposition has been held to be entitled to this "private offering" exemption. In like manner, an offering to a small group of persons might be considered as entitled to this exemption, depending, of course, on all the circumstances. In any event, this exemption is available only if such persons take the stock for the purpose of investment and not for the purpose of resale or distribution.

If a company needs any substantial amount of capital and must secure such capital from the issuance of securities to persons other than promoters or organizers, reliance upon this exemption is hazardous. However, it is available and has proved beneficial where the required capital can be obtained from a relatively small group.

Conclusion

As noted earlier, the federal securities laws and the Commission's rules and regulations are complex. The above discussion is, at best, only a cursory study of the three exemptions from registration which may be available for offerings of securities by small businesses.

The problems and questions which can arise in connection with the issuance and sale of securities in reliance upon an exemption from registration are varied and numerous. Accordingly, issuers and their counsel are encouraged to confer informally with the Commission's staff whenever an offering of securities is contemplated. The staff of the Commission, including the staff in the regional offices, is available for conferences at all times and in many instances an informal conference prior to the filing of a notification and offering circular under regulation A, or prior to the commencement of an offering under some other exemption, will result in the resolution of problems which might otherwise cause the issuer no little difficulty.

The federal securities laws were not designed, nor are they administered, with a view to hindering the raising of capital by corporate enterprises through the issuance of securities. The Securities and Exchange Commission at all times stands ready to assist corporate enterprises in complying with the various securities laws, consistent with the statutory duty imposed upon it to administer these laws for the protection of investors and in the public interest.