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IMPROVED EXEMPTIONS AND IMPROVED DISCLOSURE

An Address by

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Securities and Exchange Commission

April 30, 1974

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Brown Palace
Denver, Colorado

One of the more innocent notions that I entertained in accepting the Chairmanship of the SEC was the expectation of a fair degree of control over my own time and whereabouts. The best evidence of the fallacy in that thought is the fact that it has taken me nine months to get to Denver. It was not for lack of desire. Denver has a warm spot in my heart and those of our family.

My sister and her family have lived here since the oldest kids were babies, and for many years before his death in 1969, my father was a director of the Denver & Rio Grande. Monthly trips to board meetings in Denver were bright spots in his life and my mother's as well. Summer camping trips up in the mountains with my son are lively and happy memories. We were strictly tenderfeet, tail gate campers. What we did would be pretty sissy stuff for your fellows, but for me, it was great.

I remember, many years ago, Senator Neuberger, of Oregon, writing in the New York Times Sunday Magazine that it would be a major contribution to better government to move our nation's capital out of the miasma of Foggy Bottom and environs to the bright crispness of Denver. I thought it was a good idea at the time, and from my point of view, it would still be a good idea. But when I contemplate Washington today, and consider that you people voted down the winter Olympics even for just one season, I can imagine what would happen to a bond proposal to finance putting the whole Federal government in your lap. On the other hand, suppose it was only to move the SEC - - but that's dreaming!

Now that I am here, I would rather talk about how curiously fond my son and I were of the Great Sand Dunes and the San Juan Valley, of all the fishing licenses we bought and of all the fist that are still here for all we could do about it, of camping in the

early fall among the cliffs at Mesa Verde, and of driving all the way up Mt. Evans and how I'll never do that again! But you didn't come here for that sort of thing, so let me get down to some official words of wisdom. I will, perforce, give you a deductible speech and, hopefully, convey some of our thinking on certain matters of common concern.

The troubled times the securities industry is now facing have caused us to reconsider many of our enforcement and regulatory approaches to significant securities laws problems. Admidst complaints that we are not pragmatic enough in our resolution of these cases, we have been taking a fresh look at a number of questions. Tonight, I would like to share with you some of our recent efforts in the exemption and disclosure areas.

The Commission has, over the last few years, been using a two-pronged approach. On the one hand, the Commission has been seeking to improve the disclosure that is available to investors about public companies and, on the other, the Commission has been attempting to develop more objective rules that hopefully will facilitate the raising of capital without registration in situations where it appears unnecessary for investor protection, consistent with the expressed policies of the Congress.

When Congress enacted the federal securities laws, it recognized that, although Securities Act registration was a salutary goal, there were situations in which the protections of registration were not likely to be necessary. While carved narrowly, and construed even more circumspectly, these exemptions from '33 Act registration prevent our system from proving completely unworkable, since, in their absence, every

transaction involving securities - - including a sale of 100 shares of IBM on the New York Stock Exchange - - would be required to be registered.

Considering the complexities of the capital raising process, it has always amazed me how relatively brief and to the point the Securities Act is, and this is especially true of its exemptions. Of course, we pay for that brevity. One or two lines of the statute can be, and have been, responsible for volumes of interpretations, interpretations which are not always consistent. This is particularly true in the case of the private offering exemption, which exempts from the '33 Act's registration requirements transactions by an issuer not involving any public offering.

Characteristically, the Act contains no definition of the terms "public offering," "offering" or "public." This exemption, which is so commonly relied upon by issuers, consciously or unconsciously, was, from the beginning, a matter of some conjecture.

Skipping the history of the Commission's early efforts to put concrete meaning into the simple phrase, in 1953, the Supreme Court decided the Ralston Purina case,* which has been taken as establishing the basic criteria to be considered in determining the availability of this exemption - - whether the persons who were offered the unregistered securities needed the protections afforded by the '33 Act. This was to be determined by whether the offerees had access to the same kind of information that the company would have disclosed to them as a result of the registration process and whether they were able to fend for themselves.

It is a useless, but nevertheless satisfying, digression to observe that the Ralston Purina opinion must represent the classic case of functional, or policy-oriented,

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* 346 U.S. 119.

construction, abandoning any concern for the ordinary meaning of words and wandering, more or less, unrestrained into speculation as to what the legislature would have said if it only knew how to express itself as well as the courts. Those of you who were old enough to care about such things in 1953 surely remember the astonishment with which you first read the case - - not at the result, but at the rationale. Read it again today and you'll get that old feeling - - unless your once healthy mind has been twisted by 20 years of saying "Why, of course. Everyone knows that the word 'public' means persons with access who can fend for themselves."

Although Ralston Purina was decided in the context of an employee stock offering, where the tests employed, such as "access" to information, were especially relevant, the tests have been lifted from their context and are widely understood to apply to every private offering. This has resulted in further uncertainties, since the tests "access to information" and "fend for himself" and "in need of the protection of the Act" are not much more helpful, in offerings other than to employees, than the statutory standard "not involving any public offering."

There have long been a number of factors that persons seeking to use this exemption have looked to: a limited numder of offerees and purchasers, a lack of widespread advertising, offerees and purchasers who can "fend for themselves" in the sense of obtaining and understanding information about the issuer, controls of resales of the securities, and other types of restrictions intended to limit the offering to "sophisticated" persons and to inhibit a distribution. All of these factors may be relevant, although many persons have chosen to rely on just one at a time, discovering to their sorrow that that is not sufficient.

Since Ralston Purina, there have been remarkably few reported cases relating to the private offering exemption - - whether this is the result of ignorance of the law on the part of investors, or obedience of the law on the part of issuers, I cannot say, although it more likely is the former. The sophistication of investors is increasing, however, or at least, the sophistication of investors' counsel is. The relatively recent expansion of class actions and the increasing utilization of the federal securities laws as a potential remedy for bad investment decisions, as well as for fraudulent activity, have greatly increased the risk involved in relying on the private placement exemption. Ill-founded reliance can result in the issuer giving, in effect, a "put" to every purchaser in the offering, at least for a year. Whether or not this is an appropriate remedy for even unintentional failures to come within the strictures of the private placement exemption is, to my way of thinking, a very open question. Nevertheless, that appears to be what the law provides.

Over the past few years, the uncertainty surrounding the availability of the exemption has increased, partly, it must be admitted, as a result of judicial pronouncements resulting from understandable efforts to protect investors, and partly, perhaps, because of the growing complexity of financing arrangements in this country coupled with the present difficulties attending the raising of capital. This unhealthy, and potentially costly, uncertainty, to which the Commission made notable contributions, led the Commission to consider the adoption of a rule establishing, to the extent feasible, some objective standards for complying with the private placement exemption.

Not all transactions should be registered under the Act. There are many valid offerings that are exempt from registration, and it is in the public interest that this be so. The difficulty, of course, is one that we often run into in trying to administer the

securities laws: we must try to develop objective standards to enable diligent counsel to advise his clients and render opinions with reasonable confidence without crippling too much our enforcement efforts by providing road maps for evasion. There is a delicate balance to be struck between absolute certainty which, while serving legitimate interests, also serves some illegitimate ones, and complete uncertainty which, while making our enforcement task easier, makes capital raising more difficult and unnecessarily risky.

These have been considerations in our work on Rule 146, the result of our concern with the difficulty of determining when a valid private placement exemption is available. The Commission first proposed Rule 146 for public comment in November 1972. After receiving and analyzing many comments, and rethinking the proposal, the Commission reproposed Rule 146, in revised form, for comment, in October, 1973. Again, a number of comments were received, although they were fewer in number and lesser in degree of disenchantment. The rule was again revised, although not so greatly in substance, and, as you may know, the Commission adopted Rule 146, Transactions by an Issuer Deemed Not to Involve any Public Offering, just last week. It will not be effective, however, until June 10, 1974, and then, it will be applicable only to offerings commencing on or after that date.

The nature of our distribution system and of the mails is such that I am sure that many of you have not had a chance to look carefully at the rule as finally adopted. I want to talk briefly about certain aspects of it, but only with the caveat that you read the rule in its entirety in order to understand the interrelationship of the various conditions and the exact requirements.

We have tried to make it very clear that the rule is not intended to be the exclusive means of complying with the private placement exemption. The law, as it has developed and will develop through administrative and court pronouncements and interpretations apart from the rule, will continue to be available to sustain the exemption in a proper case. What the rule does do is offer a relatively objective method of complying with the exemption for those who choose to follow it - - a so-called safe harbor. We are well aware of the fact that the variety of types of legitimate private placements is so great that no rule could possibly encompass them all.

The rule is for use only by issuers, since it is adopted under Section 4(2) of the Act, which provides an exemption only for transactions by an issuer. The question of the secondary private placement is thus left up in air; leaving us a few things for the exercise of discretion and for future rules. It must also be remembered that the rule, as with Section 4(2), provides an exemption only from the registration provisions of the Act, not from the antifraud provisions.

In general, Rule 146 provides that transactions by an issuer involving the offer or sale of its securities will be deemed not to involve any public offering within the meaning of Section 4(2) if all of the conditions of the rule are met. These conditions relate to limitations on the manner of offering, the nature of the offerees, access to or furnishing of information about the issuer, limitations on the number of purchasers, and limitations on the subsequent disposition of securities acquired pursuant to the rule.

Stated in very summary fashion, and solely for the purpose of indicating the nature of these conditions, the manner of offering must be such as to avoid general advertising and solicitation and promotional seminars or meetings, unless carefully

controlled as to attendance. Each offeree must be capable of evaluating the merits of the proposed investment or have the services of an offeree representative with such capability, and each offeree, except in business cominbations, must be capable of bearing the economic risk of the investment if he is availing himself of an offeree representative. Each offeree or his representative must have access to, or be furnished with, the same kind of information that registration would disclose. The total number of purchasers must not exceed 35, excluding persons who purchase securities for more than $150,000 in cash, permitting institutional investors, who presumably require less protection, to participate in private placements in greater numbers. And, except in business combinations, customary precautions must be taken against nonexempt, unregistered resales.

Perhaps the most interesting new features in the rule are those of an "offeree representative" - - a device for surrogate sophistication - - and the treatment of business combinations. Formal recognition of the fact that an offeree's ability to fend for himself can be partially met by another person is new, although I believe that for a number of years there has been an informal understanding on the part of much of the securities bar that this was an acceptable procedure under certain circumstances. Two relatively recent court cases, [*] both involving business combinations, suggest that the use of a sophisticated person, or at least one with the requisite access to information, can make an otherwise unqualified person a valid offeree pursuant to the exemption.

The rule explicitly recognizes the function of an offeree representative as someone who can satisfy, by himself, with other offeree representatives or with the

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[*] Klapmeier v. Telecheck International, CCH Fed. Sec. L. Rep., ¶94,066, (C.A. 8, June, 1973) and Bowers v. Columbia General Corp., CCH Fed. Sec. L. Rep., ¶93,540, (D. Del., 1971).

offeree, the knowledge and experience test imposed by the rule. This is coupled, however, with the requirement that, where an offeree representative is used, except in business combinations, the offeree himself must be a person who can bear the economic risk of the investment.

In other words, if the offeree is economically well situation, but does not have knowledge and experience in business and financial matters, that gap can be filled by an offeree representative. However, if the offeree is not in a position to bear the economic risk, then he himself must be knowledgeable and experienced in business and financial matters. In order to satisfy the condition of the rule in this regard, where reliance is placed upon an offeree representative, the offeree must acknowledge in writing that he has such a representative.

By introducing the function of an offeree representative, we have had, of course, to define the concept. As would be expected, the offeree representative must be someone who has the requisite knowledge and experience, either alone or together with other representatives and the offeree. This approach, we believe, makes sense, since the offeree representative's function is to provide the knowledge and experience that the offeree lacks. Even more important, perhaps, is the posture in which the offeree representative finds himself.

It is essential that the offeree representative be someone who can represent the interests of the offeree. In order to avoid serious conflicts of interest, the rule provides that affiliates, officers, directors and employees of the issuer, and holders of 10 percent or more of the equity ownership of the issuer, cannot act as offeree representatives, except

in certain situations where the offeree has a specified family relationship with the offeree representative.

We recognize that there are other relationships that might exist between the offeree representative and the issuer which, although not so serious in terms of potential conflict, nevertheless might involve an actual conflict of interest, depending upon the circumstances. For this reason, the offeree representative is required to disclose to the offeree any material relationships he or his affiliates have, or had, with the issuer or its affiliates, or any relationships which are mutually contemplated. Not only must the offeree representative make this disclosure, but the issuer is also under an obligation to make the same disclosure to the offeree. These provisions would allow an investment banker to put together a deal for an issuer and to offer it to his own clients, offering his services as an offeree representative - - assuming that his dual role was properly disclosed.

The Commission decided that, although the potential for conflicts of interest was there, a number of legitimate business transactions are now done in this manner, and the required disclosures under the ule should alert the offeree to any problems. Naturally, this disclosure must be made before the offeree acknowledges the offeree representative to be acting as his representative. In addition, of course, disclosure of conflicts by the offeree representative does not relieve the representative from his obligation to act in the interest of the offeree.

The main function of the offeree representative is to obtain the information that is required to be available pursuant to the rule and to aid the offeree in understanding and evaluating it, so that an informed investment decision can be made. In some cases, the

offeree representative might be a broker-dealer or an investment adviser, with full authority to act for the offeree or to advise him; in these cases, the knowledge and experience of the offeree representative could be substituted for that of the offeree, who would have to be a person who could bear the economic risk of the investment. In other cases, the offering might be a complicated one involving tax shelter analysis or evaluation of oil and gas properties, and the offeree himself might be a generally sophisticated investor, but might need an offeree representative to provide analysis in one particular area, such as tax matters or petroleum engineering. In such cases, the knowledge and experience of the two together would be looked to, and the offeree representative would not necessarily be expected to be the one who made the investment decision. Here too, however, the offeree would have to be able to bear the economic risk of the investment.

I must admit, at this point, that we ourselves are curious as to how the provisions involving the offeree representative are going to work out in practice. We think that they serve a valuable and realistic purpose and reflect the realities of many legitimate business transactions, while providing the optimum protection for the investor. Among other things, it is intended to legitimize the participation of wealthy individuals in venture capital placement - - something economically desirable - - even though the individual chooses to, or must, rely on professional advice. On the other hand, we recognize that there may be opportunity for abuse, and we will be watching this area carefully.

Another part of the rule that is new to Section 4(2) law is the treatment of business combinations. Until Rule 145, relating to mergers, acquisitions and reclassifications, was adopted about a year ago, the problem of applying Section 4(2) to

business combination transactions was almost nonexistent since, in many instances, the transactions came within old Rule 133, which deemed most business combinations not to involve offers or sales and therefore rendered registration unnecessary. In fact, many of us spent our time trying to make sure that our business combination transactions were outside of Section 4(2), since the spectre of the negotiated transaction doctrine - - now happily forgotten - - was to be avoided.

With the adoption of Rule 145, however, and the concurrent repeal of Rule 133, business combination transactions became subject to registration, since they were deemed to involve an offer and a sale when the transaction was submitted for a stockholder vote. Because registration was required, absent an exemption, interest in the exemption provided by Section 4(2) was revived. It is still not entirely clear how Section 4(2) is interpreted by practioners in the business combination situation, particularly where all of the owners of the acquired company are not enthusiastic about the deal.

Rule 146's treatment of business combinations is the first Commission guidance that has been given in this area. The rule reflects, I think, the few court cases that are relevant, which involved private placement business combinations to small groups of shareholders, one or two of whom were sophisticated and had access and the others of whom relied on the sophisticated ones.

Rule 146 defines business combinations in the same way that Rule 145 does, covering the standard types, but omitting exchanges of securities. It also provides that the issuer, prior to the time the plan is submitted to its shareholders for approval, must have reasonable grounds to believe, and must believe, after reasonable inquiry, that each of the shareholders of the corporation to be acquired either has the requisite knowledge

and experience himself or has an offeree representative who can provide it. An offeree who used an offeree representative, however, would not need to be able to bear the economic risk of the investment, as would such an offeree in the typical private placement situation, since the offeror in these cases, the acquirer company, must make its offer to all shareholders of the company to be acquired and cannot select only the more well-to-do.

Although this provision means that an unsophisticated shareholder who is opposed to a business combination transaction could make the rule unavailable by refusing the help of an offeree representative even though tendered by the offeror at its expense, and although this particular aspect of the rule was widely criticized, we decided that we could not take away the protections of the Act to which such a person would be entitled. On the other hand, we were comforted somewhat by the notion that most shareholders smart enough to refuse to engage or accept an offeree representative in order to kill the deal or extract extra compensation will themselves probably satisfy the knowledge and experience test and will, therefore, whether they like it or not, be qualified offerees and purchasers.

In any event, the structure of the rule, as it applies to business combinations, would allow the acquiring company to discuss the transaction with shareholders of the target company beforehand, regardless of the qualifications of the shareholders. The offerees would not have to be qualified until the agreement was actually submitted for their vote or approval.

Business combinations are also treated somewhat differently in that the written agreement required by the rule from the purchase to the effect that he will not sell the

securities acquired without registration or an exemption therefrom, need not be obtained in the business combination situation. The securities acquired in the business combination would, in fact, however, be restricted in the same way as others acquired pursuant to the rule.

We believe that the business combination section is workable and that it will provide some comfort and guidance for the typical small business acquisition, while maintaining the necessary protection for investors. Only time will tell whether our belief is well founded. If we are wrong, we won't be afraid to say so and change the rule.

One of the collateral objections pressed upon us with respect to a rule on private placements was to supply a basis for justifying, and protecting from Section 12(1) exposure, the myriad small capital raising transactions by innocent persons who don't even know that they need an exemption. Today, such persons may luck out under the intrastate exemption or one of the many interpretations of Section 4(2) or, more often, I suppose, by the statute of limitations. In any event, I must admit that one is not likely to stumble into compliance with Rule 146. We have, however, given consideration to adopting rules that would unconditionally exempt issues up to, say, $100,000. While we withdrew one proposed rule in this regard, we have not yet given up on the idea altogether.

We are hopeful that Rule 146 will prove useful for both responsible businessmen seeking to raise capital and their attorneys. We think the rule is consistent with the substance of past interpretations of Section 4(2), although we realize, and indeed are proud of, the fact that the rule strikes out in some new directions. Again, we are aware that registration under the Securities Act is not the end-all, be-all of the capital raising

process, and that legitimate, valid, and desirable transactions take place every day outside of the ambit of registration. If we have helped to provide guidance for persons seeking to carry out private placements, and some assurance that their legitimate transactions will not subject them to undue liability, we will think our efforts worthwhile.

As I mentioned at the beginning, the Commission's approach to administering the Securities Act has been two-pronged. While we have been attempting to clarify some of the exemptions from registration, through the development of Rule 144, relating to resales of restricted securities, Rule 146, and Rule 147, relating to intrastate offerings, we have also been trying to improve the disclosure that is required of companies whose offerings are not exempt and whose securities are held and traded by members of the investing public.

The Commission has, over the last few years, been carrying out a program of integration of the disclosure requirements of the Securities Act of 1933, which is aired basically at public offerings, with those of the Securities Exchange Act, which is more directly related to trading activities. The objective of this program is to create a system of continuous disclosure, so that any investor, at any given time, has access to the most recent information about most publicly-held corporations. The person making an investment decision does not care whether the securities are coming directly from the corporation, as part of a public offering, or are coming from another stockholder, through the trading markets. In either case, the investor wants, and should have, access to the same type of information.

This integration of the disclosure in'33 Act registration statements and '34 Act reports has been manifested in new "short" registration forms, such as the S-16 and S-14,

which allow registration under the '33 Act through incorporation of '34 Act reports and proxy statements. The most important aspect of the program, however, is that it has resulted in greatly improved disclosure in '34 Act reports. Form 10-K, which once served as a kind of adjunct to the annual report to shareholders, was amended in 1970 to expand greatly the type of information required to be filed, by requiring such things as the five year summary of operations and the line of business disclosure.

Those of you who are sufficiently concerned with the details of these efforts are doubtless familiar with the many releases involved. Rather than recite all of these, I would rather devote my remaining minutes to one of the more recent of our proposals, namely that certain additional information be included in the company's annual report to shareholders.

Ever since the movement toward primary emphasis on continuous disclosure gained momentum - - which means with the Wheat Report, in the Commission's own activities - - the idea of the annual statutory prospectus has been abroad. There are two obvious approaches toward this goal: turn the Form 10-K into an annual prospectus and require its distribution to all securityholders, or turn the company's annual report to shareholders into such a document. We are, in a sense, experimenting in both directions. Since the amendments of 1970, the Form 10-K has moved very close to an annual prospectus, if it not already is there. Because of doubts as to benefits related to cost, we have not yet seen fit to require its broad scale distribution. We hesitate, in part, because the experience to date of a few large corporations that have offered copies of the 10-K on request does not indicate a great demand for the document on the part of individual shareholders.

As an alternative to requiring a general distribution of the full 10-K, we have recently proposed that the annual report to shareholders contain a brief description of the issuer's business, line of business and classes of products and services information substantially similar to that required by Form 10-K, a five year summary of earnings substantially similar to that required by Form 10-K, textual description of certain liquidity and working capital requirements, information about the market performance of the issuer's securities, and identification of the directors and principal executive officers of the corporation. Many annual reports to shareholders already contain much of this information, and there appears to be no reason all should not. We also propose that management state that it will send any shareholder a copy of the Form 10-K on request.

This proposed next step is obviously experimental. While we are not ready to require the mailing of the 10-K to each shareholder, we are even less ready to intrude upon management's own direct communications to shareholders. Saving only the avoidance of misleading material, we think management should continue to be able to present its annual story to its shareholders without official intervention. Hence this intermediate step, which is necessarily ambiguous as to the ultimate resolution.

Fortunately, the Commission is not the only entity interested in experimentation. Some few registrants have simply added a copy of the 10-K as an appendix to the annual report. One or two registrants have combined the documents and filed the annual report to shareholders as the 10-K. With these our staff has been cooperative in developing a form of cross-reference from the annual report to shareholders to the specific requirements of 10-K. This whole area is obviously in an interesting state of evolution.

There is no doubt in my mind that we are moving toward the equivalent of an annual prospectus to all shareholders, but it is not yet clear what the ultimate form will be.

I have recently returned from a short visit to London and Paris, where I visited with persons engaged in what we think of as the securities industry and the raising of capital. Once again, I discovered the refreshing insights one can get of our system from the lips of an informed, foreign observer. To them, our practice of free and open furnishing of important company information to all actual and potential investors is one of the marvels of the times and a source of great strength for our capital markets relative to those of anywhere else.

It is our goal to preserve and increase this element of strength, because it is good for us in itself, but also because it is good for the United States economy in the coming, increased competition for ever more scarce capital in the international capital markets of today and the future. Granted your right to complain about specific aspects that seem unreasonable in general, or to burden your clients disproportionately and unfairly, I think the total program deserves the support of all persons who recognize the importance of maintaining our leadership in this vital area.