



SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

(202) 272-2650



For Immediate Release: Thursday, October 23

80-55

COMMISSION RELEASES MEMORANDUM CONCERNING GAO REPORT ON PRIVATELY PLACED SECURITIES

The Commission today made publicly available its Memorandum concerning a report of the General Accounting Office relating to investor protection concerns arising in connection with the purchase of privately placed securities.

The Commission's memorandum was previously transmitted to the House Committee on Government Operations and the Senate Committee on Governmental Affairs, as required by the Legislative Reorganization Act of 1970, and to other Members of Congress.

October 7, 1980

Memorandum of the Securities and Exchange Commission
Concerning the Report Prepared by the General Accounting
Office on Action Needed to Better Protect Investors from
Fraud in Purchasing Privately-Placed Securities

In a report to Congress, dated May 14, 1980, the General Accounting Office examined the need for action to better protect investors from fraud in the purchase of unregistered, privately-placed securities. The primary recommendation of the report was that the Congress consider amending Section 4(2) of the Securities Act of 1933 (the "Act") -- commonly called the "private offering exemption" -- which exempts from the Act's registration requirements "transactions by an issuer not involving any public offering." The report, however, also contained a recommendation directed to the Commission that it establish a toll-free hotline to receive investor complaints concerning private offerings.

AMENDING THE PRIVATE OFFERING EXEMPTION

The General Accounting Office's report presented Congress with several options to consider in amending the private offering exemption. These options, and the Commission's comments thereupon, are as follows:

Option No. 1: That Congress provide guidance and criteria under which the private placement exemption can be used, such as limiting the exemption to specified institutional investors or to minimum dollar amount purchases.

The Commission would not favor imposing such statutorily-prescribed standards for the applicability of the private offering exemption absent a thorough examination of certain factors, which were not fully addressed in the General Accounting Office's report. By considering these factors, which are described below, Congress would have a more meaningful basis upon which to weigh the appropriateness of so modifying the exemption.

1. The Need for Flexible Standards.

It has been the Commission's experience that inflexible statutorily-prescribed standards -- as stated, for example, as specific minimum dollar amounts -- frequently tend to become less appropriate with the passage of time. In part, this is a consequence of the dynamic character of the securities industry. Changes in the markets and novel financial products often do not fit neatly into categories which were established before such developments reasonably could be envisioned. Moreover, standards defined according to dollar size tend to become undermined by the effects of inflation.

If Congress determines to mandate such inflexible standards, we anticipate that periodically Congress would be required to reconsider whether then-current standards remain appropriate in the context of continuing financial developments and inflation

rates. This Option, therefore, would likely require an on-going commitment of time and resources by both Congress and the Commission.

2. The Capital Formation Process.

Securities which are sold in reliance on the private offering exemption play an important role in the capital formation process. ^{1/} The Commission's staff estimates that billions of dollars of capital are raised annually in sales of unregistered securities in reliance upon the private offering exemption. However, this capital-raising process might no longer be available in many situations if the scope of the exemption is substantially narrowed -- for example, solely to purchases by institutional investors or to minimum dollar transactions.

We believe, therefore, that any modification of the private offering exemption should be carefully fashioned to avoid any

^{1/} Although the greatest use of the private offering exemption, in terms of the amount of capital raised, is in offerings to institutional investors, the exemption plays an important role in offerings by enterprises which are unable to attract institutional interest. The Commission has responded to the needs of such enterprises to raise capital efficiently by, among other things, adopting Rule 242 and raising the amount of capital that can be obtained pursuant to Regulation A. Moreover, Congress has recently sent to the President a bill to amend the Act to exempt from registration sales to a maximum of \$5,000,000 to an unlimited number of "accredited" investors. The private offering exemption, however, may remain the most viable financing alternative to many issuers.

unintended, adverse impact on this process of raising capital at a time when many believe that this nation is already falling short of meeting its capital requirements. The Commission urges that any changes in the private offering exemption be enacted only in the context of a thorough evaluation of this capital formation mechanism.

3. Current Commission Initiatives.

In this connection, the Commission has recently undertaken a project, funded by the Small Business Administration, to provide empirical information regarding transactions effected in reliance upon certain exemptions from the Act's registration requirements, including private offering transactions. 2/

While this project will not directly respond to the concerns expressed by the General Accounting Office, its data base and analyses may assist Congress in identifying information upon which it may more fully consider the effects of any proposed changes in the private offering exemption on the

2/ The principal elements of the projected data base for this study will be: offering volume; issuer characteristics; costs of making the offering; underwriting commitments; use of proceeds; and whether an aftermarket in the offered securities is maintained.

capital formation process. We anticipate its completion by December, 1981. 3/

The Commission expects that such information will also prove valuable to its own reconsideration of this area. As the General Accounting Office's report noted, in order to provide increased certainty regarding the applicability of the private offering exemption, in 1974 the Commission adopted Rule 146 as a "safe harbor" applicable to those private offering transactions which satisfy certain conditions. Rule 146, while not an exclusive rule, does provide standards which, if satisfied, would constitute compliance with the private offering exemption. The Commission's Office of Small Business Policy of the Division of Corporation Finance is reviewing private offering transactions and, in particular, salient aspects of Rule 146. If, as a result of this review, the Commission determines that a modification of the private offering exemption is appropriate, the Commission will take whatever action is warranted, including, if necessary, requesting Congress to modify the private offering exemption or to otherwise enhance the Commission's administrative authority in this area.

3/ Moreover, Congress has sent to the President a bill which directs the Commission to conduct an annual Government-business forum to review the current status of problems and programs relating to small business capital formation. This forum may also provide a basis for considering the effects of the private offering exemption on capital formation.

4. The Federal Interest.

Offerings by smaller and less well-known businesses often tend to be made to persons with a preexisting relationship to the business or its management. These persons will frequently be in a position to obtain access to the same kind of information that registration would disclose. If such access is available and they are able to fend for themselves in evaluating the merits and risks of the investment, there is no practical need for registration. Yet, absent the availability of the exemption, registration would be required in such cases even though there is not a sufficient federal interest to warrant the application of the full panoply of the Act's requirements. Indeed, one would expect that the application of the Act's registration requirements to many such transactions would result in widespread, inadvertent violations of the federal securities laws.

Option No. 2: That Congress provide the Commission with authority to establish rules conditioning use of the exemption.

The Commission believes that Congress could appropriately grant the Commission authority to promulgate rules which would govern reliance on the private offering exemption. Such administrative authority would provide a flexibility not existent in statutorily specified standards, while allowing a presently

unavailable degree of specificity regarding the scope of the exemption. However, the Commission would anticipate that, in considering the scope of rules to be adopted under such authority, it would act only in the context of a thorough examination of the relevant factors which are described in our comment on Option No. 1.

Option No. 3: That Congress require that issuers, unless specifically exempted by the Commission, notify the Commission when they intend to sell securities in reliance on the exemption, and provide the Commission with immediate access to promotional literature and other information relevant to the sale of such securities.

The Commission believes that its current staff limitations would preclude its considering, in depth, more than a small percentage of private offerings, and, therefore, we would not anticipate requesting that such materials be filed regarding all private offerings. Nonetheless, such authority would have certain benefits in providing the Commission with a greater ability to gather regulatory information necessary to monitor the type and frequency of private offerings. Additionally, in certain instances -- for example, when past violators of the federal securities laws are listed as associated with the offering -- the authority to require such filings could assist our enforcement program. Finally, access to promotional literature would

provide a ready means to monitor, on a selected basis, the selling practices involved in private offerings.

The Commission, however, believes that an analysis of Option No. 3 would best be considered in the context of an examination of Options Nos. 1 and 2, rather than as an independent course of action. That is, Congress should consider such notification and access requirements as a likely requirement of any possible legislatively or administratively established standards governing the applicability of the private offering exemption.

THE TOLL-FREE HOTLINE

The General Accounting Office's sole recommendation to the Commission was that it establish and publicize a toll-free telephone service to permit early contact with investors and help strengthen oversight and enforcement capabilities. The Commission is sensitive to the need to be readily accessible to public investors. The Commission presently has significant resources dedicated to receiving and reviewing investor concerns -- particularly in its Office of Consumer Affairs and the Regional and Branch Offices located in many principal cities throughout the United States.

Based on our examination of hotline programs, we believe that adequately implementing this recommendation would require a

substantial outlay of further resources, particularly staff time. Because our current budget does not provide for such a program and our present resource level does not adequately satisfy our existing operational requirements, the Commission does not believe that it presently has the ability to implement the program. We will, however, review the efficacy of a hotline in the context of preparing future budgetary submissions.