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THE EVOLVING CAPITAL MARKET SYSTEM:
A REGULATOR'S PERSPECTIVE

Aulana L. Peters
Commissioner

The views expressed herein are those of Commissioner Peters and do not necessarily represent those of the Commission, other Commissioners, or the staff.

I am delighted to have this opportunity to address the Second Annual Conference of the National Association of Securities Professionals and thank Maynard Jackson for his kind invitation. 1/

Your theme, "Riding the Bull: Access to Capital in Volatile Markets" is a timely one. Of course, as a regulator, I prefer to think of bull markets as sound, healthy markets, not as volatile. Nevertheless, I do recognize that our capital markets are evolving at a phenomenal rate. The number of developments and the rapidity with which they occur have an enormous impact on all those associated with the industry, be they public companies, securities professionals or regulators. Through it all, one of the principal concerns for you and your clients is how to raise capital quickly, efficiently and cheaply. In the recent past, the Securities and Exchange Commission has taken several initiatives to facilitate the raising of capital by corporate issuers, both small and large. These initiatives have had dramatic and far-reaching effects. Therefore, I think they are worth reviewing with you.

Two of those initiatives, Form S-18 and Regulation D, have had a significant impact on the ability of small enterprises to raise capital from the public. The Commission adopted the Form S-18 Registration Statement in 1979. Form S-18 may be used for cash offerings by certain domestic and Canadian corporate issuers that are not already reporting companies under the Securities and Exchange Act of 1934. Initially, Form S-18 was limited to use in

1/ I wish to acknowledge and express my appreciation for the assistance of my legal counsel, Ms. Jacqueline Higgs, in preparing these remarks.

offerings of \$5 million or less. In 1984, the Commission amended the form to raise the ceiling to \$7.5 million. The purpose of Form S-18 was to provide small issuers easier and faster access to capital markets through a simplified registration form. Registrants using the form need only two years of audited financial statements rather than the three years required by other forms. In addition, Form S-18 may be filed with the SEC regional offices where the staff specializes in handling this type of filing. Since the regional offices are not involved with other "S" forms, they can devote more time and attention to the processing of Forms S-18 which results in faster turnaround.

According to a recent study by James G. Manegold, Form S-18 has been adopted by the majority of firms eligible for its use. Since 1979, approximately 80-85 percent of the registrations have been for offerings of less than \$5 million and "[t]he share of these small offerings going to Form S-18 relative to Form S-1 has been constantly increasing." 2/

[I]t is clear that the growth in the number of effective registrations coincides with the availability of Form S-18. The implication is that the Commission's sensitivity to the needs of smaller concerns that are interested in going public, as witnessed by the adoption of Form S-18 and the continued broadening of its eligibility requirements may have encouraged more public offerings. 3/

2/ See J. Manegold, "An Empirical Analysis of the New Issues Securities Markets: The Effects of the Form S-18 Registration Statement" 13-14 (November 1985) (unpublished study).

3/ Id. at 36.

Thus, Professor Manegold suggests that some companies were encouraged to go to the capital markets that may not have done so without the adoption of Form S-18.

In 1982, the Commission took another step towards facilitating access to capital when it adopted Regulation D which consists of six rules designed to simplify and coordinate exemptions from the registration provisions of the Securities Act of 1933 for limited offerings.

The Securities Act of 1933 has always contained exemptions for private placements 4/ and for "small" offerings below a certain dollar amount. 5/ The reason for these exemptions, of course, is that such transactions usually involved sophisticated investors such as institutions and others who were viewed as not needing the protections of the mandatory disclosure provisions of the Act. 6/ Moreover, it was thought unnecessary to burden "small" offerings to limited numbers of people with the requirements of the Act where the benefits to the public are presumed to be remote. 7/ Although these exemptions have always existed, the adoption of Regulation D 8/ changed the equation with respect to them in three ways.

4/ Securities Act of 1933, Pub. L. No. 73-22, § 4(1), 48 Stat. 74, 77 (1933) (codified as amended at 15 U.S.C. 77d(2)).

5/ Id., § 3(b), 48 Stat. 74, 76-77 (1933) (codified as amended at 15 U.S.C. 77c(b)).

6/ See SEC v. Ralston Purina Co., 346 U.S. 119, 124-26 (1953).

7/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 7 (1933).

8/ Securities Act Release No. 6389 (Mar. 8, 1982).

First, through Regulation D, the Commission raised 9/ the small offering exemption from \$2 million to \$5 million. At the same time, the Commission raised the ceiling for offerings in which no specific disclosures must be given to purchasers from \$100,000 to \$500,000. Thus, Regulation D raised the old ceilings by 250 percent and 500 percent, respectively.

Second, Regulation D is designed to reduce uncertainty in the process of making a private placement. This is because it ties the private placement exemption to the sophistication of actual purchasers, rather than the sophistication of both offerees and purchasers. In addition, under Regulation D an issuer need not determine the ability of purchasers to bear the risk of their investment.

Finally, Regulation D makes the small offering exemption available to limited partnerships whereas its predecessor rule had been available only to corporations. These changes, taken together, made possible a major transformation in the way in which unregistered offerings of securities are organized and marketed. In fact, Regulation D may be the single most important regulatory factor, or should I say deregulatory factor, contributing to increased access to capital markets during the last decade. 10/

9/ Small Business Investment Incentive Act of 1980, Pub. L. No. 96-477, § 301, 94 Stat. 2275, 2291 (1980) (codified at 15 U.S.C. 77c(b)).

10/ The Commission recently adopted Rule 3(a)(12)(9) which eventually may rival Regulation D as a money raising device. Although securities issues pursuant to Rule 3(a)(12)(9) must be registered, they may be sold on an installment basis.

When Regulation D was first adopted in March 1982, probably few would have predicted the tremendous volume of offerings that would be made pursuant to the rule. The amount of unregistered securities issued on an annual basis pursuant to Regulation D is rising rapidly and may overtake that registered under the provisions of the 1933 Act. In fiscal 1985, an estimated \$50 billion in securities were issued pursuant to Regulation D. This compares with \$275 billion in new issues registered with the Commission in that same year. 11/

The Commission has not limited its attention to the problems and concerns of the small and growing company. Large corporate issuers have also benefitted from Commission initiatives to facilitate the businessman's access to capital. For example, in 1984, the Commission adopted Rule 415 which permits an issuer to market debt and equity securities on a delayed or continuous basis at any time within two years of their initial registration. This rule gives the issuer far more effective control over the timing of its offering, and therefore, over its success. Needless to say, this is quite a positive step from the issuer's point of view. Reportedly, Rule 415 has resulted in a tremendous savings in time and costs for them.

11/ U.S. Securities and Exchange Commission Fifty-First Annual Report 126 (1985).

The horizons for both corporate and public financing have been expanded not only by the rule-making efforts of the SEC, but also by market forces which have opened up financing opportunities beyond our national boundaries. Some small to medium-sized American companies are electing to go public in England and Canada these days. In a recent New York Times article, a London based securities professional was quoted as saying that the Unlisted Securities Market ("USM") in London would like to see more small, growing American companies going public there. 12/ The USM is the junior market on the London Stock Exchange and provides smaller companies with a source of equity capital and publicly traded shares without being listed on the main board of the exchange.

Recently, a well-known American chain of retailers of chocolate chip cookies, Mrs. Fields Inc., introduced its first publicly offered shares on the USM in London. You may find it interesting that of the fifteen foreign companies traded on the USM, ten are American. A recent article in the Economist attributes this trend to lower costs and less paperwork associated with quotation on the USM. 13/ However, in view of the small numbers, it might be an overstatement to call this phenomenon,

12/ Lohr, "A Lure to Go Public in Britain: U.S. Concerns Find Benefits", N.Y. Times, May 15, 1986, at D 1, Col. 1. (Statement by David Cohen, the executive in charge of Unlisted Securities Market activities at Chase Manhattan Securities, a London brokerage subsidiary of the New York bank).

13/ The Economist, "London's United States Market", May 10-16, 1986 at 85.

"a trend". Nonetheless, the fact that Mrs. Fields chose to go public in London reflects, among other things, the continuing globalization of the securities markets and the increased advantages and opportunities the globalization process brings to growing American companies.

It is not only young, fast growing companies that are looking abroad for capital, many of this country's major corporations and municipalities have discovered and are taking advantage of the capital-raising opportunities afforded by the Eurobond market. The statistics are staggering. According to Securities Data Company of New York:

[D]uring the first six months of 1985 a total of US\$44.7 billion was raised in the U.S. domestic market through bond issues by U.S. and foreign borrowers. In U.S. dollars alone, the Eurobond market raised US\$52 billion over the same period; in all currencies, the market broke through the \$100 billion barrier by mid-October. The creativity of the Eurobond primary markets and the development of swaps have meant that investment banks, with their worldwide networks, can offer tailor-made financing vehicles designed to suit issuers' needs. 14/

Douglas Ebert, Executive Vice President of the Manufacturers Hanover Trust Co., told an international financial conference in New York recently that Manufacturers Hanover last year executed more than \$15 billion in swaps including several new hybrids of that financial instrument. 15/ As an illustration, of how these "tailor-made financing vehicles" can work he described the first

14/ EuroMoney, "The Eurobond Market -- Cradle of Creativity" January 1986 at 5.

15/ Matthews, "Global Networks Will Give Major Banks an Edge Over Investment Houses, Bankers Tell Conference", June 2, 1986 at 2.

collateralized mortgage obligations to be denominated in Swiss francs. The ingenuity, complexity and most importantly, the utility of this transaction is summarized in the following quote from Mr. Ebert's remarks.

What started in Southern California with a pool of residential mortgages, ultimately lead to a currency swap in Tokyo, with several interest-rate swaps in between. The financial institution in California issuing the paper ended up with the low-cost, fixed-rate dollar obligation it was after. Meanwhile, investors in Geneva and Zurich got a ten year Swiss-frank bond. An industrial company in Japan was given the opportunity to cash in a stream of Swiss francs for a floating dollar obligation. And everybody was happy -- including Manufacturers Hanover, which lead the bond issue and stood in the middle of all this. 16/

In addition to interest rate swaps and collateralized mortgage obligations, other new and exotic financing instruments include repurchase agreements, nonrecourse debts, put and call options, unusual preferred stock 17/, and financial guarantees.

Of course, as a regulator, the SEC is very much interested in and concerned with the trends I have just outlined for you. In my opinion, we should not permit, and indeed have not permitted, our desire to facilitate access to capital to overshadow our obligation to ensure that the investing public is protected by full and adequate disclosure. The balance is one that is tricky to maintain, but maintain it we must.

16/ Id. at 9.

17/ "Unusual" preferred stock may include such instruments as mandatorily redeemable preferred stock and money market preferred stock. This stock is similar to commercial paper and raises the question of whether it should be treated as debt or equity.

Disclosure is viewed as the lynchpin of the federal securities laws. Changes in our rules that tend to reduce disclosure quite naturally raise concerns about investor protection. For example, the increased number of unregistered securities being offered to the public raises questions about adequate disclosure as well as misuse of the exemption from the registration provisions of the 1933 Act.

I am somewhat disturbed by the sheer volume of Regulation D offerings. When one considers the billions of dollars of securities issued pursuant to Regulation D, together with another \$45 billion issued in 1985 that were exempt from 1933 Act registration because they were sold to foreign investors, 18/ it is clear that the volume of unregistered offerings has come to represent a significant portion of the total amount of securities offerings. Of course, in the absence of registration, there is no accurate record upon which to base an assessment of just how many unregistered securities are issued each year. It is difficult to have a head count if you cannot take a census. Nevertheless, the Commission's mandate is to oversee the capital raising activities of U.S. enterprises. One might question just how effectively this can be done when approximately 25 to 30% of all new securities issued is not registered with the Commission.

18/ Statement of John Shad, Chairman, U.S. Securities and Exchange Commission, Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the House Committee on Energy and Commerce (March 5, 1986).

Quite naturally, the increasing number of unregistered securities may cause us to reevaluate the role to be played by our system of statutorily mandated disclosures where that system applies to less than two-thirds of all new issues. 19/ This is an issue that must be addressed, particularly in view of the growing internationalization of our capital markets which may require us to be even more flexible about disclosure requirements. We should recognize that a vast quantity of securities is already being marketed outside the parameters of the Securities Act of 1933. This fact may serve as the basis for a persuasive argument that foreign issuers subject to less disclosure requirements in their respective countries should not be required to comply with more when raising capital in this country.

In dealing with these issues, we, as regulators, must continue to balance the benefits to be gained from facilitating access to capital with the costs to be paid in terms of investor protection. I briefly mentioned abuses before, but do not intend to discuss the issue of length but will just point out that Regulation D is being used in circumstances for which it was not intended. In this regard, I view private counsel as having several specific responsibilities in connection with the exemption process. For example, lawyers have a "due diligence"

19/ If we took into account government securities, the percentage would be even less.

obligation in connection with the preparation of legal opinions on the availability of exemptions from registration. In a 1962 release, the Commission stated:

[I]t is the practice of responsible counsel not to furnish an opinion concerning the availability of an exemption from registration under the Securities Act for contemplated distribution unless such counsel have themselves carefully examined all of the relevant circumstances and satisfied themselves to the extent possible, that the contemplated transaction is, in fact, not a part of an unlawful distribution. 20/

Beyond the specific duties which may arise in the context of issuing legal opinions as to the legitimacy of any claimed exemption from the 1933 Act, I believe that attorneys when they assist in the preparation of offering materials for use in exempted offerings must investigate and test the accuracy and adequacy of offering materials. In the case of a Regulation D offering, these materials are not reviewed by the Commission's staff. Therefore, sufficient assurance that the materials are adequate can exist only if counsel for the issuer exercises independent judgement about the nature and extent of disclosures made.

Let me assure you that I am not saying that the Commission should view lawyers as the guarantors of the accuracy of their clients' representations or the soundness of the investment opportunities they offer. Nevertheless, I urge you to monitor closely your clients' disclosures and the basis upon which exemptions from the registration provisions of the 1933 Act are claimed.

20/ Securities Act Release No. 4445 (February 2, 1962).

In contrast to Regulation D, use of Form S-18 results in the issuance of registered securities, albeit through a simplified process. The Commission's experience with this form suggests that there are no more problems associated with it than with other registration forms. The Manegold Study, which includes a risk analysis, indicates that there is no detectable risk differential pattern for common stocks of IPO's registered under Form S-18 than there are for those registered under Form S-1. The Study also suggests that Form S-18 is not generating any significant new problems of fraud and misuse. 21/ However, because the form is so easy to use, we have encountered over-enthusiastic aficionados who file 30 at a time.

Investor protection concerns also have been raised in connection with the operation of Rule 415. The principal concern voiced is whether the speed with which an issuer is now able to go to market prevents underwriters from adequately performing their due diligence obligations under Section 5 of the 1933 Act. Thus far, I have not seen any untoward effects of Rule 415 which would lend credence to such concerns. To my knowledge, the Commission has not studied the timing patterns under the rule and its practical effect on underwriters. However, those studies the Commission has conducted show no increase in lawsuits against underwriters alleging violations of Section 11 or Section 12 of the 1933 Act. To the extent a qualifying issuer keeps its filings

21/ Supra note 2, at 37-38.

current and makes adequate disclosure, it should not be prevented from taking advantage of "windows" in the market. It is worth noting that issuers permitted to use Rule 415 for generalized offerings are S-3 companies about which much information is already available in the marketplace. Thus, performing a due diligence investigation of such companies should be relatively manageable. The Commission's staff will continue to monitor the use of Rule 415 carefully to ensure that it does not undercut the objectives of the registration process.

The trend of domestic companies going public in foreign markets and the emergence of Eurobonds and other exotic international financing instruments demonstrate how changing attitudes and our ability to process and communicate information practically instantaneously have greatly facilitated doing business on an international scale. The most obvious concerns raised by this phenomenon focus on competition; more precisely on our nation's ability to remain competitive as capital markets become increasingly international. Nevertheless, the internationalization process raises at least one investor protection issue worthy of mention here.

Some at the Commission have expressed concern about the impact of creative international financing transactions of our financial reporting rules. There is no doubt that business will look for financing wherever it is available and will take it wherever it is most economic. The SEC does not regulate that process. However, the Commission has a legitimate concern about the economic impact of these new financing arrangements on the

financial condition of reporting companies and adequate disclosure of that impact. The Commission recently highlighted several issues in this area for review by the Financial Accounting Standards Board ("FASB"). Among them were off balance sheet financing issues, the proper accounting for risk transfer instruments, income recognition and measurement issues. Last month the FASB announced a long term project to study these issues. 22/

In the two years I have been at the Commission, I have come to realize that a call for freer access to capital usually translates into a request for modification or even elimination of some rule or regulation. Indeed, where appropriate, we may want to revisit some of our rules to ensure that we do not stifle our domestic markets or lose out in the internationalization process. However, in doing so, we must not forget that our rules have contributed in no small measure to the deepest, fairest, most liquid markets in the world. Therefore, we should not rush to discard them.

On the other hand, we must not have an isolationist attitude as we approach the global markets of tomorrow. In the past forty years, the world has advanced tremendously in technology and attitudes and we must stay abreast of those developments as they continue to affect and shape the structure of our capital markets and be prepared to take advantage of the opportunities they bring.

22/ Financial Accounting Standards Board, News Release (May 15, 1986).