

DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

Sixth Session -- March 14, 1957

Subject: Techniques for the Processing
of Registration Statements

Speaker: Mr. Ralph Hocker, Branch Chief
Division of Corporation Finance

MR: HOCKER: The material I shall cover this morning is essentially a description of the filing of a registration statement with the Commission, the mechanical handling it receives during the processing period, and a brief consideration of the purpose of the processing.

As you have been told, Section 6 of the Securities Act specifies that securities may be registered by filing a registration statement with the Commission. It specifies the manner in which the registration statement must be signed, and states that the filing shall not be term complete unless the required filing fee has been paid, and that the registration statement shall be available for public inspection under such regulations as the Commission may prescribe.

The rules provide that the filing fee may be paid by U.S. postal money order, cashier's check, or cash.

In practice the registration statement is received by mail or by hand delivery. A registration statement offered by and delivery at our Office of Company Filings will not be accepted unless it is accompanied by the appropriate fee. A statement received by mail will be held unfiled while the person who filed it is informed of the fee required and given an opportunity to pay it.

Now at this stage let's consider briefly the forms which may be used for registration. For guidance and convenience I wish to point out that the complete list appears as the index to the booklet of rules under the Securities Act of 1933. S-1 is the general form for commercial and industrial companies. It is the form most frequently used. S-2 is for shares of certain corporations in the development stage. S-3 is for mining companies in the promotional stage. S-4, S-5, and S-6 are for various types of investment companies. S-8 is for certain employees stock purchase, savings and similar plans. S-9 is for nonconvertible fixed interest-bearing debt securities of companies already filing reports with the Commission under the Securities Exchange Act of 1934. The form may be used only if certain conditions regarding coverage of fixed charges are met. Generally this form is for high-grade securities. The prospectus required by the form is briefer than the prospectus required by Form S-1. A recent prospectus of a local

utility company on Form S-9 covered 17-1/2 pages, and a prospectus filed by the same company on the same day for an equity issued covered almost 22 pages.

MR. BLACKSTONE: An issuer may often put more information in its Form S-9 prospectus than is actually required by the form.

MR. HOCKER: It's interesting, too, because the description of a debt security is usually more lengthy than a description of an equity security, but in this particular example the amount of space devoted to the description of the securities was substantially the same in each prospectus. The S-9's form a definite pattern, and we constantly encourage the registrants to be brief. We exercise great restraint in making comments on them.

S-10 and S-11, petroleum interests and mining companies, are used infrequently. In the ten years that I have been particularly concerned with these matters I can only recall having seen S-10 used once.

S-12 is for certain American Depositary Receipts, and F-1 is for voting trust certificates. The form is simple, but there are usually quite a few problems connected with it. Fortunately we have few filings on Form F-1. There are also forms for certificates of interest in depositary receipts and they are very infrequently used. The Commission has not adopted any form for the securities of a foreign government or a subdivision thereof. However, filings by these issuers are reasonably infrequent.

Schedule B of the Securities Act of 1933 is followed as the guide for the preparation of the registration statement, and Rules 490, 491, and 493 under the Act provide some guidance in the preparation of the prospectus.

A registration statement may be filed only at the principal office of the Commission. It may not be filed at a regional office. This provision is found in Rule 455. At times we have had people attempt to meet deadlines by attempting to file on a Saturday, Sunday or holiday. However we can not accept such filings because a registration statement may be filed only on a business day when the Commission is open for business.

Rule 402 provides that three copies of the complete registration statement, including exhibits and all other papers and documents filed as a part of the statement, shall be filed with the Commission. An additional five copies of the registration statement, but not including exhibits excepting those evidencing the plan of distribution, are required for staff use. An additional five copies of the prospectus are required by Rule 424. You will recall that each registration statement contains a prospectus, and therefore the total number of prospectuses required to be furnished is 13. Rule 402 provides that at least one copy of the registration statement shall be manually signed. It also provides the conditions under which a registration statement may be signed pursuant to powers of attorney. We have very few powers of attorney used.

In addition to the powers of attorney, there is an informal arrangement which registrants use at their peril. It is an arrangement by which a number of signed signature sheets are

furnished to the principal officer or counsel to the company, thereby enabling him to file amendments as may be required. We do not encourage that practice.

The sizes of paper and type to be used are specified in Rules 403 and 404. I mention these things because you may need to answer inquiries from people planning to file registration statements, and while it is true that these matters are set forth in the rules, they are presented seriatim – not organized too well by subject matter – and some acquaintance with the rules is necessary to find specific answers.

One thing more about the initial filing: under Rule 404 the legend, required by Rule 433, which states among other things, that this is a preliminary form of prospectus and subject to change, is to be included on the cover page of the prospectus as filed.

There are provisions for incorporation of documents by reference to relieve companies of the mechanical burden of duplicating material previously furnished. You will find that in Rules 411 and 412.

Upon the filing of a registration statement with the Office of Company Filings, that office makes a cursory check for adequacy of signatures and computation of the filing fee. When the registration statement is filed, it is screened to prevent inadvertent disclosure of information contrary to national security policies. This processing will almost always be completed before the registration statement is released to the examining section. Should it not be completed, appropriate arrangements will be made with the section chief.

A registration statement for a company which has previously filed with us is assigned to the examining section which has processed previous filings of that company. For a new company there may have been pre-filing conferences about the registration statement participated in by the personnel of a particular examining section and the registration statement when filed will be assigned to that section. If neither of the above rules applies, the registration statement will be assigned to sections by rotation.

I have mentioned the 13 copies of the prospectus which are required to be filed. The prospectus is the document which receives most of our time and attention. Because of the large number of individuals concerned with it, we have asked that 13 copies of the prospectus be furnished. In a particular case where a lesser number is received and the work of the Division is being hampered, the examiner should discuss with the section chief whether steps should be taken to secure additional copies.

Now for the distribution of copies filed with the Commission. The original and one copy of the registration statement is sent to Dockets for the permanent files of the Commission. After the appropriate records have been made and binders prepared, these copies are available for use during the examination process. A third copy of the complete registration statement is called the X-C copy and is sent immediately to the examining section. Of the five copies filed without complete sets of exhibits, one is sent to the Division of Trading and Exchanges for review for compliance with requirements of the Securities Exchange Act of 1934, including arrangements for stabilization. Comments of that Division will be transmitted to the examining section by

memorandum. Another copy of the registration statement without exhibits goes to the Secretary of the Commission where it is available to the members of the press. Within a very few days this copy is returned to the examining section. Another copy of the registration statement is retained by the Division in the Office of Company Filings for a few days to permit them to extract from it the information for their records. And two extra copies of the registration statement are sent to the section immediately. Of the five extra copies of the prospectus, four are sent to the examining section and one is sent to the Office of the Assistant Director for use by the Assistant Director or the Branch Chief.

Frequently when a registration statement is filed, a representative of the company or its counsel delivers the statement by hand. At that time he may stop at the Office of the Assistant Director for a brief chat, to leave extra copies of the registration statement, and he may stop at the office of the section chief for the same purpose. They may discuss problems in connection with the issue which the registrant knows exist and they may discuss the proposed time schedule for the issue.

Upon receipt of the registration statement the section chief generally will scan the statement to form an impression of its complexity and problems. The section chief will assign the registration statement to an analyst (also called and "examiner") in the section. The section chief has, over the years, accumulated a considerable fund of knowledge about the companies assigned to his section. If the new filing is by one of those companies, he knows whether the company has been filing annual reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 or whether the company has previously filed one or more registration statements with the Commission. The section chief is generally familiar with the company's business since he keeps abreast of its operations by following news stories as well as filed reports. You will find that the section chief's experience will enable him upon cursory examination to tell you a great deal about the registration statement, and ordinarily he will indicate the principal factors and problems that he thinks the examiner should consider in his review and analysis of the registration statement.

Were I examining a registration statement as an examiner, I would sit down and read the prospectus first. The purpose of that reading is merely to gain an impression of what the company does, what securities it proposes to offer, and what the method of offering is. Then I would proceed to collect from the Docket Section the previous registration statements filed by the company within the past five years, if there are such filings. Filings older than five years are generally of little use in examining ordinary registration statements. I would also look at the annual reports of the company for the past two years or three years, if such reports are available, and also at proxy statements on file, if any. In addition, I would get the general correspondence file for the company -- the 132-3-1 file.

An attorney and an accountant in the section must examine the registration statement and, in so doing, will also have certain interests in any previous filings of the company. The accountant is interested in such previous filings because there must be consistency in financial statement preparation from one filing to another. The attorney may have various interests in previous filings. Perhaps the present filing concerns a debt security to be issued pursuant to a supplemental indenture where the basic indenture was qualified under a previous filing. In

addition, Item 26 of Form S-1 calls for a list of all unregistered securities sold by the company within the past three years. Companies which are already filing reports with the Commission will probably have reported all such transactions previously and it is the job of the examiner to check the list in Item 26 against such stock transactions. The examiner should also check the correspondence files to see if any claimed exemption to registration has previously been considered by the Division. If exhibits are incorporated by reference, it is necessary to get the file referred to in order to check the accuracy of such reference.

When a company files for the first time with the Commission, additional procedures are necessary in searching the files of the Commission for information with respect to the company. A search-sheet should be circulated to Docket Index, Enforcement Index, Broker-Dealer Index, General Files, and the Regulation A Promoters Index, listing the name of the registrant, each predecessor, each officer, each director, promoter and underwriter, any associate or affiliate thereof who is named in the filing. Search-sheets should be sent out promptly and the purpose is to obtain information as to whether the persons connected with the registration have appeared in other filings, whether they have been involved in investigation, whether there are broker-dealer suspension orders against them, whether there are Regulation A suspension orders against them, and matters of similar nature. All of such information could be pertinent as a matter of disclosure in the prospectus.

Where the securities to be registered are to be sold by officers and directors or employees of the company, there is ordinarily a question as to whether such persons should be registered as broker-dealers. This question should be promptly referred to Mrs. Murphy or Mr. Block in the Division of Trading and Exchanges and their comments should be obtained before sending out a letter of comment to the issuer.

If the registration statement concerns mining operations, a copy of the prospectus should be immediately furnished to Mr. Adelstein along with any technical reports and engineers' reports or maps which pertain to the area in which he would be interested. Where petroleum operations are involved, Mr. White must receive a copy.

The following categories of companies should be referred to Mr. Costello: utility companies including electric generation and distribution, gas distribution, and pipelines, air and highway transportation; also industrial companies where the judgment and skill of an engineer appears necessary regarding questions of description of property, patents, evaluations or appraisal, product technology or technology of operation. In considering the registration statement of newly organized companies close questions whether the engineer's advice should be obtained should be resolved in favor of obtaining the advice. Mr. Costello has long experience and is particularly apt at making pointed comments which are very helpful to the examiner.

On the other hand, the registration statements of seasoned companies, investment companies, and financial and banking companies need not be referred to the engineer. Normally registration statements of companies subject to regulation by the F.C.C., C.A.B., or the I.C.C. will be transmitted to the appropriate regulatory agency by the section. Where there are unusual problems in the statements of electric and gas utilities, they will be forwarded to F.P.C. by Mr. Costello. Mr. Costello may also request comments or information from other agencies, such as

the A.E.C., Department of Agriculture, Department of Commerce and the National Bureau of Standards.

It is highly desirable and important -- almost imperative -- that the examiner at an early date see that the other persons in the Commission, including other divisions, if they are involved, receive copies of the prospectus and other documents and previous filings promptly after the filing of the registration statement. All of these people have heavy schedules, and if you want to get your place in line, the thing to do is to get there at an early date.

About this time the examiner is really in a position to consider reading the registration statement with care. My first step as an examiner would be to dispose of certain mechanical checking. We previously mentioned that the filing fee and signatures were scrutinized by the Office of Company Filings. However, the responsibility for the adequacy of the signatures and the proper computation of the filing fee rests with the section, and particularly with the examiner. At this stage it is also advisable to check the list of exhibits in the registration statement with the exhibits actually furnished to determine that all those are present and also to note those which are to be furnished later.

If the company has filings under other statutes covering the same fiscal year, the remuneration information in the registration statement should be compared with the previous filings. I have already mentioned that where there are previous filings a check should be made to the response to Item 26 in the registration statement concerning unregistered sale of securities in the previous three years.

MR. BLACKSTONE: What happens if the section attorney decides that there is not a sufficient basis for exemption from registration for the sales reported under Item 26?

MR. HOCKER: There are probably two things which might occur: One, an inquiry for further information with respect to the claim of the exemption might be included in our first letter of comment, or, if it is quite clear that there is no exemption available, we would probably require that the body of the prospectus and the financial statements call attention to the sale of securities in violation of the statute and call attention to the possible contingent liabilities of the company resulting from such sales.

MR. BLACKSTONE: In other words, it results in a disclosure problem because a sale in violation of Section 5 creates a contingent liability to refund the purchase price and that liability is something the prospective purchaser of securities should know.

MR. HOCKER: That is correct.

The next thing to do is to read the annual reports on Form 10-K, annual reports to stockholders, and the proxy statements for the past two years. The purpose of this reading is to note important changes in management, remuneration arrangements, and statements regarding the course of the company's affairs. Annual reports to stockholders in recent years have been tremendously improved and in most instances I find them very informative. Naturally I think

each company is pleased to boast of its achievements and to inform the stockholders of new developments in the business.

MR. BLACKSTONE: This implies that you are dealing with a company that is subject to the 1934 Act. In quite a few of the filings, they are not listed on a securities exchange or subject to provisions of Section 15(d), in which case you don't have the annual reports with their wealth of information in the files.

MR. HOCKER: This is a good place to mention the procedure to be followed when a company files a registration statement for the first time, previous reports are not available: this is reference to the financial manuals in the financial services. To a degree it will be necessary to refer to financial services in reference to all companies, filing registration statements for the first time. I think most of you are familiar with the publications on Standard and Poor's and Moody's, and I particularly call your attention to the Industries Study Series which appear in Standard and Poor's, and I call your attention to the current news section of both services. As you know, Moody's has several series: Industrial, Municipal and Government, Banking and Finance, Utilities and Transportation. Should you have a registration statement of an insurance company, you will find some information in the Moody's Manual on Banking and Finance and you should also refer to either the Spectator Insurance Yearbook or Best's Life Insurance Reports. For any registration statement the examiner should consult the industry survey in Standard and Poor's to become generally familiar with the conditions in that industry, and he should also consult the current news sections or one of the services to inform himself of recent events in the history of the company. Some companies are listed in both services and some in only one service. All I can say is that you will just have to look for the company and you may find many companies which are not listed in either.

MR. BLACKSTONE: Can you indicate here for what the analysts are supposed to be looking -- what they are apt to find that will help them?

MR. HOCKER: We are particularly interested in something that might require disclosure that has not been made in the initial prospectus. Most of the work of reading the manuals and services simply assures us that we don't need to make comments. Many companies issue quarterly reports of sales. A smaller number report earnings on a quarterly basis. If there is a report of quarterly sales which indicates a rate of operation substantially below the rate which is indicated in the prospectus, comment should be made to cause the prospectus to be expanded to point out results of the recent period and to state the company's belief as to the cause of this decline in operations. This is the most frequent instance of information developed through the services, which requires disclosure in a prospectus.

MR. BLACKSTONE: In other words, anything that an analyst finds in looking at the service which either conflicts with something in the prospectus or gives additional information that appears significant and does not appear in the prospectus should be seriously considered in connection with the analyst's report on deficiencies to be corrected.

MR. HOCKER: This reminds me of another thing. Occasionally we find in recent news items that the Government has asserted claims in substantial amount with respect to back taxes. Certainly information with respect to substantial tax claims should be set forth in the prospectus.

After the completion of this study, so that you feel you have some grasp of the information in the prospectus, it is necessary for the examiner to read the charter and by-laws of the company and compare the description of the securities therein with the description in the prospectus. You must be sure that the description in the prospectus is adequate. Possibly cumulative voting is available, but no disclosure thereof has been made in the prospectus. Possibly the company is incorporated in a jurisdiction where there are few protections to stockholders under state law. Certain jurisdictions have very lax quorum requirements for stockholders' meetings and unless the articles or by-laws specify additional requirements disclosure of the minimal quorum requirements should be made in the prospectus. Certain jurisdictions provide that unless there is a specific request at the meeting the voting will be by show of hands rather than by shares of stock. Unless the articles or by-laws provide otherwise, this should be reflected in the prospectus.

If you find an indemnity provision running to officers and directors, you should assure yourself that it is appropriately reflected in the answer to Item 29 of the registration statement.

If the security to be offered is a debt issue, you should read the indenture filed as an exhibit and compare with it the description of the indenture in the prospectus. You should read the underwriting agreements and selling agreements. Be sure you understand whether the agreement is "firm" or "best efforts". The other exhibits should be read and compared with the description of their terms in the prospectus. While doing this, be sure to call to the attention of the accountant or the attorney any matters which you might think be of interest to them. The accountant will be particularly interested in dividend restrictions or covenants which have the effect of restricting dividends. Such restrictions are required to be set forth in the notes to the financial statement. Note carefully any bank loan agreement. Frequently they contain dividend restrictions.

It is particularly important that the examiner understand the provisions of debt arrangements, especially when there is subordinated debt, where the issue to be offered is to be subordinated to one or more previous issues. If necessary get the assistance of another examiner or the attorney or the accountant.

Where voluminous contracts are furnished in the registration statement, get a general impression of them by going through them rapidly, then discuss with the section chief the necessity of making a detailed study of them.

A number of registration statements come into the Commission which require three volumes for the original filing. This means that the exhibits including material contracts form a great pile of material. We don't have time to analyze those in detail, and until the analyst develops a sense of judgment and discrimination of his own, he should obtain the assistance and direction of the section chief before investing any substantial amount of time in analyzing these documents. However, the analyst should always read carefully contracts between the issuer and

insiders. Disclosure in the prospectus of such contracts is required by Item 20 of Form S-1 and we must be sure that such disclosure is adequate.

The examiner is probably now ready to check the registration statement against the requirements of the form on which it is filed. He knows the issue; he knows the company; and he can very readily review the form item by item to ascertain that no item of information required to be set forth has been omitted.

After disposing of these matters, which are essentially mechanical, there are a few things to be done with the prospectus. Specifically there are certain rules which govern the prospectus: Rule 406 provides that where the title of securities is required to be stated, there shall be given such information as will indicate the type and character of the issue. It is frequently necessary or appropriate for the Division to suggest that the title of that issue be expanded to include the word "subordinated." When preferred stock of unusual characteristics is registered, it may be desirable to ask that the title of that issue be expanded to indicate more clearly the contingencies under which dividends do not accrue or may not be paid.

Rule 420 provides the size of type in the prospectus which generally should not be less than 10 point. Rule 421 provides that material in the prospectus shall be set forth in reasonably short paragraphs under informative captions. It provides that a prospectus shall contain a table of contents. Rule 425 requires the legend that these securities have not been approved or disapproved by the Securities and Exchange Commission, etc. Rule 426 provides the stabilizing language. There is in addition a Division series called Memoranda of Administrative Practice. These memoranda now number in excess of 100 -- I think 120 is the most recent and exists in draft form. Many of these memoranda set forth the policy of the Division concerning disclosure of specific matters which must be in the prospectus.

When the analyst has finished all the checking (he will feel like a clerk before it is over), he is only then in a position to consider the evaluation of the prospectus as a whole as to whether its overall impression is fair and accurate, whether it is misleading in any material regard and whether the method of presentation or the language employed requires amendment. I can mention the following areas which you will cover that are not necessarily exclusive, and they require the analyst to call into play any knowledge he has of economics, financial practice, business and marketing. The areas are: the description of the company's business including the nature of the product or service dealt in, operation and distribution methods, competition, financial history, financial statements, and the earning summary.

Generally the Division will not question assertions in a prospectus merely for the purpose of disagreeing with the person who wrote the prospectus. Where assertion, conclusion or impression is questioned, we should have some basis for the questions. Clearly most of the registration statements filed here are carefully prepared and are prepared in the best of faith. There may be differences of opinion as to the meaning of certain phrases and as to the significance of certain events. The rather informal process of making comments on registration statements is one attempt to dispose of those matters. I think the new examiner has a very great difficulty in knowing how far he should go in questioning assertions in a registration statement and how much additional material he should request. All I can say is that there is no fixed

answer. You must depend on guidance received from the section chief by means of general instructions, discussions with experienced examiners, and your own knowledge. Again I point out that there will be generally no reason to collect information concerning any particular area which lies outside the prospectus unless there is present a basis or belief that the statement in the prospectus is not adequate or is not sufficient.

We are now about through with the examination of the registration statement. The analyst has a lot more work to do in the process. The climax of the examination of a registration statement, as far as I am concerned, is the consideration which the analyst must give to the summary of earnings in the prospectus. The requirement is that the summary of earnings set forth not only the statistical information, but also the information or explanation of material significant to investors in appraising the results shown. This I think is the basis for more comment in respect to registrations statement than any other in the form. Generally one should consider the trend of earnings and operations as reflected in the summary of earnings. In all but the best companies, it seems to me, the examiner should compute the ratio of gross profits to net sales and the ratio of net income before taxes to sales. In order to help an examiner, there are slide rules in circulation in the Division, and there are quite a few persons who can teach you to use them. I want to point out that it is a very simple process, and even a slow learner can learn it in about 20 minutes. All you need is one operation of the slide rule and you have all your percentages. I always thought it was very discouraging to sit down and do percentages by arithmetic or go find a calculating machine. Percentages are the readiest and clearest method of seeing the trend of gross profits from operations or of net income before taxes. If these ratios are relatively regular from year to year, that is highly favorable and it is highly unlikely that the examiner will have any comment arising therefrom. If there are wide fluctuations from year to year, it may be appropriate that the prospectus should contain an explanation of the reasons for the wide fluctuations. If there is a decrease in profits in the last year or the last fiscal year reported, that circumstance clearly calls for an explanatory statement.

The two ratios I have been talking about are principally measures of operating efficiency and of the economic position of the company. A company which has a wide gross operating margin is obviously in a much safer position than one which has a relatively small one. But I must point out that the ratios themselves are practically without meaning. They may be used in comparing the operations of one company with the operations of another, or of indicating to the examiner an area which is worthy of further exploration, but I cannot think of any instance in which, for its own sake, we would ask that the prospectus say that the ratio is such and such. The ratio standing by itself has no meaning.

The analyst should also give careful consideration to the certified financial statements filed as part of the registration statement even though the accountant in the section has primary responsibility for the review of these statements for compliance with sound accounting practice and the form prescribed by Regulation S-X. The analyst may discover in reading the notes to financial statements that certain recent events have taken place such as the arrangement for a line of bank credit or the assertion against the issuer by the Internal Revenue Service of additional income tax liabilities. Such matters would require disclosure in narrative part of the prospectus and the analyst should make certain that there is such disclosure.

Where there is doubt that the company has adequate working capital, the examiner should consider that factor. In the course of the examination I think it will be quite clear that in each instance you will form some impression of the working capital position of the company. Ordinarily the working capital position is not the basis for any comment. However, if the company represents that its operations in the past have been injured by a lack of working capital, or that the purpose of the present issue is to raise working capital, certainly there should be some consideration given as to whether the company now has adequate working capital or will have adequate working capital, assuming the issue of securities is successfully sold.

MR. BLACKSTONE: If the company appears to have adequate working capital and says the purpose of the issue is to obtain working capital, that in itself calls for some explanation.

MR. HOCKER: The form requires that a reasonably informative statement of the purposes to which the funds will be devoted be set forth. Generally we have taken the view that "additional working capital" is not a satisfactory statement of the application of such proceeds where the additional working capital to be raised relates to some development or change in the method of doing business. Perhaps a company has found it necessary to finance its customers with these additional funds to carry accounts receivable. I would ordinarily regard that as an unfavorable development and, of course, one that should be disclosed. Presumably the customers have made their own financing arrangements previously, but the issuer has now found it necessary to provide them with financing to retain them as customers. Working capital may be necessary to carry heavier inventory. The reasons and the circumstances for that should be further explained. I think we can say quite specifically that a statement that the purpose of the issue is for additional working capital will call for further disclosure of the specific purposes for which the additional working capital is needed.

We shall pursue this subject further tomorrow.