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INSIDER TRANSACTIONS UNDER THE 1940 ACT

The Sweeping Prohibition of Section 17 of the Investment Company Act Can Be Relaxed by the SEC Through Its Power to Exempt Transactions Found to be Fair to All Parties

By Tamar Frankel

Congressional hearings in 1940 revealed that investment companies were often managed for the benefit of their directors, investment advisers, and underwriters, not for the benefit of the shareholders.[1] Insiders sold to their investment companies worthless stock, bought property from them at less than the market price,[2] and borrowed money on less than customary collateral.[3] Insiders sold control of the companies to persons who looted them to pay the purchase price.[4]

To eliminate such self-dealing, section 17 of the Investment Company Act was enacted to make it unlawful for insiders to sell to, purchase from, or borrow from the investment company.[5] These transactions were prohibited altogether,[6] but the SEC was empowered to exempt transactions that conformed to specific standards. "[T]he Act requires prohibited transactions to be shown in advance of their execution to be reasonable and fair and not the product of overreaching by any person."[7] The industry did not oppose this prohibition.[8]

TAMAR FRANKEL is a professor at Boston University School of Law. This article is an edited exerpt from her treatise The Regulation of Money Managers, *(Little, Brown and Company 1978). It appears here and is published with permission of the author.*

1. Hearings on S.3580 Before a Subcomm. of the Sen. Comm. on Banking and Currency, 76th Cong., 3d Sess. 35, 37–39, 90, 103 (1940) ["1940 Senate Hearings"]; Hearings on H.R. 10065 Before the Subcomm. of the House Comm. on Interstate and Foreign Commerce, 76th Cong., 3d Sess. 65 (1940) ["1940 House Hearings"] (statement of Commissioner Robert E. Healy); 1940 Act, §1(b)(2) (the national public interest and the interests of investors are affected adversely "when the investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders. . . ").
2. 1940 Senate Hearings at 90.
3. Id. at 208. For examples of abuses before the Act see id. at 64–65.
4. Id. at 59–63, 74–76; see *Gerdes v. Reynolds*, 28 N.Y.S. 2d 622 (Sup. Ct.), referee's report confirmed, 30 N.Y.S. 2d 755 (Sup. Ct. 1941). See also *Willheim v. Murchison*, 342 F.2d 33, 40 (2d Cir.), cert. denied, 382 U.S. 840 (1965).
5. (a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section [12(d)(3)(A)] and (B) of this [Act]), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—
(1) knowingly to sell any other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;
(2) knowingly to purchase from such registered company, or from any company controlled by such registered company, any security or other property (except securities of which the seller is the issuer); or
(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section [21(b)] of this [Act].
6. *Union Sec. Corp.*, 9 S.E.C. 400, 405 (1941) ("The underlying assumption of section 17(a) . . . is that the risk of abuse when such transactions occur so greatly outweighs any advantage which an investment company can derive in those instances when the transactions are scrupulously fair; that the only sound policy is to prohibit all such transactions unqualifiedly.").
7. *Collins v. SEC*, 532 F.2d 584, 592 (8th Cir. 1976), rev'd on other grounds sub nom. *E.I. du Pont de Nemours & Co. v. Collins*, 432 U.S. 46 (1977); see *SEC v. Advance Growth Cap. Corp.*, 470 F.2d 40, 42–43 (7th Cir. 1972), motion to modify injunction denied, 539 F.2d 649 (7th Cir. 1976).
8. E.g., 1940 Senate Hearings at 80 (statement of Cyril J.C. Quinn); 1940 House Hearings at 74.

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APPLICATION OF SECTION 17

Section 17(a) makes it unlawful for any affiliated person[9] or promoter of, or any principal underwriter for, a registered investment company, or any affiliated person of such an affiliate promoter or underwriter, to effect certain transactions with the registered investment company or a company controlled by the investment company. To determine whether a company is "controlled" for purposes of section 17(a), the SEC will look through layers of companies—so long as the registered investment company has control, the SEC will apply section 17(a) despite the existence of intervening companies.[10]

The section prohibits transactions in which one party is an investment company, or a company controlled by the investment company,[11] and at least one of the other parties is (1) an affiliated person of the investment company or an affiliate of the affiliate, (2) a principal underwriter for the investment company or an affiliate of the underwriter, or (3) a promoter of the investment company or an affiliate of the promoter. The prohibitions of section 17(a) are in addition to any other federal and state law restrictions on fiduciaries' dealings with their investment companies.[12]

If neither the investment company nor a controlled company is a party, section 17(a) does not apply.[13] For example, if Company A owns 5% of the voting securities of an investment company (and is thereby its affiliate) and the investment company owns 5% of the voting securities of Company B (and is thereby an affiliate), section 17(a) does not apply to a sale by Company A to Company B. If Company B is controlled by the investment company, however, or if any of the parties is an investment company, section 17(a) applies.

A sale by an affiliate of the investment company to an affiliate of the affiliate is also outside section 17(a), if neither the investment company nor a controlled company is a party. A director of investment company A (an affiliate of Company A) may therefore sell property to a company in which he has 5% of the voting securities, or of which he is a director (even though Company B is an affiliate of an affiliate), so long as the investment company is not involved, and the director or the company is not controlled by the investment company. A wholly owned subsidiary has the status of its parent for the purpose of determining whether a controlled company is a party. A transaction between a wholly owned subsidiary of a controlled company and an affiliate is therefore prohibited.[14]

EXEMPTIONS UNDER SECTION 17(b)

It was clear in 1940 that the sweeping prohibition of section 17(a) could not exist without the grant of exemptive powers to the SEC in section 17(b). The language of this section indicates that upon a finding of fairness the SEC should grant the exemption. The discretion of the SEC under its general exemptive power in section 6(c) is broader, since that section uses "may" rather than "shall," and its standards are less specific than the standards of section 17(b).[15]

Fairness is a federal question. A merger between an investment company and its controlled company that is

9. Under section 2(a)(3) of the Investment Company Act, an affiliated person of another person is:
(A) any person directly or indirectly owning, controlling, or holding with power to vote, five per centum or more of the outstanding voting securities of such other person;
(B) any person five per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person;
(C) any person directly or indirectly controlling, controlled by, or under common control with, such other person;
(D) any officer, director, partner, copartner, or employee of such other person;
(E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and
(F) if such other person is an unincorporated investment company not having a board or directors, the depositor thereof.
10. *E.I. du Pont de Nemours & Co.*, IC-8803/8832 (1975) (section 17(a) applies only when a controlled person of a registered investment company contracts with a controlled person of the controlled person). See also 1940 Senate Hearings at 261.
11. On control see Frankel, *The Regulation of Money Managers*, VII §§1-14.
12. See generally *Analysis, Securities Transactions by Investment Company Affiliates*, 44 BNA Sec. Reg. & L. Rep. B-1 (Apr. 1, 1970). David Schenker emphasized that section 17(a) is an absolute prohibition. 1940 House Hearings at 120.
13. The first draft of the 1940 Act prohibited an affiliate from dealing with the investment company or any of its affiliates. S. 3580, Draft of May 24, 1940. The prohibition was later narrowed to controlled companies.
14. In *American Foundry Equipment Co.*, IC-880 (1946), company A controlled investment companies I and II. I owned 57 percent of D; II also owned enough stock in D to be an affiliate. D had a wholly owned subsidiary E; II controlled G; G had a wholly owned subsidiary H. A transaction between E and H fell within section 17(a) because at least one party was an affiliate and the other a controlled company of an investment company.
15. See Frankel, n. 11, supra, II §13.

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found fair under state law does not necessarily satisfy section 17(a).[16]

The SEC has consistently held that the proposed transaction must be fair not only to the investment company but to all parties,[17] including the holders of different classes of stock in the investment company.[18] This SEC review has resulted in occasional disadvantages to investment companies, which may be required to pay more for the shares of another company than they could have bargained for.[19] The SEC has been criticized for not limiting itself to protection of the investment company as allegedly intended by Congress.[20] However, an agency entrusted with supervising the fairness of transactions could not be expected to stop short when it finds unfairness to one of the parties. Perhaps the apparent disadvantage in requiring an investment company to pay a fair price for stock may, in the long run, prove an advantage, avoiding costly and disruptive litigation.[21]

To disprove overreaching, applicants should show that the fiduciaries involved did not breach their duty. When an affiliate insurance company, 100% owner of the investment adviser, gave its investment company a 30-day option to purchase a block of specified securities at cost, the application explained that the investment company did not take a corporate opportunity from the insurance company, because the latter had purchased the securities for the sole purpose of granting the option. In the judgment of the board, the option would ultimately benefit the insurance company by increasing the aggregate net asset value of the investment company, and consequently the management fee, to the subsidiary investment adviser.[22]

The SEC considers the fairness of the overall plan, not merely the transactions that require exemption. Therefore, the terms of financing a purchase of shares are relevant to the evaluation of the fairness of the purchase, even when the financing will only affect some shareholders of the investment company.[23] The SEC will not, however, examine a related transaction between two independent unaffiliated parties.[24]

In making a determination under section 17(b), the SEC must evaluate each transaction and cannot establish, as a matter of law, a general presumption as to valuation of a closed-end investment company's assets.[25] However, the courts will accord great weight to the SEC's valuation principles because Congress entrusted the function to the agency and because the agency has acquired expertise in this area.[26]

The SEC distinguishes between a decision on the business wisdom of a transaction and a determination of fairness.[27] The first is left to the management of the company or its shareholders; and the latter is entrusted to the Commission. Evaluating future growth of an investment is a business decision for the management. For example, the management

16. *Collins v. SEC*, n. 7, supra at 597 n. 23, discussed in *Comment, Fairness Standards for SEC Approval of Mergers: Collins v. SEC*, 90 Harv. L. Rev. 453 (1976). See generally Brudney & Chirelstein, *Fair Share in Corporate Mergers and Takeovers*, 88 Harv. L. Rev. 297 (1974). On valuations by the SEC, see C. Bosland, *Valuation Theories and Decisions of the Securities and Exchange Commission* (1964). For standards of fairness under the 1935 Act, See *SEC v. Central-Ill. Sec. Corp.*, 338 U.S. 96, 129 (1949).
17. *SEC v. Variable Annuity Life Ins. Co. of America*, 39 S.E.C. 680 (1960) (SEC denied exemption for loans to officers and directors of a variable annuity company which would not affect adversely the "investment company" business shareholders, namely the variable annuity contractholders, but might affect the other shareholders of the company), specific exemption granted, 42 S.E.C. 569 (1965).
18. *Fifth Ave. Coach Lines, Inc.* 43 S.E.C. 635, 639 (1967), cited with approval *E.I. du Pont de Nemours & Co. v. Collins*, 432 U.S. 46 (1977); *Bowser, Inc.*,43 S.E.C. 277 (1967); *Townsend Corp. of America*, 42 S.E.C. 282 (1964); *Madison Fund, Inc.* 40 S.E.C. 143, 151 n.11 (1960); *Atlas Corp.*, 39 S.E.C. 437 (1959); *Atlas Corp.*, 37 S.E.C. 72 (1956); *Bankers Sec. Corp.*, 23 S.E.C. 508 (1946); *American Research & Dev. Corp.*, IC-1248 (1948) (the SEC considered interests of shareholders of affiliates); *Elfun Trusts*, IC-1030 (1947) (both parties to transaction would lose their status as employees' securities companies as a result of the transaction); *Equity Fund, Inc.*, IC-616 (interests of shareholders of investment company to be merged deemed protected if they can either redeem their shares or receive redeemable shares of the surviving company); *Atlas Corp.*, IC-196 (1941) (the SEC considered effect on preferred stock which will be outstanding after the sale if consummated); see *Atlas Corp.*, 25 S.E.C. 221 (1947) (overreaching by controlled investment company seems to have been considered).
19. E.g., *SEC v. Sterling Precision Corp.*, 393 F.2d 214 (2d Cir. 1968).
20. Kroll, *The "Portfolio Affiliate" Problem*, in *Third Annual Institute on Securities Regulation* 261 (PLI, R Mundheim & A. Fleischer, Jr. eds., 1972); Comment, *The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates*, 120 U. Pa. L. Rev. 983 (1972). There is legislative history to indicate that minority shareholders of affiliated operating companies (noninvestment companies that are affiliates of investment companies) were to be protected by the Act. David Schenker, then General Counsel of the SEC, pointed out in the 1940 hearings that, notwithstanding conflicts of interest in ordinary intercompany transactions, a majority or controlling shareholder has a substantial stake in the company, whereas a controlling person in an investment company usually has no equity investment in such company. The minority in the affiliated operating company is therefore exposed to a greater danger than if it had noninvestment company affiliates. It is clear that Mr. Schenker interpreted the mandate in section 17(a) to impose upon the SEC the duty to protect from overreaching the minority interests in affiliated operating companies. 1940 Senate Hearings at 258–259. The courts affirmed the SEC position. *E.I. du Pont de Nemours & Co. v. Collins*, n 18, supra. *Collins v. SEC*, n. 7, supra, at n. 13; *SEC v. Sterling Precision Corp.* n. 19, supra.
21. Kroll, n. 20, supra.
22. *American Gen. Bond Fund, Inc.*, IC-6271/6307 (1970).
23. *Fifth Ave. Coach Lines, Inc.*, n.18, supra.
24. *Southeastern Inv. Trust, Inc.* IC-868 (1946).
25. *E.I. du Pont de Nemours & Co. v. Collins*, n. 18, supra., aff'g on this point, *Collins v. SEC*, n. 7, supra at 589.
26. *E.I. du Pont de Nemours & Co. v. Collins*, n. 18, supra.
27. *Capital Administration Co.*, 34 S.E.C 735, 748 (1953) (choice between merger and liquidation is not with the SEC; the SEC is empowered only to determine the fairness of plan before it, not to compel adoption of the plan); *Atlas Corp.*, 34 S.E.C. 343, 353 (1952); *Filbert Corp.*, 25 S.E.C. 321 (1947) (belief in future of the enterprise); *Atlas Corp.*, 25 S.E.C. 221 226 ("It is not for us to determine the . wisdom of the loans. That function reposes solely in the management . . . "); *Life Ins. Investors*, IC-7523 (1972).

of a licensed small business investment company was not second-guessed by the SEC when it decided to exchange a real estate company's notes for notes and shares of a company that would hold the real estate company's shares; the reorganization was effected to enable the real estate company to become eligible for an FHA commitment to insure income and mortgages on the real estate.[28] However, business judgment must be based on the fullest consideration of the data, especially when a proposed transaction cannot be tested against past experience.[29] Thus, when an affiliate repurchased its own shares from the investment company, management's decision was approved after the affiliate showed that its surplus was larger than the amount necessary for its business, that the problem of excess surplus had been studied for more than a year, and that in the opinion of experts repurchase of the company's shares was also desirable because of the low price at which they had been traded.[30]

Under section 17(b), a transaction between the investment company and an affiliate must be fair, but this does not necessarily require that they participate on equal terms. By contrast, section 17(d) focuses on dealings by the investment company and affiliates with third independent parties. The danger of abuse lies in unequal or unfair treatment of the investment company or affiliate, vis-a-vis each other, not by the third party. The assumption is that the third party can fend for itself. Section 17(d) provides protection for the weaker partner of one party to the transaction, the investment company, or the affiliate. If the terms of the agreement obtained by the stronger party for itself are equal to those of the weaker, the transaction may be presumed to be fair.

Since the effect of an exemption under section 17(b) is to permit a *transaction*, the SEC may take another route and exempt a *party* from the definition of an affiliate, underwriter, or promoter. When an investment company is organized as a limited partnership, the members of the public who purchase the limited partnership interests are by virtue of section 2(a)(3)(D) affiliates of the partnership and may not deal with it. Whenever an investor tenders his interest for redemption, section 17(a) applies, and an exemption is required. To avoid this result, the SEC has exempted the limited partners of such a partnership from the definition of an affiliate.[31]

The SEC tends to exempt transactions that affect only foreign interests. The SEC granted exemption from sections 17(a) and (d) not only for specified transactions but also for future transactions that resulted from pressure from the government of Mexico on certain American companies to relinquish control of their Mexican subsidiaries. Most minority shareholders of the foreign subsidiary were foreign nationals, the United States investing public had no interest in the transactions, and the exemption facilitated the U.S. policy of encouraging such foreign transactions.[32]

PROCEDURE

"Any person" may be an applicant, but the application must concern a "transaction of the applicant." Not all parties to the transaction need file. An application filed by a board of directors of an investment company inadvertently elected in violation of section 16 will not be deemed invalid, and an exemption granted on the basis of such an application is effective.[33]

An exemption is available only if the transaction is prohibited. However, where it was not clear whether the parties were affiliated by control (in which case a loan between them would have to be exempted), and there was a cloud over the propriety of the transaction between them, the SEC granted an exemption from the section under 17(b) without prejudice to a decision on the control issue.[34] The SEC has granted an exemption when the applicant stated that, although it believed that it was not affiliated with the other party to the proposed merger, it was requesting an exemption to remove any doubt as to its legality.[35] Even though the parties believe that they are not affiliated, an exemption may be their best protection. The alternatives are possible violations or lengthy proceedings, for example under section 2(a)(9), to determine the existence of control.[36]

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28. *Midland Cap. Corp.*, IC-4302/4318 (1965), modifying IC-3858 (1965) (the SEC was probably satisfied that the amendment was reached at arm's length). See also *Axe-Houghton Fund A, Inc.*, IC-4328/4343 (1965) (the SEC did grant an exemption for further substantial investments by an investment company in an affiliate that operated continuously in a deficit, whose plant was shut down for structural modification the previous year, and which again showed deficit).
29. *Talley Indus. Inc.*, 44 S.E.C. 165 (1970) (SEC refused to grant exemption unless merger plan was amended to take into account the uncertain future of one of the companies).
30. *Hartford Steam Boiler Inspection & Ins. Co.*, IC-5103/5138 (1967).
31. *Vance, Sanders Exchange Fund*, IC-9232/9267 (1976); see Frankel, n. 11, supra, II §13.
32. *United Corp.*, IC-5250/5285 (1968)
33. *Nadler v. SEC*, 296 F.2d 63 (2d Cir. 1961), cert. denied, 369 U.S. 849 (1962); *Securities Corp. Gen.*, 40 S.E.C. 427 (1960).
34. *International Bank*, 40 S.E.C. 855, 856 (1961).
35. *Incorporated Income Fund*, IC-4181/4210 (1965); see *Scudder, Stevens & Clark Balanced Fund, Inc.*, IC 4161/4182 (1965) (relationship among the parties to proposed transaction is so close that a question may arise as to whether section 17(a) applies).
36. The staff may raise the control issue even when no presumption of control exists, and the applicant may select the exemption route without conceding that affiliation exists. See, e.g., *Television-Electronics Fund, Inc.*, IC-4591/4608 (1966). (After applicant brought suit to rescind a sale, the parties settled. The seller agreed to deliver to the applicant 37,000 additional shares and pay $163,000 to cover the expenses of the litigation in exchange for a release from all claims by the applicant. The application stated that it was not to be construed as a waiver [by applicants] of any rights to take the position that the proposed transaction is not prohibited by . . . Section 17(a) . . . ").

The SEC examines applications before granting an exemption, whether or not they are contested, as required by section 17(b).[37] Part of this examination is conducted before the application is published. Prior to filing, the applicant describes the proposed transaction to the staff, which may conduct an informal investigation and request additional information. The submitted application, which incorporates conditions and changes suggested by the staff, and the assertions and reservations of the applicant, is then published pursuant to the SEC Rules of Practice.[38] The SEC has held that shareholders of an applicant are not entitled to have a copy of the application sent to them. The requirements of the Act are satisfied by a notice of a public hearing published in the Federal Register, giving shareholders an opportunity to appear at the meeting, produce evidence, and state their views.[39]

If no request for a hearing is made, the application will be granted. However, the staff warned applicants recently not to take this practice for granted and enter into any transactions before the application is actually granted.[40]

If the staff does not agree with the applicant, or if a justifiable request for a hearing is made, the SEC will hold hearings after appropriate publication of a notice. If the person seeking a hearing cannot show in his request a legal or factual basis for denying the application, the SEC may refuse to hold a hearing.[41] Similarly, no rehearing will be granted when the petitioners have raised nothing new.[42]

During the proceedings the applicant may be encouraged to change the terms of the transaction, most commonly the price.[43] In the case of *Steadman American Industry Fund, Inc.,*[44] three investment companies with interlocking directors and the same adviser proposed to merge. Under the advisory contract, the investment adviser had to reimburse each company to the extent of expenses that it incurred over 1% of the value of its assets. Because the net assets of one company had declined since the application, the adviser would have benefited from the economics of size produced by the merger. Consequently, the amended application stated that the adviser would bear a higher percentage of the cost of the merger.

The burden of justifying the exemptions is on the applicant.[45] The SEC has required a showing as to various measures of values, such as liquidating value of the enterprise as a going concern.[46] It gives weight to expert testimony of disinterested witnesses and data prepared by government agencies.[47] In *Lasalle Street Capital Corp.,*[48] the SEC considered an application under section 17(b) regarding a merger. In support of fairness, the applicant produced a report by an investment and financial analyst who was retained by both merging corporations to make a preliminary feasibility study of the merger. The report was favorable but did not contain an opinion as to the fairness of the merger. The staff argued that the applicants did not meet their burden of showing fairness; much of the evidence was general and did not specifically show the relative contribution of the shareholders of each company. The SEC approved the merger, but it remarked:

> Applicant might have been better served in meeting its burden of proving the availability of an exemption if Duff [the analyst] had been specifically requested to, and had made, a specific valuation of each company for the purposes of merger allocation. If the companies had specifically engaged Duff to determine a definitive basis for the proposed merger that would be fair, a report pursuant to such an engagement would have carried more weight and a hearing might thereby have been avoided.[49]

37. *Grace v. Ludwig,* 484 F.2d 1262, 1268 (2d Cir. 1973), cert. denied, 416 U.S. 905 (1974).
38. SEC Informal and Other Procedures sections 202.1-.4; Rule 0–5 under the Investment Company Act.
39. *Capital Administration Co.,* IC-1832 (1953) (The shareholders also requested a 60-day interval between the mailing of the application and the hearing. The SEC granted a seven-day postponement)
40. IC-8236 (1974).
41. E.g., *Highland Cap. Corp.* IC-8666/8791 (1975).
42. *Christiana Sec. Co.,* IC-8692 (1975); see *Gross v. SEC,* 418 F.2d 103, 108 (2d Cir. 1969); SEC Rules of Practice section 201.21(d).
43. *Talley Indus., Inc.,* n. 29, supra., *Pennsylvania Indus.,* 32 S.E.C. 62, 65 (1950) (applicant changed merger plan substantially); *Morris Plan Corp. of America,* 25 S.E.C. 203 (1947); *Transit Inv. Corp.,* 23 S.E.C. 555 (1946); *Pittsburgh Coke & Chem. Co.,* IC-7216 (1972) (merger, computation of net asset value changed); *Berkshire Indus. Inc.,* IC-5905 (1969) (original offer of $275 upped to $375 and at the close of the hearings to $575. Applicant then requested to reopen the hearing to introduce additional evidence and at reconvened hearing offered $635. When this offer was not accepted by the other party, the applicant withdrew.).
44. IC-6183/6313 (1970); see *Aberdeen Management Corp.,* IC-7201/7275 (1972).
45. *Lasalle St. Cap. Corp.,* 44 S.E.C. 655, 657–663 (1971); *Scripps-Howard Inv. Co.,* 17 S.E.C. 702, 710 (1944) (application denied in the absence of a showing of fairness and protection).
46. *Lasalle St. Cap. Corp.,* n. 45, supra.
47. *Talley Indus. Inc.,* n. 29, supra, at 182 (the SEC noted that the applicant relied heavily on estimated future growth of a totally new product, that the product was not assessed by an independent engineer, and that no market study or technical data evaluation was made. Proposed merger was held unfair, and exemption was conditioned on changes in terms of the merger); *Morris Plan Corp. of America,* n. 43 supra.; *Pennsylvania Indus. Inc.,* 24 S.E.C. 284 (1946) (evaluation of a building by an independent appraiser given weight); *Transit Inv. Corp.* n. 43, supra. (the SEC stressed three interested witnesses only); *Lancaster Corp.,* 23 S.E.C. 472 (1946); *United States Trucking Co.,* 17 S.E.C. 682, 686 (1944) (appraisal of real estate and lease by an independent company); *Equity Corp.* 15 S.E.C. 181, 187 (1943) (opinion of "an executive of a responsible real estate firm" cited as to fair value); *Baldwin Sec. Corp.,* IC-4580/4599 at 2 (1966); *Equity Corp.,* IC-1949 at 2 (1954) (reports by an independent research organization to evaluate the exchange of shares); see *Fifth Ave. Coach Lines, Inc.,* n. 17, supra.
48. N. 45 supra.
49. Id. at 663.

An applicant that did not produce sufficient data to show fairness of the price was denied an exemption.[50] In one case, the SEC permitted the applicant to submit further data and, in the process, to improve the price, which it then found to be fair.[51] If a *prima facie* case is established, an objector to the application must do more than merely assert that the transaction involves overreaching; he must produce some proof of it.[52]

In general, the SEC either approves or denies an application. In one exceptional case, over the dissent of a Commissioner, the SEC granted an exemption to a proposed plan of merger as specifically amended by the SEC instead of limiting itself to the terms of the application.[53]

WITHDRAWAL OF APPLICATION

An application for exemption may be withdrawn, presumably with SEC approval.[54] The SEC has not denied approval when the application was opposed on collateral issues as to the legality of earlier transactions, and the termination of the hearings on the application does not bar the objectors from raising the same issues in another forum.[55] When the parties decide to abandon the proposed transaction, the SEC will not deny the application to withdraw simply because the objecting parties would like to continue to resolve issues that were raised by the application.[56]

Other Articles on the 1940 Act

Frankel, *Distribution of Mutual Fund Shares,* 10 Rev. Sec. Reg. 860 (1977)

Ake, *Variable Life Insurance,* 9 Rev. Sec. Reg. 819 (1976)

Hawes and Sherrard, *Advice of Counsel,* 9 Rev. Sec. Reg. 887 (1976)

Ellis, *Mutual Fund Expense Limitations,* 7 Rev. Sec. Reg. 932 (1974)

Ebb, News and Notes, *Fund Advisers and Counsel's Fees,* 5 Rev. Sec. Reg. 990 (1972)

Eisenberg, *Mutual Fund Litigation,* 5 Rev. Sec. Reg. 909 (1972)

Baris, *Mutual Fund Legislation,* 4 Rev. Sec. Reg. 997 (1971)

Freedman and Rosenblatt, *Duties to Mutual Funds,* 4 Rev. Sec. Reg. 937 (1971)

50. *American Steel & Pump,* IC-5357 (1968).
51. *Talley Indus., Inc.,* n. 29, supra. (the SEC did not consider a merger fair unless certain enumerated changes were made in the terms); *Pennsylvania Indus.,* n. 43 supra. (similar substantial changes); *Transit Inv. Corp.,* n. 43, supra.; see *Fifth Ave. Coach Lines, Inc.,* n. 18, supra.
52. Kroll, n. 20, supra., see *Baldwin Sec. Corp.,* IC-4579/4598 (1966) (applicant conceded control with 22 percent ownership of stock for the purpose of the application only).
53. *Talley Indus., Inc.,* n. 29, supra., at 183. (The majority proposed changes under which it would approve. Commissioner Needham dissented and would dismiss since the applicants did not lift their burden of proof), citing *Fifth Ave. Coach Lines, INc.,* n. 18, supra., *North River Sec. Co.,* 37 S.E.C. 465 (1956); and *Transit Inv. Corp.,* 23 S.E.C 415 (1946).
54. See Frankel, n. 11, supra, IX §5 on withdrawal of application for registration as an adviser.
55. *Pacific Ins. Co.,* application, IC-4870 (1967), order for hearing, IC-4986 (1967), withdrawn, IC-5476 (1967); *Wheelaborator Corp.* application, IC-4705 (1966), withdrawn, IC-4906 (1967) (permitting withdrawal after the hearing); *Allegheny Corp.,* IC-2464 (1956).
56. *Berkshire Indus., Inc.,* application, IC-5148 (1967), notice for hearing, IC-5710 (1969) (to adduce more evidence), opinion and order, IC-5905 (1969)

ACCOUNTING DEVELOPMENTS

By Dennis S. Neier and Charles Hazelcorn

SEC INCREASES THE SMALL OFFERING EXEMPTION

The Securities and Exchange Commission has amended regulation A, its small offering exemption, to increase the aggregate amount of securities that may be sold within a 12-month period from $500,000 to $1,500,000, and to increase the amount of securities that may be sold without an offering circular from $50,000 to $100,000. The major advantage of the regulation A procedure is its exemption from the standard registration requirement to file audited financial statements for the three preceding fiscal years and other schedules and financial data called for by regulation S-X. (However, many underwriters, as well as the securities laws of many states, may require audited financial statements even for small offerings.)

The SEC indicated that, despite the primary purpose of regulation A to provide a simple and relatively inexpensive procedure for small businesses to raise capital, the number of issuers using the exemption had declined drastically during the past five years. The primary reasons for this are the loss of interest by investors in issues of relatively new companies and the difficulty of finding an underwriter to handle a small issue. We question whether, in today's inflationary cost structure, raising the regulation A ceiling to

DENNIS S. NEIER and CHARLES HAZELCORN are partners of the national accounting firm of Oppenheim, Appel, Dixon & Co., internationally Spicer and Oppenheim. They gratefully acknowledge assistance from the firm's Technical Research and Review Department in preparing this material.