



Chapman, Spira & Carson, LLC

Consulting

To recap, the following steps are usually taken in laying the groundwork for bringing an issue public:

File registration statement with Securities and Exchange Commission

Blue Sky the Issue

Issue Preliminary Prospectus

Due Diligence Meeting

Issue Final Prospectus.

Earlier we discussed in detail the steps leading up to the issuance of the final prospectus so we felt that it would be *apropos* to address the most difficult aspect of the process independently. This can be very painful for all of the people involved because no one is quite sure what the rules really are. We have been told that the SEC gives all of its examiners a secret book that details exactly what the final prospectus should contain but we have never met anybody that has actually seen it. Supposedly, each of the SEC representatives carries this book about him wherever he goes.

Some have said it is biblical in nature and the agent is to read it at all hours that he is not on the job. This book is a roadmap advising the agent on how to best make the issuer totally miserable. When exciting new methods of torturing companies new to the process are discovered, a new edition of the book is immediately published containing this important information so that it can be shared by the field staff. Some embittered issuers have stated that the SEC must be rewarding examiners who create new impediments with substantial bonuses.

The final prospectus must be promptly distributed to prospective buyers of the issue after the effective issue's date. Once the purchaser of the shares in the offering has had time to peruse the final document, he has the right to rescind his purchase literally for any reason whatsoever. In practice this occurs only when there are substantial differences between statements made by the broker and the facts that appear in the prospectus. Even if every client purchasing stock in the IPO, if it were a firm deal, were to rescind it would not effect the company in that they received good funds from the underwriter at the time the deal became effective.

Many people can't tell whether they have been told the truth or not by reading the prospectus because it is written in a language which at best is must be considered most unusual. Knowledgeable people have said that it is a cross between Sanskrit and Esperanto which we are told, the SEC believes is the language of the future. Having qualified interpreters available to determine what was meant in these languages has not been too successful in court. The next hurdle the is the most difficult,

Exempt Securities

These are securities that are not subject to the registration requirements of the 1933 Securities Act. Exempt securities also include securities that do not have to follow certain provisions of the Securities Exchange Act of 1934 in terms of margin, registration of deals, certain reporting requirements, and the identity of market makers.

U.S. Government and U.S. Government. Agency Securities

Municipal Securities

Securities issued by non-profit organizations

Bank Securities

They may be exempt, but we are not sure what that means. It may have something to do with registration the fact that they can be freely offered without a regulatory authority passing on them. In the particular case of Government securities, we think that the term exempt means that the government is not going to lie in an offering memorandum regarding the placement of their securities and a buyer shouldn't worry too much. In other words, if you can't trust Uncle Sam, who can you trust?

At the same time, salesmen recommending government securities have several problems. First, there is not much profit in these instruments for the broker. Second, it is hard to get a customer once invested in governments to switch into a penny stock on which the broker makes a lot of money. Therefore, when all is said and done, the U. S. Government has taken the position that you can call its securities whatever you want, but don't call them late for dinner.

For some period of time firms that dealt exclusively in the U. S. government arena didn't even have to be registered as a broker. Some people, such as the more prestigious brokers and banks, abused their privileges and did bad things in the government market, treating it more as their territory than the Government's. The Government became upset at losing turf and was forced to punish some of them severely. They made the government look bad. These are institutions you do business with everyday.

The government said, even though our securities are exempt, you cannot go around breaking securities laws whenever you want. After all, the public is still protected by the anti-fraud provisions in the act aren't they? Well the bad guys said, awe come-on, when you needed your merchandise moved you didn't mind our rigging the market now and then, now that you don't need help any more you're becoming sassy. What the bad guys said is mostly true.

Now municipal bonds are something else. They are almost universal free from Federal Taxation. Because of all the rights granted the states in the constitution, states and their subdivisions could independently do their own financing and not have to worry about paying assessments to the federal government. Because of this quirk, the states, cities, municipalities and taxing districts were able to pass along this benefit to the buyers of their bonds. Municipal bonds of an equivalent rating with that of the U. S. Government would sell at a price equal to the current federal income tax rate deducted from the equivalent government bond. In other words you have to compare apples with apples and not with oranges. A 20-year Virginia general obligation compared with a 20-year Treasury bond.

In any event, the non-federal taxing authorities found a good idea. They would raise a lot of money by telling people that they were going to do something or other and then they wouldn't do it. (After all the bonds were exempt, weren't

they?). Instead, they would buy U. S. Government paper with the proceeds, thus making a profit on the difference between their interest cost on debt and the rate they received from Uncle Sam. This caused taxpayers in states that weren't smart enough to do illegal things to ship money into states that were engaged in these activities. Luckily, I always lived in a state that knew how to do this. The fact that they lied as to what they were going to do with the money seemed to be OK because they were the government. I guess that seems all right, but I'm really not sure.

Another thing that the non-federal tax accessing bodies can do that seems strange is that they can sell bonds that represent financing for private industrial concerns. These strange bonds are called industrial revenues. States and other taxing authorities interesting in attracting industry can give companies showing interest in their location various benefits. These could include tax abatements, free land, plant and machinery, a cash bounty for each employee they hire along with a never ending list of additional goodies if the facility will ultimately hire enough residents, produce enough taxes and become a good enough citizen. The package given to various Japanese auto companies by various states to set up manufacturing literally went on for pages and pages. I have often wondered why no American company ever qualified for something like that but Doctor Bob said it has something to do with the CIA and it is best not to pry.

To most company's, the most singly beneficial part of the offering package is the ability to get Industrial Revenue Status. This allows the company to issue a tax-free bond and rates under those of the competition that is only paid back from the particular revenue of the project being financed. Often startup or companies with poor credit can raise money through this method that would be unavailable under any other scenario.

Primarily, because of these strange characteristics, many people have lost their savings in these investments. Vietnam veterans and old people have been particular targets of inventive financiers who create companies as fast as nefarious brokerage houses can move the paper that they generate. To some degree a damper has been put on this activity after everyone's money was lost so I guess I shouldn't even have brought it up but I still feel sorry for some of those people.

Charities that qualify for tax exempt status, are able to raise money with reasonable latitude. Recently one organization offered investors the opportunity of donating to a fund that would match whatever they put up dollar for dollar. Thus, the potential patrons were told they would receive a double deduction from the internal revenue service. With taxes (including federal income taxes) approaching 50% in some states, money could be given to charity and when the tax benefits were added in, there literally would be no cost to the donor and he would be held in great esteem in his community. Many important people donated to this cause because they wanted to be held in greater esteem than they already were. When the whole thing turned out to be a fraud, they became liable for unpaid taxes, and lost whatever esteem they had previously garnered and probably a little more for being such idiots to believe in being able to get something for nothing. The guy that ran the charity is going to be in jail for a long time but that won't help everybody who got screwed.

Most of the money we donate to charity is never used for the purpose the donor intended. By far the largest percentage as a rule goes for general and administrative expenses, so that the people running the charity can have nice homes, big cars and send their kids to college so that they can become legitimate when they graduate. I guess that's why charities are exempt. If we knew that none of the money was going where we intended, we probably wouldn't be so generous and these kids couldn't go to college. We think that continued exemptions for charities is probably a good idea, Uncle Louie runs a not-for-profit and maybe someday I'll need a good job.

Bank Securities are also exempt. This may be because most of the crash of 1929 was blamed on the banks and when the securities laws were written in 1933 and 1934 it was thought best to stay totally clear of anything remotely connected with banking because it would give the brokerage industry a bad name. Brokers have gotten a bad name on their own and many of the exemptions in the 1933 and 1934 acts are no longer required.

It was also felt that banks needed more latitude in telling their stories so that they could raise money. If banks had to disclose everything, the SEC felt that no one would ever put money into that kind of security. They felt it best to allow the banks to make up whatever story they wanted for the good of making the industry health again. The banks became very adept at making up stories and raised substantial sums of money.

Regulation D

The Securities and Exchange Regulation D exempts registration for private placements of Securities and Exchange Commission if:

Issuer believes buyer is a sophisticated investor- I think this is one of the more important definitions that we will deal with. Notice that the discretion as to the buyers sophistication is left to the Issuer. This seems a little like having the fox guard the chicken coupe. I can just picture the president of Blodget Widgets, a company that is down to its last \$20 in the bank, saying to an investor holding a check for \$ 1 million, "I don't believe that you are sophisticated enough to invest in my company". It is possible that this has occurred in the distant past, but it was not the action of a company officer that caused the event; it was more likely the corporate counsel that was afraid to lose his license to practice. You can make book on the fact that the attorney never did any work for Blodget again.

Another confusing aspect of this regulation is the fact that the going definition of an accredited person is one who earned \$200,000 during the previous two years and has a net worth of \$1 million. I'm not sure that this is a good definition of a sophisticated investor. Doctor Bob is probably worth a whole lot more than that and he certainly earns more than \$200 thousand a year, but I have never seen anybody worse with money.

I mean this guy puts his money into every hair-brained investment that comes down the pike. You may remember that he was the guy that said buy comic books; comic books are going through the roof. That was just before they collapsed. Next he started buying something called commemorative plates that were also going to make him a lot of money. The plate market fell apart when the moving people were moving them into the warehouse, the guy dropped them on the pavement. Then he invested in a company that looked for sunken treasure, and they actual found the stuff, but the state impounded it. Doctor Bob still visits his treasure in the state nautical museum though and thinks of what might have been.

Ultimately, things got so bad that they had to appoint a conservator for Doctor Bob so he wouldn't keep messing up. Well, in spite of the fact that the court won't let him sign his own name to a check for anything but groceries, Doctor Bob can still fill out private placement memorandums and qualify as a sophisticated investor in the eyes of the securities laws of the U. S. Government. Things keep going from bad to worse for him. Yesterday the fella in the white jacket said that Doctor Bob couldn't write with anything that had a sharp point anymore. How is he going to write complicated prescriptions?

Buyer must have financial information in memorandum form. This too is extremely important. It makes a lot of sense that they get all of this information, except for one thing, the financials are not necessarily done by an accountant. As a matter of fact for the most part, they are created by highly imaginative people that could have found more successful careers writing science fiction. They weave stories that would make the characters in Alice in Wonderland stand up and take notice.

Almost all private placement memoranda show a series of projections that have no basis in fact in the real world; they predict that the issuing company will have a profit somewhat in excess of the combined gross national products of the European Community by the year 2004. Many people with great intellect (among them Doctor Bob) place a lot of faith in these projections. It was once estimated that if you added all of the projected after-tax income to be generated

by companies doing private placements in 1996, they would show earnings of more than the estimated gross domestic product of China, The United States and Japan in 2050. These kind of statistics make a person less than sanguine when approaching financials that appear in many of the private placement memoranda.

Issuer is assured buyer does not intend to make a quick sale of the securities. This one is a real corker. The private placement memorandum contains a statement that the buyer is not going to turn around and sell the offering immediately. We don't understand why that is of any consequence, other than as a subliminal message by the government saying, "your odds of ever seeing a nickel on this investment are next to zilch. Don't get any ideas that

you're going to be able to turn this thing around for a quick profit." We would ask the government a more germane question. To whom would I sell this thing if I could sell it at all? Maybe the government knows people that are buying up all of these gems and they are subversive or something. Doctor Bob would certainly like to meet them.

Exit Strategies

Things tend to get so bad in these deals that for the most part we won't do them at all unless there is an exit strategy. What this means is that I have no interest in becoming a permanent minority stockholder in a company run by a bunch of people I know nothing about. If it is successful I don't want management filtering all of the profits out of the company in large salaries and expenses accounts. I am not interested in helping put their children through school by having the corporation pay interest on classes of stock I don't own and I am not interested in having to go through extensive litigation to get what I was promised in the first place. What we insist upon is management's agreement to a definitive exit program, in writing, before we even think of making the investment.

There are many ways that it can be done such as guaranteeing to do a public offering in which your shares are freed up as part of the registration process. For legal purposes, these intentions should be spelled out, chapter and verse within the private placement itself. This will not help a lot, because if the deal is a bummer anyway, nothing is going to save you from losing your money. One major American brokerage firm admittedly sold its customers over a billion dollars worth of questionable securities and is now after getting caught is trying to figure out how much they have to give back. An exit strategy only protects you from losing all of your money if the deal is a success and even then your odds are poor.

Securities may not be sold to more than 35 non-accredited investors. Sometimes this statement is true and sometimes it isn't. In the deals that you are likely to run across it is probably true. In actuality, this is not what the SEC means and it is somewhat strange that it has become so convoluted over time. While it is true that most transactions cannot be sold to more than 35 non-accredited investors, it is also the fact that it cannot be shown to more than 35 non-accredited investors. Doctor Bob was telling me about a Temperance League meeting he went at which they were pushing a Monaco gold mining investment.