DIVISION OF CORPORATION FINANCE

TRAINING PROGRAM LECTURES

Fourteenth Session -- April 10, 1957

Subject: Analysis of a Registration Statement of a Company Offering Services

Speaker: Mr. Joseph P. Romeo, Section Chief Division of Corporation Finance

MR. ROMEO: The company I am going to talk about this morning is Pyramid Productions, Inc., an independent producer of national television shows. The word "independent" here means that the company is not connected with any of the television networks. It produces half-hour shows of the kind to be seen evenings between the hours of 8 and 11 o'clock.

Practically every one of you here, I am sure, has seen at least one of this company's shows. For example, Pyramid produces "The Big Story", which is one of the oldest half-hour shows still on television. Originally, it was a radio story which went on the air for the first time around ten years ago. It was initially sponsored on the radio by American Tobacco Company. The show was very successful on the air, and in 1949 American and Pyramid entered into an agreement to have "The Big Story" produced as a live television show. It was first exhibited over the NBC Television Network, and it is still on that network so far as I know, after having been shown there continuously for eight years.

American Tobacco Company has sponsored the show all these years, and in September, 1955, it and Simonize Company entered into a contract with Pyramid for the telecast of "The Big Story" over NBC for the next five years.

I have singled out "The Big Story" because Pyramid's fortunes, since the inception of the company, have been very heavily dependent upon its success or failure. In 1951 it accounted for 60% of Pyramid's total gross revenues; in 1952, 61%, in 1953, 52%; in 1954, 60%; in 1955, 60%; and in 1956, 61%.

Other shows produced by Pyramid, which some of you may have seen, are "Treasury Men in Action", which on an average has **accounted** for about 20% of Pyramid's gross **income**, "Playhouse 15", "Mail Story", "Man Behind the Badge", and several others. These shows, like "The Big Story", are drama productions and, in the main, depict the exploits of operators of the Treasury Department and of the Post Office Department, as well as the exploits of other law enforcement officers.

The registration statement which is the subject of my discussion, was the first filing of any kind the company made with the Commission. The office address of the attorneys for the

company was 285 Madison Ave., New York. I had never previously run across this firm in my registration work, and I had not read very many pages of the prospectus before I knew we had a tough case on our hands.

Among the factors that led me to this conclusion are the following: First, Pyramid was organized less than five years ago. Second, the television show production industry is in its early infancy. None of the financial services has a description of the industry. Fourth, there were no previous filings that were sufficiently comparable to be of much help. Further, the industry was and still is in a state of somewhat violent flux, and the position of the independents, such as Pyramid, was and still is somewhat uncertain. Further, there was evidence that an amateur, or perhaps even worse, had prepared the statement. For example, no one with any previous S. E. C. experience would have included a statement in a prospectus such as the one on Page 9, and I quote: "The company feels that by the beginning of 1957 there will be an increase in sales of one-half hour television shows and that the one-half series <u>will</u> thereafter <u>always</u> remain in great demand." That is quite a prediction **indeed**!

Additional evidence that we had a tough one on our hands was contained in the balance sheet and in the summary of earnings. A glance at these indicated possible serious trouble. The company had $773,000 in current liabilities, but only $116,000 in cash and receivables. It had inventory of $1,787,000, and gross sales for 1955 (the last full year) amounted to only $1,614,000. This, in turn, represented a drop of 25% below 1954. Worse still, sales during 1956 were running at a rate substantially lower than in 1955. Also, the company lost $30,000 in 1955, as compared with a profit of $333,000 in 1954, and a profit of nearly $1,000,000 in 1953. Moreover, losses for the first six months of 1956 were at a rate ten times as great as during the year 1955. On top of all that, however, came the worst blow of all.

The accountant's certificate listed the balance sheet which was dated as of July 13, 1956, and profit and loss statements for the years 1951 through 1955, and statement for the interim 1956 period through July 13. The name of the accounting firm was unfamiliar to me. So, too, was the statement in the certificate: "Figures presented in the above listed statements relating to the calendar years 1951 through 1955 were taken from the federal income tax returns of the company and its predecessor." We were ready to throw up our hands at that point, but we didn't. But here was evidence that one of the fundamental requirements of the form had been overlooked.

There were other indications, however, of poor preparation and of possible serious problems. This will be evident from some of the things that I will discuss further. However, all of this evidence that I have mentioned left us without descriptions of the business industry or industrial practices, muchless the completeness and accuracy needed in an adequate disclosure for investors. The question then before us was whether we should attempt to handle this case by the usual letter of comment, or whether we should look into the possibility of stop-order proceedings, or whether we should try what is known in shop language as a "bed-bug" letter. Such a letter is one sent when it appears that the **people** who prepared the statement have made a sincere attempt to comply with the requirements, but because of inexperience, or for other reasons, have done such a poor job that it will be necessary for the staff to practically re-write the prospectus. It is not our function to do that, of course, as the Chairman pointed out over a year

ago in one of his speeches; nor, as everyone here painfully appreciates right now, do we have the time to do it. At any rate, a "bed-bug" letter is a very short one, and while we didn't use it here, I think it might be well to point out what it is. In substance, it says:

"A review of your registration statement indicates that it contains numerous deficiencies of such a character that it is impracticable to comment on them in detail. Accordingly, it is suggested that a request for withdrawal of the registration statement be filed immediately. Withdrawal will not preclude the filing of a registration statement at a later date. But before doing so, it would appear desirable for the registrant to confer with the staff of this Division to discuss the problems present in the filing by your company."

In this instance it was decided that neither stop-order proceedings nor a "bed-bug" letter was desirable. This conclusion was reached because it was realized that there were problems on both sides of the fence. The registrant was in the same boat as we were to a very large extent as to the availability of previous and comparable filings and published industry information. Accordingly, it was decided to use what I might call a modified-letter-of-comment approach. This approach consisted, first, of arranging for a conference with officials of the registrant for the purpose of getting further information; and second, of utilizing other sources of information that were available such as, other Government departments and trade publications. As to the latter, personal interviews were had with the **staff** writer of one of the prominent TV trade journals. We made phone calls to TV specialists **in the Department of Commerce and we obtained a lot of valuable** information from them. The upshot of all this is that we obtained from the three sources enough background information about the company and about the industry to feel that we were in a position to undertake a letter of comment, so after some time, in which the registrant was patient and cooperative, a letter of comment was duly prepared and mailed to the company.

MR. BLACKSTONE. Would you tell us first how much they were offering?

MR. ROMEO. They were **offering** common stock, 200,000 shares at $5 per share. About as many shares were owned by four or five persons in the company, so that if all the shares were sold, you would have a 50-50 division between the public and officials of the company.

The offering, of course, was on a best efforts basis by an underwriter who was not too well known but who had been registered for at least ten years. One of the first things to do, of course, is to check whether the proposed underwriter is registered as a broker-dealer.

Item 1 of Form S-1, which was the form on which they filed, requires disclosure of all underwriting discounts and commissions received or to be received by the underwriters, directly or indirectly, in respect to a sale of the securities being offered. Paragraph 17 of Schedule A defines commissions as including not only cash payments to an underwriter, but also contracts or anything else of value paid or to be set aside for the benefit of the underwriter. Included among things of value to the underwriter are contracts or covenants in underwriting contracts such as the following in Pyramid's contract with the underwriter: "In the event that the underwriter sells all of the common stock to be offered hereunder, the company will not issue or sell, contract to issue

or sell, or offer for sale to the public any of its securities for a period of five years from the closing date hereof without the written consent of the underwriter, unless the company shall first offer the underwriter the opportunity to underwrite the public **offering** of such securities on terms at least as favorable as can be obtained **elsewhere**." A covenant of this kind is known in the trade as "right of first refusal". Obviously they are a thing of value to the underwriter as a source of future business.

Also representing a thing of value to the underwriter along the same lines are covenants like the following included in Pyramid's agreement: "The company and the principal shareholders will use their best efforts and agree to vote their stock for a period of five years following the closing herein to procure the nomination of and the selection to the board of directors of the company of one nominee designated by the underwriter." This is known as a "right to name a director."

In running through the underwriting agreement in each case, the examiner should be on the look-out for covenants of this kind. In the event one is found, it has been the policy of the Division to require disclosure of its existence by means of a footnote to the price table on the facing page of the prospectus. Since they were not disclosed in Pyramid's prospectus, our letter of comment included the following paragraph: "Note A to the table should also disclose (1) the right of first refusal for future financing, and (2) the right to name a director granted to the underwriter by the underwriting agreement."

The amendment contained a statement in a note to the price table which read as follows: "The company has granted the underwriter the right of first refusal to future financing and the right to name a director."

Before going on to the next deficiency, I should like to point out that disclosures of this kind are important to investors not only because they indicate the underwriter is getting a high price, but also because the existence of a right of first refusal can be embarrassing to a company as well as tying its hands in future financing, with consequent delays in financing plans at a time when speed might well be of the essence.

As I said earlier, all of Pyramid's common stock was held by four or five people connected with the management. There had never, to our knowledge at least, been any quoted prices for the stock. Accordingly, the investor would be left to his own devices to place a value on the stock. In view of the lack of quoted prices, the offering price set by the company, more likely than not, was more or less arbitrarily determined without much if any reference to asset value or past and prospective earnings. In view of the fact that all of the stock of Pyramid was owned by five managing people, the possibility existed that these men who set the price in the first place may have been influenced in setting that price by the effect it would have on their own holdings. Therefore, our letter of comment included the following paragraph:

"Disclosure should be made on the facing page that there is no present market for the registrant's shares, and that the offering price of $5 per share has arbitrarily determined if, as appears, was the case."

The amendment filed in response to this comment contained a statement on the facing page readings as follows:

"There is no present market for the shares and the offering price has been arbitrarily determined."

That is a very simple statement, but it has to be carefully read and weighed. We cannot go much further than that -- we cannot lead the investor too much by the hand -- putting a statement like that on the facing page is about all we can do. I might add that in addition to furnishing a point of disclosure to the investor, our comment may **have had the effect of reducing** the price per share. In the amendment the offering price was reduced from $5 per share to what was, in effect, $4 per share.

There existed a number of factors in the Pyramid case which indicated the offering was highly speculative. In cases of this type it is the policy of the Division to require the inclusion at the very outset of the narrative part of the prospectus of a thing called an "Introductory Statement." The purpose of this is to make available to the investor in a prominent place a summary of the adverse factors contributing to the speculative nature of the offering. These factors might very well be set forth in various places throughout the prospectus. But we feel that this is not enough. For one thing, there is always the possibility that the investor may read only the first three or four pages and stop there. I might add in this connection that the first four or five pages of some prospectuses usually are devoted to a routine description of the business. Certain registrants, for one reason or another, have been known to discuss the more controversial aspects of the business as far back in the prospectus as possible. In addition to that, the adverse aspects will be scattered about throughout the text of the later pages and the cumulative effect of these factors may not register on the investor. For this reason we require in a highly speculative offering (that is an important point to remember) a summary in a prominent place so that the investor will have only himself to blame if he doesn't find out about them.

The comment we made on Pyramid is more or less typical of this type of situation. I should like to read it to you for this reason, and also because it sets forth the highlights of some of the speculative features of the industry, as well. The first paragraph is standard:

"In view of the nature of the common stock proposed to be offered and in the interest of adequate disclosure, it is suggested that there be inserted as the first information on page 3 under a caption entitled, 'Introductory Statement', a series of separate paragraphs setting forth the various aspects of the company's business contributing to the speculative nature of the offering. In this connection, it would appear that the information given should cover at least the following to the extent true and applicable. First, the company has operated at a loss since 1955. Second, the company is principally engaged in the business of creating, developing, packaging and producing live and film shows and programs primarily for television release, which is a highly competitive business, and many competitors have substantially more capital with which to operate, including the production division of the large television networks. Third, the success of the company is dependent upon public acceptance of its programs, which is subject to fads of

unpredictable duration. Fourth, the company has entered into separate employment contracts with two of its promoters, who are the principal officers, for a period of 20 years which provide each with a minimum annual compensation of $39,000 for salary and expensed, with a maximum of $52,000, plus cost of travel as more fully described on Page ___ of the prospectus. In addition, each promoter has options to purchase 50,000 shares of common stock, as more fully described on Page __ of the prospectus."

In response to this comment the company put an introductory statement in at the very beginning of the narrative portion of the prospectus. The statement included followed our comment almost word for word so it will serve no purpose for me to read it to you.

However, I should like to make an observation as to what may have been the effect of our highlighting the employment arrangement with the principal officers and stockholders. Remember that each of these two men had options to buy 50,000 shares each which, by the way, was 25% of the total number of shares being offered. These options were, in effect, lifetime options. It may be of interest to note that when the amendment was filed, all references to the options were deleted -- for the very good reason that they had been cancelled.

Another comment in our letter raised a question as to the management. The two principal promoters had feathered their nests by giving themselves what amounted to a lifetime contract with very high salaries and expense accounts -- very high in relation to the volume of business and net earnings of the company. These contracts were entered into only a few days before the registration statement was filed -- exactly one week before, in fact. These fellows were going to make sure that they were taken care of before the company became publicly owned. However, I will say this for them: they were no different from practically everybody else in this industry that I have run across. It seems to be one of the principal characteristics of an industry of this type, as it is of the sister movie industry. My advice to the examiner who is analyzing one of these companies, movie, television, etc., is one word, "Management." That is the prime requisite to the success or failure of the company. So check very carefully into salary and other remuneration arrangements. Above all, I would caution the examiner to read most carefully the employment contracts filed as exhibits. If none are filed, it is imperative that a comment be included in the letter about them. I would be willing to bet that the top officers of every company in this industry seeking public financing will have arrangements similar to those of Pyramid. The exhibit instructions to Form S-1 clearly call for this. I should like to refer you to Paragraphs 11 and 13(b) of the instructions as to exhibits.

In this particular case the only reference to the terms of the contract in the original prospectus consisted of a simple sentence back on Page 10, which reads as follows:

"On September 20, 1956, Messrs. Rosenthal and Loentham, entered into contracts of employment with the company under which their compensation was fixed at $39,000 per annum for each."

If the examiner in this case had not checked the contracts which were filed as exhibits, the prospectus would have failed to disclose the very important terms of the contracts. For example, the prospectus failed to disclose that the contracts were to run for 20 years -- practically

the balance of the lives (useful lives) of these men. The prospectus also failed to disclose that each of the men was to receive 10% of the aggregate gross proceeds of two programs produced by them. The prospectus also failed to disclose that under the contracts each man was to receive $200 per week for expenses which did not have to be accounted for, plus travel expenses of $100 per day. Finally, the original prospectus failed to disclose that under the terms of the contracts the company would pay the cost of insurance in the amount of $100,000 on each of these men, with insured's family to be beneficiary of one-half of the policy.

All of these terms were fully disclosed in the amended prospectus as a result of the following comment in our letter:

"The disclosure regarding the terms of the contracts with Messrs. Rosenthal and Loentham should include information regarding the provisions relating to (1) the duration thereof, (2) additional compensation, and (3) the $100 per day travel pay, as well as the insurance benefits."

The original prospectus gave no indication as to the per cent of gross income contributed by any of the seven or eight principal shows of the company. As a result of the conference which we held with the president of the company before we prepared our letter of comment, we learned, among other things, that "The Big Story" and "Treasury Men" were Pyramid's principal revenue producers. Accordingly, we included the following comment in our letter:

"Since 'The Big Story' and 'Treasury Men in Action' series contributed more than 15% of the gross volume of the business done during the last fiscal year, the percentage of gross volume contributed by each of these series should be indicated for this period as required by Item 9(a)."

As a result of this comment the prospectus now discloses that "The Big Story" and "Treasury Men" accounted for form 70 to 80% of the company's gross income.

Incidentally, this is another very important item to check when examining the prospectus of a television show producer, or a movie company, or a **Broadway producer. The information is specifically called for by Item 9 of Form S-1, which reads in part:**

> "If the business consists of the production or distribution of different kinds of products or services, indicate, in so far as practicable, the relative importance of each product or service, or class of similar products or services, which contributed 15% or more to the gross volume of business done during the last fiscal year."

The reason for this requirement, of course, goes to the fact that, all other things being equal, a company with gross revenues spread out over a number of products is a much sounder investment than one, like Pyramid, which depends very heavily on the revenue from one or two products. I would shudder to think what would happen to Pyramid if the public in general gets tired (as I most emphatically confess I am) of one-half hour drama shows dealing with crime. I

bear Pyramid no ill-will, but I do hope that somebody comes up with a substitute for that kind of show.

Page 10 of the original prospectus contained the statement: "The company is one of the largest producers of national television shows."

In order to tone down that statement our letter included the following comment:

"In connection with the statement in the first sentence, it should be pointed out, if such is the case, that the Registrant, accounts for a relatively insignificant proportion of the total industry's production, and that it is in competition with much larger companies with substantially greater financial resources."

As a result of this comment the company added the statement that it accounts for "a relatively insignificant proportion of the total industry's production, and is in **competition with much larger companies with substantially** greater financial resources."

The significance of this disclosure, of course, is that while large size is not necessarily an indication of strength, nor smallness an indication of weakness, nevertheless a company with smaller financial resources might be considered to be at somewhat of a disadvantage when things get rough. Further, the scope of its activities and its possibilities of future growth might well be limited by its relatively smaller financial resources.

Our letter of comment also had a short comment on the prediction, previously mentioned, that one-half hour series "would always be in great demand". It read, "The basis for the belief expressed in the third from the last sentence should be indicated, or the sentence should be deleted." Need I add -- the sentence was deleted.

Another comment read like this: "The percentage of gross income accounted for by national, regional and syndicated sales should be indicated."

Initial run of a program series commands the best revenue, whereas re-runs on a syndicated or regional basis may not be made on such a favorable basis.

There are terms in this industry such as "national distribution" and "syndicated distribution" which should be explained. National distribution is the first run of a picture or series. "The Big Story" would be purchased by a sponsor such as American Tobacco Co. The sponsor would have exclusive rights to the national distribution of the initial form of that story. The contract with American Tobacco Company, which was filed as an exhibit, provides that so long as "The Big Story" is being distributed nationally, Pyramid cannot do anything about distributing it locally (local distribution is on a syndication basis). It should be obvious that national distribution is much more profitable to the company than syndication. When a picture is syndicated, the company or the distributor sells it throughout the country to local stations.

As a result of the comment I mentioned a moment ago, the company included a table in the prospectus which showed clearly a downward trend in the proportion of total income which

is accounted for by national distribution, and conversely, of course, it indicated an increase in the amount of income received from syndicated sales. The investor could draw some logical conclusions from that because the trend was unmistakable. It might indicate that Pyramid is running out of ideas and before very long would have to depend upon the syndicated market, and then perhaps have no income unless it came up with a new show. That was the purpose of including a table of that nature in the prospectus.

One of the things that showed this filing was poorly prepared was the failure to give a coherent account of the history of the company. In a promotion such a history is important because it will often show that the promoters tried this or that thing that didn't work out, that certain people are no longer with the company, etc. That was the case here.

There was no reference to the fact that the original promoters was no longer an officer of the company. We found out by careful reading of the footnotes to the financial statements that the company had a contract with a man named Proctor to pay him about $20,000 per year. We wondered about that, and about other things such as royalties. There was no discussion at all of the fact that royalties, which constitutes a very heavy drag on earnings, would have to be paid. A large part of the company's future income could already be mortgaged in this way. So we included a paragraph in our letter which I shall read:

"Since the registrant was organized within the past five years, the information called for by Item 11 of Form S-1 should be set forth in the prospectus. Attention is also directed to the requirements of Item 20. In this connection, information as to the organization of the registrant, its succession to other entities, the information required by Items 11 and 20, and the information as to the general development of the business within the past five years required by Item 9(a), should be presented in clear, concise, and understandable fashion, as required by Paragraph D(a) of the general instructions to Form S-1."

That paragraph D(a) is quite often overlooked, as are the other general instructions. A lot of examiners think of the form in terms of the items. One of the acceleration standards observed by the Commission is whether the prospectus is clear, concise and understandable. That, of course, is an intangible thing.

As a result of this deficiency we got a much better presentation of the history of the company and the business, and among other things, it was pointed out that Rosenthal, Loentham and Proctor had a falling out and, in effect, Proctor had been bought out, with a consequent mortgage on future earnings.

There were other deficiencies, such as the fact that they were going to pay off very heavy loans. Another characteristic of this industry is the fact that bank financing is ordinarily not available. There is another TV show company in here right now which is very heavily in debt to so-called "loan sharks". Those "loan sharks" take up to 40% per year interest. Pyramid was not quite so badly off. In order to produce its shows, Pyramid had placed itself in the hands of a benevolent "loan shark", paying it only 15% a year interest.

Adjourned.