

INSTRUCTIONAL MANUAL
The Securities Act of 1933

FOREWORD

In the usual sense of the term this is not an instructional manual. It does not tell a staff member precisely what to do and how to do it.

The manual is a revision of the syllabus for a course in the Federal Regulation of the Security Business. The Commission authorized George S. Parlin of this office to give this course at the New York Stock Exchange Institute (later called the New York Institute of Finance) in 1937-8-9; and in the Graduate School of Law of New York University in 1946-7-8. The first time the course was given a syllabus was submitted to the General Counsel's Office for review. The present revision has not been so submitted.

The present revision was made by Newton Feldman in collaboration with Mr. Parlin and with the assistance of Mrs. Irene Duffy.

The present revision is one of the teaching tools for use in the Instructional Program of this office. A study of it will give an insight into the over-all pattern of the Act. It is not designed to give concrete answers to all of the problems which will be encountered in the enforcement of the Act. For those problems there is no substitute for clear thinking and a constructive imagination. At most, this manual can only alert a reader to some of the problems under the Act and to solutions which have, in the past, been suggested by past and present members of the staff of the Commission.

PAUL WINDELS, JR.
Regional Administrator
New York Regional Office

INSTRUCTIONAL MANUAL

I: INTRODUCTION TO SECTION 5

The prohibitions of Section 5 of the Securities Act of 1933 with respect to the offer, sale, and delivery after sale of a security relate to three different periods: (A) Before a registration statement is filed; (B) during the waiting period; and (C) after the effective date. In each period the prohibition is against the use of the mails or instrumentality of interstate commerce.

Any use of the mails is sufficient to establish jurisdiction. It need not be interstate. The intrastate use of an instrumentality of interstate commerce, such as the telephone or telegraph, is doubtful and should not be relied upon where the jurisdictional element can be satisfied by other means. Ordinarily the distribution of a security will involve a use of the mails. The mailing of a confirmation will be sufficient. In the following discussion it will be assumed, therefore, that there has been a use of the mails.

(A) Before Filing A Registration Statement

Subdivision (c) of Section 5 prohibits offering a security for sale unless a registration statement has been filed. Section 2(3) defines "offer for sale" to include any attempt to dispose of a security for value. The word "attempt" has been given the broadest possible interpretation and would include every step in the entire offering process. It would for instance include all, advance publicity and announcements which would have the effect of "warming up" or "softening up" the public in anticipation of a forthcoming issue. It would also include the obtaining of a list of prospective purchasers, or the solicitation of an indication of interest. Section 2(3), however, expressly excludes preliminary negotiations between an issuer and any underwriter. This is for the reason that until the underwriting arrangements are agreed upon, a registration statement cannot be completed.

This exclusion applies only to underwriters and not to members of the selling group or other persons not in privity of contract with the issuer. In the case of a secondary distribution on behalf of a controlling person, the exclusion would be applicable to his preliminary negotiations and agreements with an underwriter.

Rule 135, another exception, permits notice to be given to stockholders in pro rata offerings prior to the filing of the registration statement under certain stipulated conditions.

(B) During The Waiting Period

Between the filing of a registration and its effective date it is permissible to make an offer to sell the security provided that the offer is so conditioned that it cannot be accepted

until after the effective date. Section 5(a) prohibits a sale, a contract of sale or a firm commitment to sell prior to the effective date of the registration statement.

Subdivision (b) of Section 5 prohibits the use of certain prospectuses. A prospectus is defined in Section 2(10)* to include all communications in writing which offer a security for sale. The term “offer for sale” is defined in Section 2(3) to include any attempt to dispose of a security for value. Therefore, with two exceptions which are excluded by Section 2(10), any written communication used in an attempt to sell a security is a prospectus. An oral communication (otherwise than by radio or television) is not a prospectus and cannot violate Section 5(b). It may, however, violate Section 5(c) if a registration statement has not been filed. [*Section 2(10) reads in pertinent part: The term “prospectus” means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security -----.]

The two exceptions are: (a) written communications which are preceded or accompanied by an offering (final) prospectus; and (b) a “Tombstone” (a communication which states from whom a preliminary or final prospectus may be obtained and in addition does no more than identify the security, state the price, and by whom orders will be executed). Thus the ordinary “Market Letter” would be a prospectus unless it was preceded or accompanied by the final prospectus. Such communication, therefore, cannot be used during the waiting period.

During the waiting period the following types of prospectuses may be used:

(1) “Red Herrings”. Part I of the registration statement is a preliminary prospectus. Rule 433 specifies the legend which must be on the preliminary prospectus, and which is required to be printed in red. Consequently, the preliminary prospectus is usually referred to as a “Red Herring” prospectus. Usually it does not contain the offering price, conversion rate and other data related to the price. For this reason it is sometimes called the “Priceless” prospectus. Any brochure or other literature which precedes, accompanies, or follows the preliminary (Red Herring) prospectus would not come within the exception in Section 2(10)(a) and hence might be a prospectus which would violate Section 5(b).

(2) Expanded Tombstones. A communication meeting the requirements of Rule 134 may be used. This is sometimes referred to as an “expanded tombstone” as it permits something more than the “Tombstone exception” in Section 2(10)(b).

(3) Standard Statistics Cards. Rule 434 permits summary cards prepared by independent services such as Standard and Poors. They are required to be filed with the registration statement and are checked by the Division of Corporation Finance for accuracy and fairness.

(4) Summary prospectuses. Rule 434A permits the use of a summary of the prospectus under certain restricted conditions. It is required to be filed with the registration statement.

(C) After The Effective Date

Each offeree must be given the final prospectus with the first use of the mails in the offer, confirmation of sale, or delivery of the security after sale. The failure to do so would violate Section 5(b).

With this background, let us now consider the elements of a prima facie case of a violation of Section 5.

II: THE ELEMENTS OF A PRIMA FACIE CASE

A typical case under Section 5 might be as follows:

A boiler room telephones from New York City to a victim in Oshkosh, Wisconsin and talks him into buying 1,000 shares of worthless stock. It then mails him a confirmation. On receipt of payment, the boiler room mails the victim a stock certificate. A registration statement has not been filed. The telephone call and the mailing of the confirmation would violate both Sections 5(c) and 5(a). The mailing of the stock certificate would violate Section 5(a), but neither would violate Section 5(b).

(A) To establish a prima facie case of a violation of Section 5(a) the following elements must be proved:

- (1) A use of the mails or an instrumentality of interstate commerce.
- (2) A sale or a delivery after sale.
- (3) That the subject of the sale was a security within the definition in Section 2(1).
- (4) That a registration statement has not become effective.

(B) The establishment of a prima facie case of a violation of Section 5(b) would require one to show:

- (1) A use of the mails or an instrumentality of interstate commerce.
- (2) The transmittal of a prospectus.
- (3) That the prospectus does not meet the requirements of Section 10.
- (4) That the registration statement has been filed.

(C) To establish a prima facie case of a violation of Section 5(c) the following elements must be proved:

- (1) A use of the mails or an instrumentality of interstate commerce.
- (2) An offer for sale within the definition in Section 2(3).
- (3) That the subject of the offer was a security within the definition in Section 2(1).
- (4) That a registration statement has not been filed.

If these four elements are alleged, a prima facie case has been established. Ordinarily such allegations are not disputed under Sections 5(a), (b), or (c). The controversy usually is over the question of whether there is an affirmative defense.

The burden of proof is on the person who claims an exemption SEC v. Gilligan, Will & Co. 267 F2d 461; SEC v. Micro-Moisture Controls Inc. 167 F. Supp. 716, Aff'd as SEC v. Culpepper CCA, Oct. 59, 270 F2d 241, 21 FRD 164. An exemption should be strictly construed against the person who claims it.

(D) In examining a set of facts to determine whether there has been a violation of Section 5, the following questions are raised:

- (1) Has there been a use of the mails or an instrumentality of interstate commerce? (See III - (A) infra)
- (2) Has there been an offer for sale, a sale, or delivery after sale? (See III - (B) infra)
- (3) Is there a security? (See IV infra)
- (4) Has a registration statement been filed? (For discussion of the registration process, see IX infra)
- (5) Is the security exempt:--
 - (a) because it is part of an exempt class of securities? (See VI-B infra) or
 - (b) because of the small amount (Issues not exceeding \$300,000 exempted pursuant to Section 3(b)?) (See VI-C infra)
- (6) Is the transaction exempt? (See VII infra)

These questions will, be considered more in detail in the following pages.

III: PROHIBITIONS AND SPECIAL TYPES OF SALES

(A) Use Of The Mails And Interstate Commerce

The principles involved in the use of the mails or an instrumentality of interstate commerce are as follows:

(1) Use of the mails or interstate commerce

Both Sections 5 and 17 prohibit the use of the mails or interstate commerce. A transaction which does not involve a use of the mails or interstate commerce is not prohibited.

(2) Intrastate transactions

A use of the mails between two points within the same state comes within the prohibitions. An intrastate use of the telephone, telegraph or an interstate carrier, however, might not be prohibited.

(B) Offers For Sale Sales And Deliver After Sale

In addition to the definition of “Sale” and “Offer for Sale” under Section 2(3), it is necessary to consider their application to special types of sales listed below:

SPECIAL TYPES OF SALES

(1) “When Issued” and “When Distributed” trading

(a) “When Issued” and “When Distributed” Contracts. Contracts to sell a security “When, as and if issued” (or distributed) are not normally registered. Whether registration is not required because such contracts are not themselves securities or because they are issued in a transaction exempt under the second clause of Section 4(1) as not involving any public offering, need not be considered at this place. The important point here is that such contracts constitute a “sale” of the security which is the subject of the contract.

Therefore, if such security, or the transaction in which it is sold, is not exempt, then the sale of such contract may violate Section 5.

(i) Where the subject security is required to be registered, the sale of such security on a when issued or when distributed basis prior to the effective date of a registration statement would violate Section 5(a). If the contract were not preceded or accompanied by the final prospectus it would violate Section 5(b). If a registration statement had not been filed, the sale of such a contract would violate Section 5(c). However, the security which is the subject of the contract, or the transaction in which it is issued, may be exempt from the provisions of Section 5. The problem then arises: When does the exemption come into being?

(ii) Exempted securities may be sold on a when issued or when distributed basis at any time because the security is always exempt. For example, stock of a national bank, exempt under Section 3(a)(2); or the stock of a common carrier, the issuance of which is subject to the approval of the Interstate Commerce Commission under Section 20(a) of the Interstate Commerce Act, may be sold on a when issued or when distributed basis at any time.

(iii) Section 3(a)(9) presents a different problem. The exemption applies to the exchange of its securities by an issuer rather than to the security itself. Therefore it has been thought that the exemption did not come into being prior to the time when the old security could be deposited in exchange for the new one. There the sale of the new security on a when issued basis prior to the time when deposit of the old security is permissible would violate Section 5.

(iv) Section 3(a)(10) does not exempt a security until the entry of a court order approving the fairness of the plan of exchange of securities. Therefore a when issued or when distributed contract cannot be sold until the entry of such an order. When issued trading may continue during the pendency of an appeal or until the order of approval has been stayed, vacated or reversed.

(v) The first and third clauses of Section 4(1) would exempt a distribution through a dealer by a person who is not in a control relationship to the issuer. Hence, prior to such distribution there may be when issued trading in the security to be distributed.

(vi) Mergers, consolidations and sales of assets may not require registration because of Rule 133. In general, when issued trading is permissible as soon as all of the conditions to the compliance with the Rule have been met. Ordinarily, when issued trading may commence as soon as the stockholders have met and voted to approve the plan. However, if the stockholder's approval were conditional when issued trading could not commence until all of such conditions had been satisfied.

(vii) Spin-offs and stock dividends are governed by the same broad principles. In a "Spin-off", a parent corporation declares a dividend to its stockholders payable in the stock of a subsidiary corporation. Such a dividend would not constitute a sale within the principles set out in 1933 Act Release No. 929. Hence the stock of the subsidiary corporation would not be required to be registered. Ordinarily such a dividend would be declared by the Board of Directors and "When Issued" trading would be permissible after the declaration of the dividend. Sometimes, however, the dividend is declared contingent upon the happening of some other event, such as the approval of stockholders. In such a case, when issued trading is only permissible after all of such contingencies have been satisfied.

(2) Short Sales

Short sales are treated as “When Issued” sales. A short sale prior to the effective date of a registration statement involves a violation of Section 5 if it is intended to cover the short sale by a delivery of registered stock after the registration statement becomes effective.

(3) News Articles

True news articles do not violate Section 5. However, if such articles are paid for directly or indirectly they would be an attempt to dispose of a security and hence would be a sale in violation of Section 5. The dissemination of press releases by the issuer or an underwriter prior to the filing of a registration statement would constitute an offer for sale in violation of Section 5(c). (SEC v. Arvida 169 F Supp 211)

(4) Offers to Buy

The purpose of the prohibition against offers to buy unregistered securities is explained in the Committee Report (H. R. Rep. No. 85, p.11) to be to prevent dealers from making offers to buy between the period of the filing of the registration statement and the date upon which a statement becomes effective. The report pointed out that “otherwise the underwriter, although only entitled to accept such offers to buy after the effective date of the registration statement could accept them in the order of their priority and thus bring pressure upon dealers who wish to avail themselves of a particular security offering to rush their orders to buy without adequate consideration of the nature of the security being offered.”

In view of the purpose indicated in the report, it seems clear that offers to buy unregistered securities made by an issuer would not be prohibited; and generally that offers to buy may be made to any person who would not himself be prohibited from making an offer to sell such unregistered securities. For instance, an issuer may make an offer to sell to a prospective underwriter by reason of the “preliminary negotiations” exception in Section 2(3); therefore, such underwriter may approach the issuer in the first instance with an offer to buy. Also offers to buy may be made to persons whose offers to sell in a specific case would be exempt under Section 4(1) as where a dealer offers to buy a security from a customer who is not an issuer, underwriter or dealer. Also where an issuer makes a solicitation of tenders to its own security holders, there would be no violation of Section 5(c). There might, however, be a violation of Section 10(b) of the Securities Exchange Act of 1934 if the disclosures required by Rule X-10-(b)5 were not made. As a rule of thumb such disclosures should include as a minimum a balance sheet and profit and loss statement as of the close of the last fiscal year, plus such further disclosures as are needed to prevent such statements from being misleading. Offers to buy shares of another corporation would not require registration because of the exemption under Section 4(1). A solicitation of tenders to the shareholders of another corporation by an issuer raise questions under state but usually not Federal law. However, since an underwriter may not sell to dealers prior to effective registration, dealers may not offer to buy from underwriters.

(5) Acceptance of an offer to sell

The acceptance of an offer to sell is not an offer to buy and, therefore, would not violate Section 5(c). Hence, if a customer offers to sell an unregistered security to a dealer, the acceptance by the dealer of such offer would not violate Section 5(c).

(6) Offerings exclusively abroad

Use of the mails or interstate commerce in connection with an offering made exclusively abroad does not violate Section 5 because the offering is exempt under Section 4(1), Clause (2). The term “public offering” as used in Section 4(1), Clause (2), has been interpreted not to include offerings made exclusively abroad where the securities have come to rest in the hands of ultimate investors abroad.

(7) Offerings on the floor of an exchange

In the case of an offering on the floor of a registered exchange, Section 5(b)(2) is satisfied by the delivery of a supply of prospectuses to the exchange. See Rule 153

(8) Bonuses

Stock given as a bonus in connection with the sale of another security or of merchandise is “sold”. (See the fourth sentence of Section 2(3) which defines the term “sale” to include stock given as a bonus on account of the purchase of anything).

(9) Dividends

Securities issued as dividends are not “sold” and registration is not required. (See Security Act Release No. 929)

(10) Issuance of rights

An issuance of rights without consideration is not a sale of the right but it is an offer for sale of the underlying security. Therefore the underlying security is required to be registered. Usually the registration statement includes the rights to cover the possible sale of the rights themselves for a consideration by controlling persons.

(11) Free distribution of assessable stock

The free distribution of assessable stock involves a sale of the stock. Gold Producers, Inc. 1.S.E.C. 1 (1933). An exemption in the sale of assessable stock may be available under Regulation F of the Securities Act of 1933) which includes provisions covering the levying of assessments, and the sale of such stock upon default.

(12) Stamped bonds indicating a reduction in interest

A solicitation of consents of the bondholders to a stamping of their bonds to indicate a reduction in interest would involve a sale of the stamped bonds. SEC v. Gas & Electric Company et al., (S.D.N.Y., 1938) 1 SEC Jud. Dec. 578, 24 F. Supp. 899, aff'd in CCA 2, 1938, 1 SEC Jud. Dec. 592, 99 F. 2d 795.

(13) Mergers, consolidations, and sales of assets

Statutory mergers, consolidations and sales of assets are effected by a vote of security holders binding upon all security holders assenting and non-assenting alike (except insofar as dissenting security holders may be entitled to a statutory right of appraisal) do not involve a sale. National Supply Company v. Leland Stanford, Jr., Univ. (S.D. Cal. 1942) 2 SEC Jud. Dec. 659; 46 Supp. 389 Aff'd. CCA 9, 1943. However, the subsequent resale of securities received in such a distribution may involve a sale requiring registration. See Rule 133 under the 1933 Act. SEC v. Micro Moisture Controls, Inc. rearg. 167 F. Supp. 716, Aff'd as SEC v. Culpepper, CCA, Oct. '59 270 F 2d 241, 21FRD 164. Matter of Great Sweet Grass Oils Ltd., 1934 Act. Rel. No. 5483 (1957) Aff'd. 256 F. 2d 893 (CADC June 24, 1958).

(14) Convertible securities

Any offering of a security immediately convertible into a second security (as preferred stock convertible into common) involves an offering of the second security (the common). Where one security is immediately convertible into the other, both are registered at the time of the offering of the convertible security. Where conversion cannot be effected until a date subsequent to the offering of the convertible security, registration of the security into which conversion is made is not required prior to the date when conversion is permitted. If an exemption under Section 3(a)9 is available at the time of conversion, an up-to-date prospectus need not be delivered.

(15) Solicitations of waivers of pre-emptive rights

Whether a solicitation of waivers of pre-emptive rights is really an attempt to cut down the number to whom an offer must be made or whether it is a disguised attempt to sell, a new security is a question of fact. When made at a time when no public offering is definitely contemplated, however, a sale would not seem to be involved.

(16) Pledge of securities

In the ordinary pledge transaction the parties intend that at maturity the loan will be paid and the collateral returned to the pledgor. Thus such a commercial transaction would not involve an "Attempt to dispose of a security" and, hence, would not be a sale. If, however, the pledge is the first step in a process of distributing the pledged securities, the pledge might well be a sale which would require registration. Moreover, if the collateral is taken under circumstances where it is contemplated that the payment of the debt will be effected by realization on the collateral, the sale by the pledgee would be an

underwriting transaction which would require registration. SEC v. Guild Films Co., Inc. (178 Fed Supp 418, S.D.N.Y. Nov. 13, 1959).

(17) Fractional shares

In connection with stock dividends a question frequently arises with respect to the sale of fractional shares. For example: Corporation A declares a three per cent stock dividend. The holder of 50 shares would be entitled to one and one-half shares. Under the laws of most states a corporation may not issue a fraction of a share. Corporation A, therefore, wishes to give its stockholders the right to buy an additional fraction in order to make up a full share. Of course, Corporation A could sell the number of full, shares representing the aggregate of the fractional shares and pay the stockholders entitled to receive fractional shares their part of the proceeds; or, if the cash position of the corporation were strong enough it could simply provide for a dividend in full shares and cash equal to the value of any fractional shares. However, if full shares are to be sold on the market, registration, or at least qualification under Regulation A, would be required.

As a matter of practice, since the number of fractional shares could not exceed the number of stockholders, and presumably would be considerably less if a majority of holders held round lots of multiples of 100 shares, the whole matter has been considered de minus and no objection is raised if the matter is handled in the following manner:

Corporation A delivers to its transfer agent the number of full shares called for by the stock dividend. In the foregoing example this would be three per cent of the outstanding shares. The transfer agent then offers to purchase or sell fractional shares as agent for the stockholders in an amount necessary to round out holdings to an even share. The transfer agent will then match up buy orders and sell orders as far as practicable and will buy or sell in the open market an amount required to balance the operation. Should all of the stockholders desire to purchase the required fraction, the transfer agent may have to purchase additional stock in the open market. However, as indicated above, the amount so purchased cannot possibly be substantial and usually will, be negligible.

IV: WHAT IS A SECURITY?

(A) Types of Securities

The prohibitions of Section 5 apply only to "Securities". That term is defined in Section 2(1) of the Act. The definition includes all of the usual forms of securities (such as stock, bonds, debentures, voting trust certificates, equipment trust certificates, receivers certificates, etc.) These comprise a large majority of all, of the cases handled in the New York Regional Office. However, the definition includes a few less usual types of securities which warrant some comment.

(1) Pre-organization Certificates and Subscriptions

A subscription for stock in a corporation to be formed in the future usually involves the sale of a security. There is some doubt, however, whether such a subscription is a security unless it is in writing.

(2) Evidence of Indebtedness

(a) Open Accounts. An indebtedness evidenced only by the books of the issuer as an open account, does not constitute a security.

(b) Interest Coupons. An overdue interest coupon detached from a bond would be an evidence of indebtedness and hence a security.

(c) Travel Book Stamps. Travel Book Stamps redeemable either in cash or for travel accommodations, are considered to be securities. On the other hand, trading stamps given with the purchase of merchandise and redeemable for articles (other than securities) to be selected from a catalogue, are not treated as securities. (See Securities Act Release No. 3890)

(3) Guaranties

A guaranty is itself a security. Thus a bond of A, guaranteed by B, is, in effect, two securities: one, the bond of A; and the other the guaranty of B. Ordinarily, however, both securities would be included in the same registration statement. In that case the registration statement would be signed by A and by B.

(4) Receipt for a Security

The ordinary certificate of deposit issued by the depository of a security holders protective committee, is a security. However, it is considered that a receipt for a security which evidences no more than the obligations of an ordinary bailee would not be a security. Thus the ordinary window ticket issued by a transfer agent, evidencing the deposit of stock for transfer, would not be a security. [Handwritten note: Difference is that the bailee merely holds but protective committee is to take action to enforce rights.]

(5) Investment Contracts

The terms "investment contracts" and "certificates of interest or participation in any profit-sharing agreement" are in the nature of catch-all phrases to include within the term "security" unusual types of instruments. Any particular plan may fall within both of such terms. The principal difference is that a "certificate of interest or participation in a profit-sharing agreement" must be in writing while an "investment contract" may be oral.

A contract for the purchase of a commodity without any provision for resale (such as the ordinary commodity "futures" contract) is not a security. However, a contract for the sale of 10,000 grains of gold when, as and if produced with the further proviso that the gold would be held by a trustee and sold for the account of the purchaser involves the sale of a

security. Similarly, a contract for the sale of a specified number of barrels of oil was held a security where the purchaser did not intend to take actual delivery but rather the proceeds of the sale of the oil and where actual delivery would have been impracticable and unprofitable for the purchaser. S.E.C.v. Crude Oil Corporation of America, 17 F. Supp. 164 (W.D. Wisc. 1936), 93 F 2d 844 (7th Cir. 1937). The contract in this case specified that actual delivery was intended but provided that if the purchaser did not demand delivery the seller was authorized to dispose of the oil and remit the proceeds to the purchaser.

Contracts for the sale of pairs of breeding animals which provide for their care and ranching have been held to be securities. The leading case on such contracts is S.E.C. v. Payne, 35 F. Supp. 873 (1940).

Part interests in a ship sold under an agreement which provided that the seller was to retain full control and management of the ship and dividing the profits pro rata was held to be a certificate of interest or participation in a profit-sharing agreement. S.E.C. v. Pyre et al., 39 F. Supp. 434 (D. Mass. 1941).

In S.E.C. v. C. M. Joiner Leasing Corp., 320 U.S. 352, 88 L. Ed. 93, 64 S. Ct. 120 (1943), oil leases and assignments were held to be investment contracts and hence securities.

In W. J. Howe Company, 163 ALR 1043, 66 S. Ct.1100 (1946) the court rejected “the suggestion of the Circuit Court of Appeals, 151 F. 2d at 717, that an investment contract is necessarily missing when the enterprise is not speculative or promotional in character and where the tangible interest which is sold has intrinsic value independent of the success of the enterprise as a whole.” It then stated that the test is “whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.” It accordingly held that a sale of orange groves with a contract for their care, cultivation and harvesting constituted an investment contract and hence a security even though 15% of the purchasers bought the land without the contract for care and operation.

In addition to the W. J. Howey case, mentioned above, there are a number of cases involving pecan groves, tung trees, etc. Such cases are collected in the Tenth Annual Report of the Commission at page 25. The principle involved is that a sale of real estate coupled with a contract for the planting, care and harvesting of orchards or groves is the sale of an investment contract and hence of a security.

(a) When Issued Contracts.

The customary form of when issued contracts is not itself a security. It is, however, a sale of the security which is the subject of the when issued contract.

(b) Puts, Calls and Straddles.

Puts, calls and straddles are transferable options. A put is an option to sell; a call is an option to buy; and a straddle is an option to do either one or both. It has been thought that a put was not a security but that a call, while not itself a security, was an offer by the optioner for sale of the security under option. A staff memorandum, however, reached the conclusion some years ago that puts, calls and straddles are in themselves securities, and the Put and Call Dealers were required to register under the 1934 Act. (See Memorandum relating to broker-dealer registration under the 1934 Act from Irving Pollock to Milton Kroll, re: Gordon B Todd about August, 1948). In this aspect there may be a difference between the 1933 and 1934 Acts, since under the 1934 Act, Put and Call Dealers are required to be registered; the question as to whether puts and calls are securities for the purposes of the 1933 Act cannot be considered to have been definitely settled. It may be that they are securities, but transactions in them are exempt under Section 4(1).

(c) Limited Partnership Interests.

A general partnership agreement is not a security. However, the interest of a limited partner who merely puts money into the venture with no voice in the day-to-day conduct of the business is an investment contract and hence a security. Theatrical ventures, for example, are commonly financed by the public offering of limited partnership interests. In such enterprises the promoters and producers are the general partners and the limited partners have no control whatever of the production. Recently this type of financing has been used to finance real estate deals. In the real estate field this type of operation is known as a syndication.

(d) Employee Participation Plans.

Employee pension and profit-sharing plans may involve the offering of an investment contract and hence require the registration of a security.

In general, a non-contributory or an involuntary plan does not involve a security. However, a payroll deduction plan which provides that the employees contribution could be used to purchase securities of the employer in the open market would constitute a security.

(e) Installment Purchase Contracts

The provision that payment for a security may be made in installments does not of itself make an installment purchase contract a security. The Monthly Investment Plan of the New York Stock Exchange (M.I.P.) does not constitute a security. However the periodic payment plans of investment companies do involve a security in addition to the security being purchased.

(f) Contracts involving real estate

A deed conveying title to real estate is not a security. However, when real estate is sold with a contract for its management by someone other than the buyer it may be a security.

(6) “Any other interest or instrument commonly known as a security.”

This catch-all phrase in the definition of a security in Section 2(1) was designed to include any unusual type of interest or instrument which had been held to be a security by any State or Federal court or any state Blue Sky Commission. In alleging that a security is involved it is not necessary to specify whether it is an investment contract or a certificate of interest in any profit-sharing agreement; or an interest or instrument commonly known as a security. A given instrument may qualify as a security under each of such classifications.

(7) Receipts for Voluntary Contributions

Receipts for voluntary contributions are not securities. For example: A bondholders protective committee solicited from the bondholders voluntary contributions to the expense of the committee of 50 cents per bond. Every bondholder, whether or not he contributed, would share in the results obtained by the committee. The receipts evidencing receipt by the committee of such voluntary contributions was not a security. [Handwritten note: A window ticket is not a security but certificate of deposit from a protective committee is a security.]

(8) Commodity Futures

The ordinary contract for the future delivery of commodities is not a security.

(9) Variable Annuity Contracts

Variable annuity contracts have been held to be a security by the U. S. Supreme Court; see S.E.C. v. Variable Annuity Life Insurance Company, 359 US 65, 79 Supreme Court 618, March 23, 1959.

(B) Changes In Securities Provisions

(1) Modifications Creating a New Security

The question of what modification in a security makes it a new or different security comes up in many different settings. In some cases the question is whether a new registration under the Securities Act of 1933 is required or whether a post-effective amendment will be sufficient. In others it is a question of whether a payment, made in the course of soliciting modifications of the security in question, will destroy an exemption under Section 3(a)(9) and hence require registration. Similar questions are raised under the Securities and Exchange Act of 1934 and the Trust Indenture Act of 1939. It is difficult to lay down hard and fast rules which will apply to all such situations. For the purposes of this discussion it will be sufficient to consider some of the situations which have arisen under the Securities Act of 1933 and the solutions reached.

The leading case on the subject is S.E.C. v. Associated Gas & Electric Co., 24 Fed. Sup. 899, 1 SEC Jud. Dec. 578, S.D.N.Y. In this case the holders of investment certificates were given an alternative offer to receive 20% in cash if they extended the maturity of their certificates to 1939, or an additional 2% if they extended the maturity to 1943. The election was to be evidenced by the stamping of a legend on the certificate. The certificates so stamped were held to be a new security which required registration under the Security Act of 1933. Similarly the modification or extension of a mortgage will usually constitute a new security as will a change of investment policy or a change in the method of valuing the underlying security in an investment company.

Where A purchased the assets of B and guaranteed the bonds of B in consideration of a reduction of the interest rate and the subordination of the bonds to a bank loan, the sale of a non-exempt security would be involved. Probably the correct analysis of this situation would be that a bond of B and a guarantee of A were offered in exchange for the old bonds of B. Unless an exemption were available for the new bonds of B under Section 3(a)(9), two securities would have to be registered: to wit, the new bonds of B and the Guaranty of A.

A similar result would be reached where a preferred stock was modified to eliminate certain rights in the event of default including the right to accumulated dividends and the right to elect a majority of the board of directors. A new class of stock would be offered.

(2) Modifications Not Creating A New Security

On the other hand, in a case where a deposit agreement contained provisions for its extension, an extension pursuant to such provisions would not create a new security. Nor would the cancellation of a guarantee on a bond constitute the issuance of a new security. A change in the par value during the offering of stock subject to a registration statement would not require the filing of a new registration statement for the unsold balance; a post effective amendment, however, would be required. A case involving a reduction of the sinking fund from \$400,000 to \$200,000 pursuant to a provision of the indenture would not create a new security so as to require the qualification of the indenture under the Trust Indenture Act. Similarly an amendment of an indenture to permit the bondholders to raise the interest rate did not create a new security for the purposes of the Trust Indenture Act of 1939. This would be so for the reason that the bondholders were being given an additional right and were not being asked to give up any of their rights. However, if the change in the indenture were to permit an increase in the compensation of the officers and directors of the issuer or to permit payment of expenses or compensation of the trustee, such amendment would create a new security since it would reduce the rights of the bondholders. .

It may be that the problems under the Trust Indenture Act of 1939 were resolved on the basis that there was no need to amend the indenture when the security holders were only given additional rights. This might be so particularly if there were to be no further sales of the security. Probably, therefore, they should not be considered as a precedent on the question of whether an additional right creates a different security. For the present

purposes it is sufficient to point out that a difference may exist as between a change in conditions which creates a new security for the purposes of the Securities Act of 1933 as distinguished from the Trust Indenture Act of 1939.

V: ADVERTISEMENTS

(A) Advertising By Underwriters, Issuers And Others In Similar Position

An advertisement may be a prospectus within the definition of Section 2(10) if it offers a security for sale. As indicated above, the term “offer for sale” is defined in Section 2(3) to include “any attempt to dispose of a security for value.” It should be noted, however, that there is a distinction between advertisements used in connection with a distribution, and trading or institutional ads.

Distributional advertisements may be classified according to the time of publication.

(1) Prior to filing the registration statement any advertisements in aid of a distribution would violate Section 5(c).

(2) During the waiting period such an advertisement would violate Section 5(b) unless it came within one of the following provisions:.

(a) The “Tombstone” exception in Section 2(10)(b).

(b) The “Expanded Tombstone” permitted under Rule 134.

An example of one of the problems which arises with respect to advertising is presented here:

An issuer filed a registration statement for an issue of securities to be offered through underwriters. Following the effective date of the registration statement, efforts to market the issue were not wholly successful and a substantial amount of the securities remained in the hands of the underwriters and dealers. At this point the issuer published an advertisement which received wide newspaper and magazine circulation and which included data purporting to show reserves of raw materials in terms of estimated future dollar realization per share. The advertisements took the conventional form of a product advertisement except for the inclusion of calculations of per-share asset values.

The Commission brought an action to enjoin further publications of the advertisement on the theory that its content and use, at a time when the existence of unsold allotments in the hands of underwriters and dealers indicated clearly that the distribution of the registered securities had not been completed, involved a violation of Section 5 and 17(a) of the Securities Act.

The above and nine other examples of similar situations can be found in Securities Act of 1933 Release Number 3844.

(B) Trading Advertisements

An advertisement soliciting transactions by a broker or dealer (not in aid of a distribution) might be exempt from the prohibitions of Section 5 by virtue of the third clause of Section 4(1). This will, be discussed in detail under the heading of "Exempted Transactions." At this point it will be sufficient only to point out that within 40 days of the first day of the public offering by the issuer or underwriter, the advertisement of a broker or dealer, even though he were not a member of the underwriting or selling group, would be subject to the same limitations as an advertisement in aid of the distribution. However, if the advertisement meets the requirements of the tombstone ad except that it also contains one of the following phrases it would not be objectionable:

"For banks, brokers and dealers only."

"We maintain markets in."

(C) Institutional Advertising

Institutional ads, not published in an effort to dispose of any particular security, do not violate Section 5. However, if the advertiser has a particular security to distribute, the advertisement may violate Section 5 even though the security is not identified. For example: An underwriter is distributing shares of A B C Electronics Corporation. If he publishes an advertisement referring generally to the electronics industry without mentioning the A B C Electronics Corporation by name, he may violate Section 5 if persons responding to the ad are offered shares of such corporation.

A special variation of this problem is presented by the advertisement of mutual funds. A plan sometimes called "The Weisenberger Plan" is not considered objectionable. A dealer under this plan would advertise mutual funds without mentioning a particular fund by name. Persons who responded to the ad would then be given a questionnaire designed to bring out the type of fund in which he might be interested. Upon receipt of the completed questionnaire, the dealer determines which of a number of different plans will best meet the requirements specified in the questionnaire. The dealer will then furnish the prospective customer with a copy of the offering prospectus on each issue which he proposes to offer.

It should be noted that this is a three step plan: (1) An institutional ad is published. (2) A questionnaire is obtained prior to the discussion of any particular plan. (3) An offering prospectus is furnished to the customer before any effort is made to sell him any specific security.

The advertising and promotional literature developed by mutual funds has received special attention in a pamphlet outlined "Statement of Policy" which was issued by the Securities and Exchange Commission, November 5, 1957 (as amended).

Any issuer engaged in a distribution of securities may continue to advertise its product or services in accordance with its regular advertising program. Similarly it may follow any established custom of publishing a notice of the declaration or payment of a dividend, or an announcement of any matter of an operational nature not related to the distribution of securities.

(D) Advertising of Intrastate Issues

The advertisement of issues exempt under Section 3(a)(11) presents one special problem.

If an intrastate offering is made without registration in reliance upon an exemption under Section 3(a)(11), an offering of any part of the issue to any non-resident will, defeat the claim of an exemption. Since an advertisement may be read by non-residents as well as residents it would be impossible to prove, after the publication of such an advertisement, that the exemption was available.

To meet this dilemma it is usual, to insert in an advertisement of an issue for which an intrastate exemption under Section 3(a)(11) is claimed, a line reading substantially as follows:

"This issue is offered * * only to bona fide residents of the state of incorporation."

Such a limitation of the offering advertisement would be sufficient to prevent the advertisement from itself destroying the claimed exemption.

VI: EXEMPTED SECURITIES

Exempted securities are of two types: exempted classes of securities exempted under Section 3(a); and offerings not exceeding \$300,000 exempted by rule or regulation pursuant to Section 3(b).

(A) Scope of Exemption

The exemption of securities under either Section 3(a) or (b) is only an exemption from the registration and prospectus requirements of Section 5. It is not an exemption from the anti-fraud provisions of Section 17 or the civil liability provisions of Section 12(2) except for securities exempt under Section 3(a)(2).

(B) Section 3(a)

Eleven classes of securities are exempted by Section 3(a). Of these only Sections 3(a)(9) and 3(a)(11) (which are mentioned in their proper order below) require extended comment.

(1) Section 3(a)(1), Securities publicly offered prior to July 27, 1933.

Section 3(a)(1) exempts securities offered to the public prior to the effective date of the Act but not a new offering after that date by the issuer or an underwriter. A quarter of a century having passed since the passage of the Act this exemption is rarely available.

An exemption under Section 3(a)(1) is not available in the following situations although it is sometimes claimed:

(a) Additional shares of an outstanding class

For example: Common stock of Corporation A has been outstanding since 1900. In 1955 Corporation A offered to its stockholders the right to subscribe to an additional share for each share held. Such an offering would not be exempt and registration would be required.

(b) Treasury stock

Suppose, for example, that Corporation A sold 1,000,000 shares of common stock in 1920. Between 1935 and 1940 it reacquired and held alive in its treasury, 203,000 of such shares. In 1959 Corporation A reoffers such 200,000 shares of treasury stock. The exemption will not be available and registration will, be required since it is a new offering by the issuer. (In this connection it should be noted that the term "Security" is defined in Section 2(1) to include treasury stock.)

(c) Sales by a controlling person

Suppose, for example, that a controlling person of Corporation A has held a block of stock since 1920. In 1959 he wishes to make a secondary distribution of such block through a dealer. The exemption would not be available because the dealer in distributing for a controlling person would be an underwriter and a new distribution by an underwriter is not exempt.

(2) Section 3(a)(2) Governments, Municipals and Bank Stocks.

The securities commonly referred to as "Governments and Municipals" as well as securities issued by national and state banks are exempted by Section 3(a)(2). Two situations require comment under this exemption:

The "E Bond" racket. A promoter advertised that he would sell a security representing an investment in a speculative enterprise but that the U.S. Government would guarantee the return of the full amount within 10 years. The plan was to buy an "E Bond" of the U.S.

Government for \$75 which would be paid off in 10 years at \$100 and in the meantime to use the difference to finance a speculative venture. It was claimed that the exemption in Section 3(a)(2) was applicable. On such facts a consent injunction was obtained in the case of S.E.C. v. W. Godfrey Haynes, (E.D. Pa.) Litigation Release No. 432 dated January 12, 1948.

Federal Savings & Loan Association Accounts. The accounts of Federal Savings & Loan Associations are securities within the definition of that term in Section 2(1). They are exempt from the registration requirements of the Securities Act of 1933, however, pursuant to Section 3(a)(2). They are not “exempted securities” within the definition of Section 3(a)(12) of the Securities Exchange Act of 1934. Therefore, a person soliciting such accounts is required to be registered as a broker-dealer pursuant to Section 15(a) and (b) of the 1934 Act even though he is selling only a security exempt from registration under the 1933 Act. (A Federal Savings & Loan Association account may also be exempt under Section 3(a)(5) of the 1933 Act. The result would be the same.)

(3) Section 3(a)(3), Nine Months Commercial Paper.

Section 3(a)(3) exempts certain securities with a maturity of not exceeding nine months which are issued in a current transaction. There is a legislative history (H.R. Rep. No. 85, 73rd Cong., 1st Sess. 1933) to show that the exemption was only intended to cover commercial paper meeting the requirements for rediscount with the Federal Reserve Bank. In S.E.C. vs. Sire Plan the position was taken that Section 3(a)(3) did not exempt notes issued in connection with the purchase of real estate. (See the brief filed by the N.Y. Regional Office.)

(4) Section 3(a)(4), Non-profit Association.

Section 3(a)(4) exempts securities of certain non-profit organizations. This exemption is not applicable to such issuers if they are organized for social, athletic or recreational purposes. Organizations such as the Harvard Club of New York City, the New York Athletic Club and Phi Delta Theta national fraternity, and various golf clubs and swimming pools have been advised that the exemption was not available to them and that their securities should be registered unless some other exemption was available.

The principal argument arises over the issue of whether such issuers are organized for “fraternal” purposes. On the basis of decisions under the tax laws the term has been strictly construed as limited to organizations providing death benefits to its members.

(5) Section 3(a)(5), Building & Loan Associations etc.

For a discussion of the problem of solicitation of accounts for Federal Savings & Loan Associations see Par. 2, *supra*.

(6) Section 3(a)(6), Common Carriers.

Securities of common carriers the issuance of which is subject to the approval of the Interstate Commerce Commission, are exempted under Section 3(a)(6). Section 20(a) of the Interstate Commerce Act became effective in 1920. The principal problem under this exemption arises when a controlling person makes a secondary distribution of stock issued prior to 1920. Since, at the time of issuance, such issuance, was not subject to the approval of the ICC, the exemption would not be available and the secondary distribution by a controlling person through an underwriter would require registration.

(7) Section 3(a)(7), Receivers Certificates.

The exemption for receivers certificates under Section 3(a)(7) does not require any comment.

(8) Section 3(a)(8), Variable Contracts.

Ordinary annuity contracts issued by an insurance company are exempt under Section 3(a)(8). The new variable annuity contracts, however, have been held by the Supreme Court of the United States S.E.C. v. Variable Annuity Life Insurance Co., 359 US 65, 79 Supreme Court 618, March 23, 1959 to be a security not exempt under Section 3(a)(8).

(9) Sec. 3(a)(9) Securities Issued in Exchanges.

(a) The issuers must be identical.

The persons with whom the security is to be exchanged must be security holders of the issuer. For this purpose a parent company cannot be regarded as the same issuer as its subsidiary. Similarly, an exchange of stock of Company A for the stock of Company B is not within the exemption, even though the new A stock represents an interest in a company with the same assets as previously belonged to B. Securities of a corporation would not be exempt if exchanged for deposit receipts issued by a committee, since different issuers would be involved. Likewise, voting trust certificates exchanged for corporate securities are not exempt under Section 3(a)(9).

(b) Extensions of Voting Trust and Deposit Agreements.

Voting trust certificates issued under different trust agreements do not have the same issuer. Consequently, the exemption does not apply to voting trust certificates issued by a protective committee in exchange for its outstanding certificates of deposit even though the same persons acted both as voting trustees and as members of the protective committee.

When a trust agreement has no provisions for its extension, extension is regarded as creating a new agreement and a new issuer. Thus the offer of extension does not come within the exemption. Extension of such an agreement or of a deposit agreement pursuant to the provisions of the agreement, however, has been held to make the outstanding

securities issued under the agreement exempt. (See discussion under VII C(14): Special Problem on Voting Trust Certificates)

(c) Exchanges Involving Guaranteed Securities.

(i) Securities issued by A are offered in exchange for outstanding securities of A guaranteed by B. An exemption under Section 3(a)(9) is available.

Upon acquisition by A of the guaranteed security the guaranty of B is extinguished by operation of law. This would be equally true if the guaranty were on a separate instrument which was not physically surrendered to A. Hence it is immaterial, both to A and to the security holder whether or not the guaranty is surrendered. It seems clear therefore that the offer of exchange is, in practical effect, merely an offering of a security of A in exchange for another security of A.

(ii) Securities issued by B are offered in exchange for securities issued by A and guaranteed by B. An exception under Section 3(a)(9) is not available.

When B acquires the outstanding security of A, it receives an obligation which it can enforce against A in addition to the cancellation of its own liability as a guarantor. The offer of exchange, therefore, would seem to be, in practical effect, an offer to exchange a security of B for two securities: (1) the security of A; and (2) the guaranty of B. As stated above the exchange of a security of B for a security of A is not exempt under this section.

(iii) Securities issued by A and guaranteed by B are offered in exchange for securities issued by A. The exemption is available with respect to the security to be issued by A; but the guaranty of B will have to be registered.

A guaranteed security, is, in effect, two securities. Hence, two registrations are required unless one or both securities are exempt. The security to be issued by A is offered in exchange for another security issued by A and hence the exemption is available. But the guaranty (which is issued by B) is offered in exchange for a security issued by A and since a security so offered is not exempt it must be registered even though the primary security is exempt from registration.

(d) The offering must be “exclusively” in exchange.

The exemption will not apply where the transaction as a whole involves an issuance of securities otherwise than in an exchange with the issuer’s security holders. Thus, if as part of the same transaction, any part of the issue is sold for cash or intended to be sold for cash or delivered to creditors of the issuer who are not “security holders” thereof the exemption does not apply to any part of the issue. Even though the part not exchanged with security holders is offered only in a private offering, or only in foreign countries or only to residents of the state of incorporation of the issuer, or is to be registered, the exemption is inapplicable (See Release No. 2029.) It is immaterial that the unexchanged

portion is to be sold for cash only to existing security holders. A sale for cash is not an exchange within the meaning of this section.

(e) Issuance of part in transactions not involving sales.

In a statutory merger where part of the issue was exchanged with security holders of the corporation into which the constituent corporations were merged, while the remainder was issued, pursuant to the plan of merger, in transactions which did not involve sales, the securities exchanged were entitled to the exemption. Similarly, if the unexchanged portion of the issue is the subject of a gift, a stock dividend, or is pledged as collateral to secure bona fide loans, the exemption is available; provided, however, that in the latter case the pledgees do not acquire the collateral with a view to its distribution. This does not mean that the exemption will necessarily be destroyed if securities of the same class as those exchanged are at any time sold, or exchanged with other than security holders. But such a sale or exchange must be in a different transaction and not part of the same general plan. (See later discussion of integration)

(f) Offering need not be to entire class.

It is not necessary to the application of the exemption under Section 3(a)(9) that the security exchanged be offered in exchange to all of any class of existing security holders.

(g) Sale of part of issue for cash.

The sale of any part of the issue for cash will defeat the exemption since the security will then not be exclusively exchanged.

Thus, where a corporation made an exchange offer which involved the issuance of scrip, the sale for cash of sufficient stock to enable the company to liquidate the scrip would void the exemption of the exchange offer.

Similarly, a corporation in order to limit its taxes on undivided corporate surplus desired to eliminate dividend limitations contained in an issue of preferred stock and notes held by banks. To this end it proposed to offer new preferred and common in exchange for the old preferred and to sell additional common to pay off the notes. The common offered in exchange for the old preferred was not exempt since it was a part of the same general plan as the sale for cash.

(h) Exchanges must be for Securities only.

An offer by the issuer to make a cash payment in addition to the delivery of the new securities, will not defeat the exemption. The requirement of a cash payment by the security holder, however, will destroy the exemption.

Sales wherein securities are sold for cash are not within the concept of "exchange" as embodied in this section. Securities to be issued upon the exercise of warrants or

subscription rights, which require cash payments by the holders thereof are not exempt. However, where the warrants are exercisable by turning in another security of the same issuer, the section would apply.

In other words cash payments by the corporation do not defeat the exemption. Cash payments to the corporation destroy the exemption.

(i) Same: Convertible securities.

Securities subject to a conversion right are entitled to a Section 3(a)(9) exemption without regard to the circumstances of the original issuance of the securities carrying the conversion right.

The concept of the application of the exemption in Section 3(a)(9) to convertible securities has gone through several stages of development. It hardly seems necessary to trace that development here. The following summarizes the present practice.

Suppose a corporation has debentures convertible into common stock which is to be offered to the public for cash. If the debentures are immediately convertible, there is an offering of both the debentures and the common stock into which they may be converted. A registration statement should, therefore, cover both securities. If, when a debenture is converted, the exchange is exempt under Section 3(a)(9), it will not be necessary to deliver an up-to-date prospectus. If, there was an offering of the common stock for cash simultaneously with the offering of the convertible debentures, this offering of common stock for cash would not defeat an exemption under Section 3(a)(9) for a conversion of the debentures into common stock. This can only be justified on the basis that the common offered for cash and the common offering on conversion are not to be considered as parts of an integrated offering because of the difference in time of offering, purpose of issue, consideration and method of distribution. (See discussion of "Integrated Offerings" at Section VIII below.)

(j) Modification of outstanding securities.

The exception is applicable where the transaction consists in the modification of the terms of outstanding securities, if no commission is paid in connection with it. (SEC vs Assoc. Gas & Electric, *supra*.)

(k) Exchange for accumulated dividends.

The issuance of securities in consideration of the waiver of accumulated dividends on outstanding stock or stock purchase rights attached thereto is an exchange within the exception. If the accrued dividends are payable either in cash or securities at the option of the security holder, no sale is involved unless the cash dividend is first declared and the security holder subsequently given a right to take stock. This principle is not applicable to accrued dividends on preferred stock, which involve a vested right to cash.

(l) Offers in discharge of debts.

The exemption does not apply to securities issued in discharge of debts not represented by instruments, since such debts are not securities.

(m) Exchange for securities called for redemption.

Securities offered in exchange for securities called for redemption, where the offer expires on the redemption date, are exempt, if the new securities are offered exclusively in exchange and the security holders have only a general claim against the issuer for the redemption funds. If the redemption funds are deposited under such circumstances that the security holders have only an interest in a specific fund and no claim against the issuer, they would cease to be security holders of the issuer and the exemption would be unavailable.

(n) Necessary cash adjustment re interest or dividends.

The Commission has by Rule 149 adopted the interpretation that cash may be required of a security holder in an exchange under Section 3(a)(9) where the cash in question represents a necessary adjustment in respect of interest or dividends on the securities involved in the exchange.

(o) Exchanges with a view to further distribution.

Section 3(a)(9) is applicable only to exchanges which are bona fide in the sense that they are not effected merely as a step in a plan to evade the registration requirements of the Act. Any attempt to do indirectly that which could not be done directly will not be tolerated. As the Court of Appeals (2nd Circuit) said in S.E.C. v. Gilligan, Will Co. (at footnote 26), "Any other construction of Section 3(a)(9) would permit evasion of the registration provisions by the simple expedient of so-called non-public sales of convertible securities looking to the public distribution of the underlying security on conversion." Also in Thompson Ross Securities Co., 6 S.E.C. 1111, 1118 (1940) the Commission held that Section 3(a)(9) does not "permanently exempt security offered in a transaction of exchange."

Thus the availability of the 3(a)(9) exemption must be determined solely on the basis of the factors pertaining to the exchange itself as outlined above. Assuming that the conditions are such that Section 3(a)(9) does provide an exemption for the issuance of securities offered in an exchange that exemption applies to that exchange only. See Securities Act Release 3825 (Crowell Collier Publishing Co.) pg. 6. It does not provide for the sale of the new securities by the persons who received them in exchange for their old securities. Whether such subsequent sale requires registration or not must be determined on its own facts; any exemption available for this subsequent sale is entirely independent of the 3a(9) exemption by which the securities were issued.

(p) Same: Redistribution by a controlling stockholder.

The question of whether the securities issued in exchange retain their exempt character in redistributions by controlling stockholders is fully considered in Release No. 646. The opinion contained in that release is to the effect that the exemption does not become an inseparable attribute of the security; redistribution by a controlling stockholder of securities originally issued as exempt under this section will necessitate registration unless another exemption is available. Similarly, the section will not exempt securities redistributed by an underwriter who purchased outstanding securities for the purpose of effecting the exchange in which the new securities were acquired. (S.E.C. v. Gilligan, Will & Co. 267 F. 2d 461).

Further where a controlling stockholder makes an exchange with the issuer with a view to redistribution, such stockholder is an underwriter and the securities must be registered even though the stockholder distributes directly to the public.

(q) Examples of Redistributions.

(i) An issuer in arrears on its cumulative preferred stock, made an arrangement with a dealer under which the dealer would purchase preferred stock, convert it into common and resell the common. The dealer would be paid enough per share converted to make the transaction profitable to him. In such a situation the exemption in Section 3(a)(9) is not applicable.

(ii) An issuer desired to redeem its convertible debentures. Since the conversion price was attractive and the market value in excess of the redemption price, it expected complete conversion. However, in the event of a market reaction, the issuer might be called on to redeem bonds beyond the amount of its present cash position. To insure against this it proposed to arrange with certain dealers that the latter should for a flat sum fixed in advance agree to purchase all, debentures offered, in excess of the redemption prices and convert such debentures. Although the dealers might resell to the public, Section 3(a)(9) would still be applicable since the arrangement was not directed to the distribution of the common stock but to the insurance of the company against redemption.

(iii) A corporation entered into an arrangement with the holders of its preferred stock (the underwriters) under which such stock would be reclassified and made convertible. The underwriters agreed to convert a substantial portion of the stock and distribute the common stock so acquired to the public. Section 3(a)(9) was inapplicable, since the purpose of the exchange was the distribution of the common stock to the public for cash.

(r) Absence of “commission or other remuneration.”

In order to have an exemption under Section 3(a)(9) the entire exchange must be carried out without the payment of commission, for the payment of commissions for soliciting the exchange of any part of the issue will destroy the exemption as to all of it.

The following are examples of payment of “commissions or other remuneration” which might defeat the exemption:

(i) The payment of compensation for the solicitation of proxies from bondholders to vote in favor of changes in the terms of the indenture governing their rights would be commission or other remuneration paid for soliciting the exchange of the new bonds resulting from the change.

(ii) Where a stockholder’s vote was required to authorize a new class of stock, and the new stock was then to be offered to the stockholders in an exchange, the payment of compensation to an agent to solicit proxies favorable to the authorization would prevent application of the exemption to the new stock.

(s) Same: Out-of-pocket expenses.

Payment to a dealer for aid in soliciting exchanges would not prevent application of the exemption where the payment covered only out-of-pocket expenses and did not include remuneration for time or for salary of the dealer’s employees and where no pecuniary advantage would accrue to the dealer from the exchange.

Similarly, payment by the issuer of a committee’s out-of-pocket expenses and counsel fees would not destroy the exemption.

(t) Use of employees of the Issuer. One of the most frequently asked questions is whether the words “Commission or other remuneration” include payments made to persons temporarily employed to act in connection with the exchange. Clearly, the ordinary issuer a corporation can act only through agents. In order to make an exchange, it must at least use the services of its employees, and it must ordinarily compensate them for their work.

A distinction should be drawn between compensation to regular employees whose services are used in soliciting the exchange and compensation to employees temporarily hired for the special purpose of making such solicitation. The former does not destroy the exemption provided that no additional compensation, other than traveling and out-of-pocket expenses, is paid for the solicitation. The latter would make the exemption unavailable. This would be so even if the special employees were paid a fixed salary. The fact that a person specially employed for the purpose of solicitation is also a director, but not a regular employee, of the issuer does not avoid the effect of destroying the exemption.

The hiring of special employees to perform the work of regular employees detailed to solicit the exchange would prevent application of the exemption.

The fact that commissions or other remunerations are paid by an officer of the issuer rather than by the issuer himself will not avoid the result of making the exemption inapplicable.

(10) Sec. 3(a)(10): Exchanges approved by a court.

List of securities exempted.

Securities are exempted under Section 3(a)(10) if issued:

(a) In exchange for one or more bona fide outstanding securities, claims or property interests; or

(b) Partly in exchange and partly for cash;

where the terms and conditions of such exchange are approved after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear by:

(i) Any court;

(ii) Any official or agency of the United States;

(iii) Any state or territorial banking or insurance commission; or

(iv) Other governmental authority expressly authorized by law to grant such approval.

(11) Sec. 3(a)(11): Securities Sold Intrastate.

(a) Entire issue must be sold as specified

The exemption does not apply unless the entire “issue” of which the security is a part is sold only to residents of the state where the issuer resides or is incorporated and where it is doing business.

(b) Offering to non-resident destroys exemption.

Offers or sales of any part of the issue to non-residents makes the entire issue ineligible for the exemption. A single sale or offer for sale to a non-resident destroys the exemption (In re Peterson Engine Co. 2 SEC 893). Thus the mere offering to a non-resident would destroy the exemption for the entire issue even though no purchase is made by the non-resident.

Where a portion of an issue has been sold to residents without registration, the sale or offer for sale of any part of the remainder to non-residents may make all the previous uses of the mails or interstate commerce in sales to residents violations of the Act, unless some other exemption is available. In other words, the exemption under 3(a)(11) is not available if any part of the integrated offering is made to a non-resident. Where, however, the distribution was originally intended to be confined to residents, but subsequently the issue was registered and the distribution extended, the original sales to residents prior to

registration would not be considered part of a single integrated issue because of the difference in the method of distribution. (For discussion of “Integration” see Sec. VIII) (For advertising of issues under Sec. 3(a)(11) see Section V(D)).

(c) What constitutes an “issue”

In general the term “issue” is restricted by the concept of “class”, so that, for example, two classes of securities of the same issuer might be offered simultaneously, of which one might be exempt, though the other were sold to non-residents. Of course, if the classes were substantially identical the subdivision might be regarded as nominal and both classes held to be part of the same issue.

However, the term is not strictly co-extensive with “Class”. For example, where the last previous issue of bonds under an open-end indenture was made more than a year ago, the offer of additional bonds under the same mortgage would be a separate issue, and, meeting itself the requirements of Section 3(a)(11), would be entitled to exemption. So, also, a block of authorized but unissued stock now to be issued for the first time constitutes a separate issue for the purpose of this provision. The redistribution of treasury securities, if contemplated as a related part of the same plan, transaction or definite program with respect to the previous offering, would be a part of the same issue. (For discussion of integration see VIII-infra)

(d) Issuance of promotion stock to a non-resident.

Stock issued for property or services is regarded as part of the same issue as stock of the same class simultaneously offered to the public for cash. Thus, if any “promotion” stock is issued to a non-resident, the exemption will be destroyed. Promotion stock, labeled as a class different from the stock to be sold for cash, would still be part of the same issue if the difference in the rights of the two classes was not substantial. Assuming a substantial difference between the classes, if the promotion stock were convertible into the stock being offered to the public, the promotion stock would be part of the same issue as the stock sold to the public, even though the exercise date of the conversion privilege was postponed. Contrast this with the “promotion exemption” under Section 4(1) clause 2, infra.

(e) General test of “new issue”.

Generally speaking, an offering of securities of the same class as securities outstanding is a new and distinct issue if the offering of the outstanding securities was not made as a related part of a plan or transaction or definite program which included or contemplated the present offering.

(f) Sales to resident agent for non-resident principal.

Sales to a resident agent for a known nonresident principal make the exemption inapplicable. Sale to a resident agent for a non-resident principal, however, might not

destroy the exemption if the foreign residence of the principal were not known. But reasonable inquiry should be made where the purchaser is a professional agent such as a broker.

(g) Effect of resales.

Where the securities are sold to resident purchasers for investment, later resales by them to non-residents do not affect the exemption. But, for the purposes of this exemption, the issue is not considered "sold" when merely sold to an underwriter or to dealers who purchase with a view to distribution. To secure the exemption the distribution of the issue must be completed without sales to non-resident investors. It seems that the question when a distribution is complete is a purely objective one. Resale within a short time or through the persons who distributed the issue may be evidence that the original purchase was not for investment. The existence of an interstate over-the-counter market might also be of some weight in consideration of the purchaser's intention. Similarly, the question of the character of the purchaser, as a professional or non-professional, would be significant but not controlling. If a resident purchaser who purchases with a view to distribution resells to a non-resident, directly or through agents or dealers, the exemption is defeated.

(h) Sales through underwriters.

If the ultimate distribution is to be made to residents it makes no difference that the sale is effected through an underwriter. Also, the residence of a purchasing underwriter is not of importance if the distribution is so made. In the case of offerings made by controlling stockholders, some of whom are non-residents, it having been determined that a separate issue is involved, the exemption would seem to be available, regardless of the residence of the controlling stockholders.

(i) Convertible securities.

Securities subject to a conversion right would not be exempt under this section, if, at the time of the conversion, any holder of the convertible securities were a non-resident. However, the former securities, if subject to an immediate right to convert, would be exempt under the provisions of Section 3(a)(9).

Securities subject to a warrant or right to subscribe would not be exempt, unless the warrants were exercisable only by residents. The difference in treatment between warrants and convertible securities results from the fact that the cash payment required in connection with the exercise of warrants would defeat the 3(a)(9) exemption whereas no cash payment is involved in the conversion of securities.

(j) Residence of the issuer.

The issuer must be a "person resident and doing business within, or, if a corporation, incorporated by and doing business within such state or territory."

Certificates of deposit are entitled to the exemption if all members of the committee issuing the certificates were residents of the state to whose residents the issue was confined. Voting trust and other types of trust certificates issued against deposited securities are exempt if the trustees are residents of the state in which the securities are distributed. However, the underlying securities, also considered to be offered, must be considered separately and must themselves qualify. In the case of a common law trust the residence of the trustees is determinative.

(k) Preorganization subscriptions.

With regard to preorganization subscriptions, the requirement that the issuer be resident in or incorporated by the state to whose residents the sale of the issue is confined requires not only that the issuer of the subscriptions must be a local resident or corporation but that the issuer which is to be organized must be also.

(1) Issuers place of business.

In addition to being resident in, or incorporated by, the state or territory to whose residents the issue is sold, the issuer must be doing business there. The exemption does not require that its business be confined to that state or territory, but the main part of its business must be done there, however. The selling of the securities in question is not of itself "doing business" for the purpose of the exemption. And where a holding corporation's only activity was to furnish capital for a foreign subsidiary, it could not be considered as "doing business" in the state of its incorporation.

The ordinary transactions incident to opening an office and the negotiation of agreements relating to the conduct of an out-of-state business might, if such negotiations constituted the main part of its business be sufficient business within the state, provided such business is not merely incidental to the sale of securities.

(C) The Small Amount Exemptions.

Section 3(b) of the Act authorizes the Commission, by rule and regulation, to exempt issues, the aggregate offering price of which to the public does not exceed \$300,000. A number of bills have been introduced in Congress to increase this amount to \$500,000. The Commission has supported these bills but none have as yet been adopted. Of such rules and regulations in effect at this time (October 27, 1959) the ones of most interest to the New York Regional Office are Regulation A and Regulation B. Regulation A applies to issuers incorporated and having their principal business with the United States or Canada. Regulation B applies to oil, gas and mineral rights. Regulation A is administered by Regional Offices. Regulation B is administered by the Division of Corporation Finance from the principal office in Washington, D. C.

There is an Instructional Manual covering Regulation A. Regulation B is covered by the manual of the Division of Corporation Finance.

There is one point under Regulation A which is not covered by the Instructional Manual under that Regulation which is of sufficient importance to warrant mention. This is the subject of over-allotments.

For many years it has been customary for underwriters to over-allot 10% on a stock issue and 5% on a bond issue. For example: On a Regulation A issue the underwriter will sell 330,000 shares at \$1 per share when the issue is limited to 300,000 shares. He will, in effect, go short 30,000 shares or 10% of the issue.

The reason for the over-allotment is two-fold: First, because some of the customers will cancel their orders or fail to pay the purchase price within the seven day period prescribed by Regulation T of the Federal Reserve Board; and second, because this will give the underwriter buying power with which to support the market during the period of distribution. Any such stabilizing of the market would, of course, be subject to the Stabilizing Rules, 240.10B6 and 240.10B7.

Perhaps it should be noted at this point that the stabilizing of an offering under Regulation A requires the filing of Stabilizing Reports on Form X17A1, pursuant to Rule 240.17A2. These reports are not filed with the Regional Office where the Notification on Form 1-A is filed. Stabilizing Reports are filed with the Division of Trading & Exchanges at the principal office of the Commission in Washington, D. C.

Since the underwriter will repurchase the amount of the over-allotment, the amount of such over-allotment is not considered to be a part of the offering and not required to be included in the \$300,000 ceiling. This is in accordance with the practice of the Division of Corporation Finance in the case of fully registered offerings. If a registration statement is filed for an offering of 300,000 shares of common stock offered at \$10 per share, no objection is raised if the underwriter goes short an additional 33,000 shares and only pays a filing fee on an aggregate public offering price of \$3,000,000.

One difference between the procedure under full registration and under Regulation A should be mentioned briefly at this point although it is covered in detail in the Regulation A instructional Manual.

There is no provision in Regulation A for a "Red Herring" similar to that permitted under Rule 433. During the ten-day waiting period under Regulation A, the underwriter may not take any steps to organize a Selling Group or to interest dealers in the forthcoming issue. In the case of a fully registered issue the underwriter may, and usually does, send a copy of the Preliminary or "Red Herring" prospectus to each dealer who may be invited to join the selling group although he cannot make any agreement with such dealers prior to the effective date of the registration statement.

VII: EXEMPTED TRANSACTIONS

(A) Introduction to Section 4

A registration statement is required to be signed by the corporate issuer and its principal officers and a majority of its directors. (See Section 6) Section 4 recognizes that there may be a distribution of a security by a person who is unable to get the corporate issuer to file such a registration statement. Since Congress did not wish to place such a person in a position where he could neither sell without registration nor cause the corporate issuer to file a registration statement, Section 4 exempts from the prohibitions of Section 5 transactions by persons who are unable to obtain registration. It may be that the foregoing statement is too broad. The transactions of a statutory underwriter (who may not be in a position to obtain registration) are never exempt. However, in studying the interrelation of Section 2(4), 2(11), 2(12) and 4(1), it will be helpful to bear in mind the broad principle that there is an exemption from the registration requirements available, in most cases, for any person who is unable to protect himself by obtaining the filing of a registration statement.

In the case of a secondary distribution the question of whether registration is required boils down to this: Is the selling stockholder able to cause the corporate issuer to register his security?

If a selling security holder is not in a position to cause registration of his securities by the issuer, such registration is not required. The difficult point arises in determining whether or not a given security holder is in such a position. Any self-serving declaration to this effect has little probative value. If the selling security holder could obtain registration by payment of the expenses in connection with such registration, no exemption is available.

In the case of a primary distribution to the public, the corporation and the underwriter are obviously in a position to cause a registration statement to be filed. Therefore their transactions are not exempt. On the other hand transactions by dealers are exempt except:

- (1) For 40 days following a public offering by the corporate issuer or an underwriter. Even though a dealer is not an underwriter he is required to deliver a prospectus with all sales made during this 40 day period.
- (2) Where the dealer is acting as an underwriter his transaction is not exempt. Where the dealer is acting as an underwriter he is presumably in a position to obtain registration and therefore exemption is not available.
- (3) The solicitation of brokerage transactions is not exempted.

Transactions by anyone else are always exempt.

(B) Transactions By A Person Other Than An Issuer, Underwriter Or Dealer

Customers' Transactions

The transactions of an ordinary customer are exempt from the registration requirements of the Act under the first clause of Section 4(1) on the grounds that the customer is a person other than an issuer, underwriter or dealer.

In order fully to understand the effect of this exemption it will be necessary to consider the following three elements:

- (1) Who is an “issuer” within the definition in Section 2(4)?
- (2) Who is an “underwriter” within the definition in Section 2(11)?
- (3) Who is a “dealer” within the definition in Section 2(12)?

1. An Issuer

(a) General Definition of Issuer

Generally speaking, the “issuer” of a security includes “every person who issues or proposes to issue” the security. In the case of stock, that person is the corporation; in the case of bonds or evidences of indebtedness, the primary obligor; and in the case of guarantees, the guarantor.

(b) Preorganization Certificates

In the case of preorganization certificates, the issuer is the person or group of persons managing the preorganization syndicate or otherwise in charge of carrying out the purposes of the preorganization agreement.

(c) Guaranteed Securities

Although they may be included in a single instrument a guaranteed security is in effect two securities: (1) the primary security; and (2) the guarantee. Each party (i.e. the primary obligor and the guarantor) is responsible only for registering his own security, though a guaranteed security may be registered on a single statement signed by both the obligor and the guarantor, if this procedure seems desirable.

(d) Certificates of Deposit, Voting Trust and Investment Trust Certificates

(i) Business Trust: In the ordinary business trust (commonly known as a Massachusetts business trust) the trust itself, rather than the trustee individually, is the issuer of the trust certificates.

(ii) Voting Trust Certificates and Certificates of Deposit: The issuers of voting trust certificates or of certificates of deposit are generally the voting trustees or committee members. However, the issuer is person “performing the acts and assuming the duties of

depositor manager.” In interpreting this phrase the substance rather than form of the transaction must be examined to determine who is exercising the managerial function.

Bankers who, under the deposit agreement, have a voice in determining when the plan of reorganization is to become operative are the issuers of the certificates of deposit.

Where a depository has the power under a deposit agreement to execute a supplemental indenture, the terms of which are to be subject to its discretion but will be binding upon all depositors, the depository is the issuer of the certificates of deposit.

Even in a case where the depository is described as the agent of the original issuer, a readjustment committee having power to approve or disapprove actions taken under the plan would be the “issuer” of the certificates of deposit.

Similarly, a description of a trust officer of the depository as the “agent for” the original issuer would not suffice to make the original issuer, rather than the trust officer, the issuer of the certificates of deposit where the trust officer is given broad discretion with respect to carrying out the plan of reorganization.

Where an agreement provides for the deposit of foreign shares with a view to making a public distribution of the American Depositary Receipts, the depositor would be the issuer of the American certificates.

Where the deposit agreement does not provide for a specific depositor or manager, the depository is the issuer since it would be the person exercising the managerial functions.

(iii) American Depositary Receipts: There may, however, be several issuers of the same security. In the case of American Depositary Receipts, both the depositor which initiates the deposit and the depository which administers the deposit agreement may be co-issuers. If, however, the depository exercises only ministerial functions, then the person or persons in whom discretion or management of the agreement is vested must be regarded as the co-issuer or co-issuers with the depositor. (See also Instruction A, Form S-12 applicable to registration of ADRs when the deposited security is not required to be registered.)

(iv) Same: Committee or Trustees Acting Under Several Agreements: Frequently the same person or persons act as a committee or as trustees under several different deposit or trust agreements. Where each agreement relates to a separate matter, each committee or group of trustees would be a different issuer with respect to such agreement.

2. An Underwriter

(a) General Definition of an Underwriter

The clear case of an underwriter is one who has purchased from an issuer with a view to distribution.

(b) “Purchases” from an Issuer

The concept of “purchase” has been considered to be complimentary to the concept of “sale” in Section 2(3). It is not confined to acquisitions for cash, but includes acquisitions in exchanges.

Although an entire block of securities is ordinarily purchased from an issuer, a purchase of small lots over a period of time as orders appear on the market would nevertheless appear to be made with a view to distribution.

(c) Pledgee as Underwriter

In disposing of securities pledged with it as collateral for a loan, a bank is not acting as underwriter if it did not originally receive such collateral with a view to distribution. If it did receive the collateral with such a purpose it would be an underwriter. But if the bank accepts securities in satisfaction of its notes rather than in foreclosure of the notes, it is purchasing the securities and becomes an underwriter if the purchase is made for distribution.

In the ordinary loan transaction where the debt is secured by a pledge of securities as collateral, the position urged by the Commission in the Guild Films case (S.E.C. v. Guild Films Co. Inc. 178 Fed Supp 418, SDNY Nov. 13, 1959) was succinctly stated by Ryan, J. in his opinion as follows:

“The touchstone to the transaction is the good faith of the parties a good faith consisting (of) an absence of intent on the part of the one delivering the property that it be sold and an absence of intent on the part of the one receiving it, at the time he receives the property to sell it.”

Where the pledgee, by reason of his ownership of securities is in a control relationship to the issuer whose securities are pledged, any person selling the pledged securities for the pledgee would be an “underwriter” (because of the pledgee’s control relationship) regardless of whether or not such pledged securities were taken with a view to distribution.

The purchase must, of course, be made from the issuer. In one case three commercial banks held defaulted notes secured by the controlling stock of a corporation. The banks had not sold the collateral in accordance with the terms of the notes, but made a sale of the notes to a group of investment bankers who proposed to make an offering of the collateral to the stockholders of the issuer. In taking over the notes from the commercial banks, the investment bankers had purchased the collateral from and with a view to distribution.

On the other hand, a dealer who was retained by a controlling stockholder to stimulate activity in an issuer’s securities by buying and selling in the open market, would be an

underwriter even though he did not purchase from the issuer since he was “selling for” the issuer.

(d) Acquisition “With a View to Distribution”

Ordinarily both the issuer and the purchaser from the issuer will contemplate distribution by the latter when the purchase is made. But it seems unnecessary in order to constitute the purchaser an underwriter, that the issuer should have distribution in view when it makes the sale so long as the purchaser does. The purchaser must have distribution in view at the time of the purchase. A person who purchases for investment does not become an underwriter of such securities by reason of the fact that he may contemplate a disposition if conditions should arise which would render the course imperative. However such conditions must be personal to the purchaser and not such as could have been reasonably contemplated at the time of purchase. Holding for a six months capital gain period; holding in an investment account rather than a trading account; holding for a deferred sale; holding for a market rise; holding for sale if the market does not rise or holding for a year, does not furnish the basis for holding that the purchaser is not an underwriter. (See In the Matter of Crowell-Collier Publishing Company, 1933 Act Release No. 3825.)

A person who purchases with a view to distribution may, nevertheless, not be an underwriter if he does not also participate in such distribution. Thus, if it acquired the controlling stock of B with an intent to distribute but without having determined the method of distribution at the time of acquisition, no registration would be required until the method of public distribution had been determined. There must be a public offering in the chain of disposition in order that there may be an underwriting.

Where the R.F.C. buys securities from the issuer with a view to resale to a single individual, the R.F.C. would be an underwriter if the purchaser from it took with a view to distribution. This would be even more true if the R.F.C. distributes directly to the public.

(e) Purchases under Options

Whether the holder of an option to purchase securities from their issuer is an underwriter depends upon his intent at the time he exercises the option rather than at the time he secured the option. However, in determining whether a person who accepts the pledge of securities as collateral for a loan is an underwriter, it is the purpose entertained at the time of such acceptance which is important.

If the loan transaction is bona fide, in the sense that the pledgee has satisfied himself that in the absence of unforeseen circumstances the loan will be paid off and the collateral returned, the subsequent acquisition of title to the collateral by the pledgee is not considered the type of acquisition contemplated by Section 2(11) since it is only “incidental” to the collection of indebtedness.

(f) Intention to Distribute is a Question of Fact

Intention to distribute rather than to hold for investment is a question of fact in the particular case. However, actual distribution within a short period after acquisition would be evidence that the purchase was made with a view to distribution. Likewise purchases by a firm in the underwriting business would prima facie be regarded as being made for the purpose of distribution. A declaration in a registration statement that it is intended to distribute certain shares will, be regarded as conclusive in the absence of affirmative evidence to the contrary.

A view to distribution does not necessarily require that the purchaser have at the time of purchase a definite intent to accomplish or initiate an immediate disposal of the securities to the public. The term covers a case in which the purchaser at the time of purchase definitely intends to effect at the earliest practicable moment a disposition of his holdings in such a manner that they may reasonably be expected to come into the hands of the public. The purchaser may be an underwriter even though at the time of purchase the precise date, manner and terms of disposition to the public have not become crystallized in his mind.

The correlative concept of taking “for investment” does not require that the purchaser intends to retain his securities for any specific period of time. As a rule of thumb a holding for less than two or three years is open to question.

(g) A Seller for an Issuer

Section 2(11) defines an “underwriter” to include any person who sells for an issuer in connection with the distribution of a security.

It is unnecessary that the “underwriter” have title. It is sufficient to make him an “underwriter” if his function is merely to secure a purchaser for the securities offered. Recommendation of a security may alone be sufficient if made pursuant to some arrangement with the issuer or another underwriter. In this connection it should be noted that while payment of compensation for recommendation of a security would be proof of such an arrangement, the absence of payment would not preclude application of the classification. (See S.E.C. v. Chinese Consolidated Benevolent Association, Inc., 120 F 2d 738 (2nd Cir. 1941), cert. den. 314 US 618.)

(h) Compensation for Clerical Work

Frequently a banker receives compensation for clerical or depository work in connection with a reorganization. The performance of such purely mechanical duties would not make him an underwriter; nor would he assume that status if, in order to eliminate fractional interests, he effected purchases and sales for the holders thereof acting in the capacity of agent for and pursuant to instructions of the stockholders who would pay the brokerage commissions and taxes thereon. But if he also recommends a plan of reorganization put forward by the person from whom the compensation is to be received, he is placed in an

ambiguous position, where it may be suspected that the recommendation is the result of an arrangement. In such case the banker would seem to be an underwriter unless it were clear that the recommendation was an independent action. This principle would also be applicable to a newspaper publisher who uses his prestige or influence to encourage purchases of an advertised security.

(i) Sale by a Subsidiary or Parent

The question of selling “for” an issuer has arisen also in cases where a subsidiary sells securities of its parent. For example, a subsidiary might be an underwriter of securities of its parent company, acquired on the market, if in fact such subsidiary were so dominated by the parent as to render its actions dependent upon the discretion of the parent.

Similarly, in a case involving a sale by a parent of securities of its subsidiary, the fact that the purpose of the sale was reimbursement of the parent for advances to the subsidiary was deemed an indication that the real purpose was financing the subsidiary and that the parent was “selling for” the subsidiary. Where an offering of securities of a subsidiary by the parent was made as a part of a reorganization plan intended to benefit both companies, the parent might be construed to be “selling for” its subsidiary.

(j) Sales for a Controlling Stockholder

When a stockholder not in control of a corporation sells his holdings at the request of, and pursuant to the terms of a contract with a controlling stockholder, the sales are to be regarded as having been made “for” the controlling stockholder and the seller is therefore an underwriter. (Also with respect to the auctioning of assessable stock, see Regulation F)

(k) Persons not Effecting “Sales”

Where, by a provision of the Act or of a regulation of the Commission, certain activities are declared not to amount to a sale, persons who engage in such activities on behalf of the issuer are not underwriters, even though such activities may later result in actual sales. For example, the sale of a convertible security which may not be converted until some later date is not a present sale of the underlying security. Therefore, persons who sell such convertible securities for an issuer, are not underwriters of the securities received upon conversion.

(l) The Issuer may also be an Underwriter

Under certain circumstances it is possible for one to occupy a double position, as issuer and as underwriter. For example: The holder of a controlling interest proposes to give gratis shares of common stock owned by him to persons who subscribed for shares of the issuer’s preferred stock. The issuer proposes to communicate this offer to potential subscribers. The “gift” under Section 2(3) would be a “sale”, and the issuer would therefore be “selling” the common stock for a person in control.

Another example: A parent and a subsidiary jointly work out a plan of capital readjustment of the subsidiary. Under the plan both the parent and the subsidiary propose to offer the securities of the subsidiary to the existing security holders of the subsidiary. Registration of these securities offered by the parent as well as those offered by the subsidiary might be required since a court might hold that the parent was selling for the subsidiary.

(m) The issuer need not have title to the security sold.

The issuer need not have actual ownership of the security sold (either legal or equitable).

Some examples are: A redistribution of stock held by certain stockholders was to be effected in order to prevent the issuer from being classified as a “personal holding company” for the purposes of the Revenue Act of 1954. Since this provision of the Revenue Act would effect the issuer more than the stockholders, the stockholders in question would be “selling for” the issuer. Similarly, where a company proposed to offer its treasury stock to its employees in a particular state and at the same time the officers of the company are to sell their personally owned stock to non-resident employees, the officers would be underwriters under this clause and the sale of such stock by them would be an integral part of what would be a single distribution among the company’s employees.

A holder of securities of an issuer proposes to sell, part of his holdings to the public under an agreement with the issuer to turn over the proceeds to it, receiving in return securities of the issuer in replacement of those sold by him. Under such circumstances, the security holder would be an underwriter. This might be so, even though there was no indication that the security holder was to receive a replacement of the securities sold.

A stockholder loaned money to an issuer on a promissory note. He sold his personal stockholdings in order to raise funds for such loan. The issuer granted to the stockholder an option to purchase additional securities from the issuer in replacement of the securities sold. While merely selling securities in order to raise funds to lend to the issuer on a note would not make a security holder an underwriter, the granting of the option makes it clear that the security holder was in this instance an underwriter.

(n) An Underwriting Must Involve a Distribution

Distribution is an essential element of underwriting. An acquisition from or sale for an issuer which does not also involve a distribution does not involve an underwriting. Distribution implies an offering to a substantial number of persons. Thus, one who purchases for resale to a single predetermined purchaser who takes for investment and not for further sales is not an underwriter. In fact, the word “distribution” in Section 2(11) (definition of an “underwriter”) has been given the same meaning as “public offering” in Section 4(1).* If the offering is considered private, no distribution will be involved. However, the question is as to the persons to whom the offer is addressed rather than

those to whom the sale is made. The question of what constitutes a “public offering” will be taken up at a later point. [* The term “distribution” as defined in Rule 154 has a much more limited meaning than the term “public offering.” It cannot be used in interpreting the word “distribution” as used in Section 2(11) or the words “public offering” as used in Section 4(1).]

(o) An Underwriting Involves Selling

“Distribution” as well, as “public offering” means a transaction involving selling. Where securities are purchased with a view to distribution as gifts or as a stock dividend, the distributor is held not to be an underwriter. This holding does not apply of course where a purchaser of stock from an issuer “gives” it away as a bonus to purchasers of other securities. In such case the stock is considered “sold” and the distributor is an underwriter.

“Distribution” may exist though no organized campaign in the “street” sense is involved and though the offering in question may be regarded by the dealer making it as merely day-to-day conduct of an over-the-counter market.

(p) Indirect Distribution

Devices to secure indirect distribution without registration have been met by Rule 140 which defines the term “distribution.” The rule, however, is inapplicable unless the securities are purchased from the issuer.

Example: A corporation sells its own securities to the public to obtain funds to purchase securities of an affiliate. The publicly held securities are convertible at the end of one year into securities of the affiliate. The corporation is, therefore, engaged in distributing securities of its affiliate and is an underwriter.

(q) Finders

A finder is not an underwriter. Although the purpose of distribution is immaterial, it is necessary to find that a distribution of a security is involved before there can be an underwriter. Thus, a person who, in connection with the liquidation of the business of a firm, sells an unsold portion of an issue of securities with respect to which the firm was an underwriter would in himself be an underwriter.

However, the fact that a person is to receive a certain percentage of an underwriter’s commission does not necessarily make him an underwriter. He must participate in the activities of the distribution of securities or the responsibility of underwriting. These cases involve “finders” whose functions generally involve bringing together the issuer and underwriter.

While a person who merely furnishes an underwriter money to enable him to enter into an underwriting contract is not an underwriter, persons who participate in any such

underwriting transaction or who have a direct or indirect participation in such transaction are deemed to be underwriters. The test is one of participation in the underwriting rather than that of mere interest in it. However, where a person not only furnishes funds to an underwriter but, in addition, takes a finder's fee based upon the amount of shares sold, he would be an underwriter.

Where the finder receives as his fee a part of the issue being distributed, the finder may be regarded as a participant in the distribution if he resells the securities by way of public offering. A person other than a finder may be in a similar position if he purchases from an underwriter at the price paid by the underwriter. This would be true even if he purchased for investment since by purchasing on the same terms as the underwriter he has assumed part of the underwriting risk and participated in the underwriting.

(r) An "Old-Fashioned" Underwriter

An underwriter of the "old-fashioned" type is one who agrees to take up an unsold portion of an offering. Such activities come within the definition in Section 2(11).

However, it is considered essential to the classification of an "old-fashioned" underwriter as an underwriter that he receive compensation for his agreement to purchase all or part of the unsold remainder of a publicly offered issue. A person who purchases from an issuer with a view to distribution or sells for an issuer in connection with a distribution may be an underwriter even though he receives no compensation.

So where a person has agreed to purchase the unsold portion of an offering on the same terms as those on which the offering was made generally and where it was intended to hold the securities purchased for investment, the purchaser is not an underwriter. If, however, the terms are different from those on which the public offering is to be made, the purchaser would be an underwriter even though he purchased without a view to distribution, except to the extent that the purchaser is a person whose interest is not included within the terms of "participates" and "participation" as defined in Rule 142. It may be that an "old-fashioned" underwriter is an underwriter only with respect to the amount sold and not with respect to the unsold portion provided he takes the unsold portion for investment rather than distribution.

(s) Dealers Selling on Commission

A person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission, is not an underwriter. (See the definition of an underwriter in Section 2(11)).

(i) Size and Nature of Commission

Any opinion as to what constitutes the "usual and customary *** commission" had generally been refused. But in one case a 40% commission was said to be in excess thereof.

The term “commission” includes a discount from the selling price allowed by an underwriter to a dealer. It is defined in Rule 141.

(ii) Source of Commission

The commission must be received from an underwriter or dealer. However, Rule 141(b) and (c) defines the term “commission from an underwriter or dealer” to include commission paid by an underwriter or dealer in control relationship with the issuer. This rule expressly excludes commission paid to a sub-underwriter or member of a distributing syndicate from the term “usual and customary distributors’ or sellers’ commission.” Consequently, a syndicate member who received only such a commission would nevertheless be an underwriter in this particular situation where the underwriter is also a controlling person.

A dealer engaged as agent for the underwriting syndicate to place part of an issue with dealers in a certain area is an underwriter within Rule 141(c) as a person who manages the distribution of a substantial portion of the issue or “performs functions normally performed by an underwriter syndicate.” Where a dealer receives an overriding commission in addition to the usual spread on shares sold by him directly to the public, such dealer is probably an underwriter since his compensation exceeds that allowed to other dealers for comparable service on the particular issue.

(t) Factor of Control

A person in a control relationship to the issuer is an “issuer” for the purpose of making an underwriter any person who purchased from or sells for such issuer in connection with a distribution. A person is in a control relationship if he, directly or indirectly controls, is controlled by, or is under common control with the issuer.

This provision (contained in the last sentence of Section 2(11)) is limited to the purpose of defining an underwriter. Thus, although a person who purchases securities from one in control of the issuing corporation with a view to distribution will be an underwriter, the person in control of the corporation is not an issuer for the purposes of an exemption under Section 3(a)(1) or the second clause of Section 4(1) or for the purpose of signing a registration statement. Hence, if an offering is made directly by the person in control without the use of selling agents or dealers, it may be an offering by a person other than an issuer, underwriter or dealer, and thus be exempt.

If the person in control is a corporation, sales by its officers or agents performing their regular functions would be sales by the corporation and no underwriter would be involved. However, a person employed by the controlling corporation for the special purpose must be considered to be an underwriter. Similarly, a person selling securities for trustees of an estate in a controlling position would be an underwriter.

Where a default in dividends on the preferred stock gave the preferred stockholders the right to vote and the directors representing the holder of a majority of the common stock formed only a minority of the board, the majority common stockholder might not be in control. Generally speaking, however, the question of whether or not control exists is one of fact to be determined by the courts upon all the surrounding facts and circumstances and should, therefore, be left to the determination of those concerned.

3. A Dealer

(a) Brokers and Banks may be “Dealers”

The definition of “dealer” in Section 2(12) includes brokers as well as those persons who, because acting on their own account, come within the more usual concept of dealers. (Note the difference in definition of dealer between Section 3(a)(s) in the 1934 Act and Section 2(12) of the 1933 Act.)

Banks may be dealers within the definition. But an investment counsel who confines himself to the giving of investment advice is not. An auctioneer who is regularly engaged in the business of auctioning securities is a dealer but may be entitled to a broker’s exemption under Section 4(2). The manager of a discretionary account probably is a dealer even though his transactions do not constitute sales to his principals.

It should be noted that the status of dealer unlike that of underwriter, does not depend upon a particular relationship to a particular transaction or series of transactions. It depends upon the general employment of the person in question.

(4) Miscellaneous Application of Exemption

(a) Conversion into Securities of another Issuer

Where A issues securities convertible at a future date into securities of B, owned by A and acquired by A without a view to distribution at the time of acquisition, the transfer of the B securities upon the exercise of the right of conversion will be an exempt transaction under the first clause of Section 4(1).

(b) Sale by Pledgee

The sale of securities by a pledgee should be an exempt transaction unless the loan and pledge had been made as a step in a distribution. The sale by an issuer of its own stock acquired in a pledge transaction would, of course, not be exempt.

(c) Sales of Parent Company’s Stock by a Subsidiary

The sale of a parent’s stock by a subsidiary would not constitute a sale by an issuer unless the circumstances were such as to require a disregard of the corporate fiction. However, the subsidiary may be an underwriter if it is selling for the parent, even though the

securities were not acquired for distribution, if the benefits of the sale were to accrue primarily to the parent.

(d) Sales on an Exchange by a Controlling Person

A controlling person is not an “issuer” within the definition in Section 2(4) of the 1933 Act. Hence his transactions are exempt unless he is either an “underwriter” or a “dealer” as those terms are defined in Sections 2(11) and 2(12), respectively. However, the broker who sells for a controlling person on a national securities exchange may be an underwriter. If the broker is selling for a controlling person in connection with a distribution, he is acting as an underwriter rather than as a broker. Hence his sales on the exchange are not “brokers’ transactions” and cannot be the subject of an exemption under Section 4(2). This is the essence of the Commission’s opinion in the Matter of Ira Haupt & Company 1933 Act Release No. 3845. (For a discussion of the effect of Rule 154 see, Brokers’ Transactions under Section 4(2) of the 1933 Act, [Section VII E(2) of this Manual]

Whether or not the transaction of the controlling person is exempt, makes little difference if the broker is making a distribution on an exchange. If the security is not registered the broker will violate Section 5 and the controlling person will be liable as a principal under the federal statute against aiding and abetting (18 USCA 2(b)).

The only case where it may make a difference whether the controlling person has violated Section 5 himself or has aided and abetted in its violation is where unusual circumstances make it desirable to proceed against the controlling person alone without joining the broker-underwriter.

(C) Transactions By An Issuer Not Involving A Public Offering

(1) Offering on an Exchange

An offering of securities on the floor of an exchange involves a public offering. Such an offering is addressed to the public generally, including all who can afford to retain a broker to execute an order to buy securities, and seems to be made in one of the most public ways possible.

In Release No. 285, the General Counsel said: “. . . I feel that transactions which are effected by direct negotiations by the issuer are more likely to be non-public than those effected through the use of the machinery of public distribution.”

(2) Number of Offerees

It is, of course, the group of offerees rather than the group of actual or expected purchasers which is important. Accordingly, it is theoretically possible to have a public offering of a single security (See S.E.C. v. Ralston Purina, *infra*). Where state laws require a published solicitation of bids for an issue, a public offering is involved,

although the issue is sold privately and the issuer is under no obligation to sell to the highest bidder. Similarly, where a private group created a voting trust and deposited securities under it, a public offering would be involved since as a matter of state law 600 additional stockholders would be entitled to deposit under the agreement. The fact that only twelve persons would be actively solicited and that deposits by others were not desired by the issuer would not be significant. (See "Special Problem on voting trust certificates," subdivision C(14), *infra*).

The implication in Release No. 285 is that too much stress should not be laid on the numerical standard. The opinion points out that "In no sense is the question to be determined exclusively by the number of prospective offerees." "The determination of what constitutes a public offering is essentially a question of fact, in which all of the surrounding circumstances are of moment." On the other hand, the opinion recognizes that the size of the group is important. It mentions the fact that previous opinions had been expressed that an "offering of securities to an insubstantial number of persons is a transaction by the issuer not involving any public offering." and that "under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number . . ." It expressly declares that the number of offerees is only one fact to be considered.

Since the opinion in Release No. 285 it has been the general policy of the General Counsel's office not to express any opinion unless it is clear that a public offering is involved. However, in some cases where it is clear that a public offering is not involved, opinions are hazarded as to how a court might view the transactions in question or it is stated that no action will be recommended to the Commission if the transactions are consummated without registration.

The leading case on the subject of what constitutes a public offering is S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953). The holding in this case is that an offering to 700 employees of the issuer, including some at the clerical level, is a public offering. The case is important, however, for two dicta: (1) The court cited with apparent approval the Commission's 1933 Act Release Number 285; and (2) footnote No. 11 at page 125 of the opinion indicated that there might be a public offering to as few as one or two persons.

Shortly after the Supreme Court handed down its opinion in the Ralston Purina case, the Commission adopted a minute to the effect that it was not necessary to revise 1933 Act Release No. 285. More recently, however, there has been discussion at the staff level of the desirability of revising such release. It is suggested that such opinion at least shifts the emphasis from the number of offerees to their relationship to the corporation and to each other. In the light of such opinion it is suggested that the test of whether or not there is a public offering is: Was the security offered to anyone who did not previously have access to all of the information which he could have obtained through a registration statement.

Since the publication of Release 285 the following situations would each appear to involve a public offering: An offering to 200 stockholders of the issuer; an offering to its

135 stockholders by an American issuer, the group containing only 29 Americans; an offering by a dealer to twenty or thirty clients; an offering by an issuer to 450 employees.

(3) Character of Offerees

An offering confined to a particular group does not prevent its having the character of a “public offering” for the purposes of Section 4(1). The conference report on the Securities Act states: “Sales of stock to stockholders become subject to the Act unless the stockholders are so small in number that the sale to them does not constitute a public offering.”

Thus, an offering restricted to the security holders of a corporation or to its employees or to the depositors of a closed bank may involve a public offering.

These views have been confirmed by the decision of the Circuit Court of Appeals for the Ninth Circuit in S.E.C. v. Sunbeam Gold Mines Company, 95 F. (2d) 699 (1938). In that case the court held that an offering to 530 stockholders of a company involved a public offering.

Although the restriction of an offering to a predefined group does not necessarily prevent its having the character of a public offering, the fact that it is so restricted is given considerable weight. An offering thus restricted may be entitled to the exemption though an offering to the same number of persons from the general public would not be.

The burden on the company claiming the benefit of the exemption is to prove that the offerees had knowledge similar to that which could be obtained from a registration statement.

(4) Number of Units Offered

Release No. 285 indicates that the number of units offered is a factor of importance. It says: “If the denominations of the units are such that only an insubstantial number of units are offered, presumably no public offering would be involved. But where many units are offered in small denominations or are convertible into small denominations there is some indication that the issuer recognizes the possibility, if not the probability, of a distribution of the security to the public generally.”

(5) Size of Offering

Release No. 285 also indicates that the size of the offering is a factor to be considered because the possibility of a public distribution subsequent to the initial private distribution must be taken into account. “Hence,” it states, “I feel that the exemption was intended to be applied chiefly to small offerings, which in their nature are less likely to be publicly offered even if redistributed.”

(6) Offering in Two Steps

It frequently occurs that a transaction by the issuer does not directly involve a public offering, but is, however, a step preliminary to a public offering with which it is so closely connected that the two are regarded as one for the purposes of the Act.

In determining whether a public offering is involved, it is necessary to consider all the offerings intended to be made either by the issuer or by the persons directly or indirectly purchasing from the issuer. If a purchaser of a single bond from an issuer acquires it with the purpose of issuing certificates of participation therein in a public offering, a public offering of the bond would be involved if the issuer has not taken steps reasonably calculated to prevent a public offering of the certificates without registration. Or where stock is subject to outstanding options, issuance of the stock against the exercise of such options will require its registration, if the exercise is made with a view to distribution.

If a direct offering by the issuer is such that, in itself, it involves no public offering the availability of the exemption to the issuer in case resales are made depends on whether the issuer has taken steps reasonably calculated to preclude a public offering. Agreement by the purchaser that before selling to the public he will offer the securities back to the issuer will not assure the availability of the exemption.

If an issuer makes a sale to a single person and that person has not determined whether he is taking for investment or with a view to distribution, the original sale is exempt but registration is required prior to a public offering by the purchaser.

The effect of the foregoing would seem to be to make such a distribution a violation by the issuer, as well as by the underwriter, if the securities are non-exempt and unregistered and the issuer has not taken steps reasonably calculated to prevent a public offering without registration.

(7) Pledge of Stock

The question of whether securities must be registered if pledged by their issuer probably depends upon similar factors. No registration is necessary if the loan secured by the pledge is bona fide in the sense that it is expected to be paid and the transaction is not entered into with a view to distribution of the pledged securities.

(8) Issuance of Warrants to Purchase Securities

Another type of offering in two steps is involved in the issuance of warrants to purchase securities. Although the original distribution of the warrants may be so limited that it does not involve a public offering, if the warrants can be transferred the issuance of securities against their exercise may not enjoy the exemption. Thus, the registration of the securities subject to the warrants has been considered necessary where the warrants are freely transferable, even though there is no public offering of the warrants, and the original takers of the warrants acquire them with no view to distribution, and agree that if the warrants are exercised the stock will be purchased for investment. However, it has

been stated that the exemption might be obtained if there were issued to each purchaser a single option running specifically to him and assignable only as a whole, where the option provided that the issuer was not obliged to deliver the stock if the right to purchase was sought with a view to public distribution. Even under such circumstances it would be necessary that the option be taken for investment only. On the other hand, a sale of convertible preferred stock to three or four persons was thought not to involve a public offering of the common into which the preferred was convertible, when the preferred was not taken for the purpose of acquiring the common for public distribution.

(9) Offering Pending Registration

An offering to meet current expenditures pending a sale of securities under a registration statement, if properly limited, may be considered a separate offering from the public offering under the registration statement. (See discussion of Integrated Offerings, *Infra*)

(10) Sales Contingent Upon Public Offering

All securities the sale of which is contingent upon the sale of securities to the public must be considered as part of a public offering. On the other hand when certain securities are issued to promoters and organizers for property, services, or cash, such disposition may be entitled to an exemption under Section 4(1), although other securities of the same class are to be offered for cash to the public, provided, of course, that the promoters do not intend to distribute the securities received by them. This is sometimes referred to as the "Promoter's Exemption." Actually it is an exception to the integrated offering concept rather than an exemption. (See memo dated July 2, 1956 from Manuel Cohen re "The so-called Promoter's Exemption.") Also a private sale of part of an issue may be made where the balance is distributed in transactions outside the scope of the Act.

(11) Offering Partly Abroad

In determining whether a public offering is involved in an offering addressed partly to persons in the United States and partly to persons abroad, the number of persons addressed abroad must be considered. No distinction is to be made in the latter case between offerings originating abroad and offers originating in this country. Where a New York corporation offered securities to its existing security holders, consisting of 29 Americans and 106 English security holders, a public offering was involved. Where a Canadian corporation proposed to issue \$2,000,000 of bonds through a public offering of one-half the amount in Canada or England and an offering of the other half to a group of not more than twenty-five in this country, who would purchase for investment, it was necessary to register. The so-called private offering in this country was a part of a single offering, which would, as a whole, be public.

(12) Subsequent Registration

Where an issuer offers securities in a transaction not involving a public offering a subsequent registration and offering to the public would not destroy the exemption with respect to the original private offering. This is specifically so provided in Rule 152.

(13) Offering Exclusively Abroad

The term “public offering” in the second clause of the section does not include an offering made exclusively abroad and such offering would, therefore, be exempt. A similar construction is to be given to the term “offered to the public,” in the third clause.

If, however, a sale is made to foreign dealers who take with a view to redistribution within the United States the exemption would be inapplicable.

(14) Special Problem On Voting Trust Certificates

The execution of a voting trust agreement may raise a problem under the laws of certain states. Under the laws of New York and Delaware (and perhaps other states) every stockholder of a corporation subject to the Laws of such state is entitled to deposit his stock under the terms of the voting trust agreement. Thus when three or four of the larger stockholders execute a voting trust agreement, there is an offering of voting trust certificates to every stockholder. The execution of a voting trust agreement under such circumstances would normally constitute the making of a public offering of the voting trust certificates. Consequently, the exemption provided in the second clause of Section 4(1) would not be available and such voting trust certificates would have to be registered in the absence of some other exemption.

(D) Transaction By Dealers Not Within 40 Days Of A Public Offering

(1) Issues not Publicly Offered

Where the original issue involves no public offering there is no date from which the limitation is to be calculated and, therefore, no restriction on the application of the exemption. Thus, also where securities were issued as a stock dividend and were therefore considered not to have been “offered” by the issuer because no consideration was asked in return, the limitation on the exemption would be inapplicable. Similarly, the limitation is inapplicable in respect of securities distributed in any transactions where a sale is not involved in such distribution.

Although the general principle applies to stock purchase warrants given away by the issuer to existing security holders, the warrants may not be traded without compliance with Section 5, since a sale of the right involves an offering of the underlying security.

(2) Securities Offered Exclusively Abroad

Since an exclusively foreign offering is not a public offering within the second clause of the section, a security which is the subject of such an offering is not “offered to the

public” within the meaning of the third clause. Consequently, dealers may trade in securities which have been offered exclusively outside the United States even though 40 days has not elapsed since the first date of public offering. A different conclusion, of course, applies where a public offering is made partly abroad and partly in the United States.

(3) Split-Ups

Where securities are altered in the course of a public distribution by a split-up so that they become new securities, the first date of public offering is the first date upon which the new securities were offered. The dealer’s exemption will not apply until 40 days after the first offering of the split stock. However where new securities are issued in respect of securities outstanding prior to a split-up they could properly be dealt in under this exemption since they were “sold” and therefore not offered to the public.

(4) A question is presented in cases where securities once offered are reacquired by the issuer or a controlling person who makes a redistribution there of. The dealer’s exemption attaches upon the expiration of 40 days from the first date of public offering, and is not affected by any subsequent offerings of the same securities by the issuer or underwriter. Of course, transactions by any dealer acting as an underwriter in respect of such securities would not be exempt.

(5) Effect Of Failure To Register Securities

The exemption granted by this section is applicable 40 days after a public offering even though the public offering in question was illegal because the securities were not registered.

(6) Additional Issues

The exemption provided by this clause is applicable only in respect of the specific securities offered. Where part of a class was previously offered, the dealer’s exemption in respect of the balance of the class would attach only upon the expiration of 40 days from the offering to the public of the latter securities, unless, of course, another exemption was applicable to such transactions or securities.

(7) Unsold Underwriting Of Allotments

Securities included in a purchase made by a dealer from an underwriter with a view to distribution are “part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities . . . by or through an underwriter” and hence the exemption is not applicable.

Securities acquired by a dealer for investment would not be part of an unsold allotment and could therefore be sold without compliance with Section 5 more than 40 days after the first date of public offering of the issue (assuming a bona fide taking for investment

which normally requires a holding considerably in excess of 40 days, and a satisfactory change in circumstance). However, the fact that a dealer is disposing of an unsold allotment does not deprive him of the exemption with respect to transactions in securities of the same class which are not part of the unsold allotment and which were first offered to the public more than 40 days prior to the present offering.

(E) Unsolicited Brokerage Transactions

(1) Limitation to Brokers

The customer must rely upon an exemption available to himself personally. In a sale on a national securities exchange the customer would normally rely on the exemption in the first clause of Sec. 4(1). The broker would rely on the exemption in Section 4(2). If the customer is an issuer and it is conceded that the offering on the stock exchange would be a public offering no exemption is available to the customer. On the other hand, if the customer is a controlling stockholder he himself would seem to be entitled to an exemption under the first clause of Section 4(1). However, if such a stockholder were engaged in a true "distribution" of his holdings, under the doctrine of the Ira Haupt case, supra, the broker would be an underwriter and the stockholder might be liable for having participated in a violation by the broker as an "aider and abettor."

(2) Character of "Brokers' Transactions"

The term "brokers' transactions" is restricted to those transactions in which a person acts as broker, or agent, for another. The status of "broker" for the purpose of this exemption is based upon a relationship existing with respect to the particular transaction. The exemption does not apply to a broker when selling as a dealer.

The Commission adopted Rule 230.154 concerning brokers' transactions in order to limit the effect of the Ira Haupt case, supra. It did so by defining the term "brokers' transactions" as used in Section 4(2) of the Act.

In the Ira Haupt case, supra, the Commission held that a broker making a distribution for a controlling person was acting as an underwriter and that he could not avail himself of the exemption in Section 4(2) for brokers' transactions. (For a discussion of the background of the Ira Haupt case see 1946 Annual Survey of American Law, page 536). In order to permit casual trading by persons who might be considered to be in control of the issuer, Rule 230.154 defines "Brokers' Transactions" to include transactions which might otherwise be considered to be "Underwriters' Transactions" requiring registration. It is important to note that whatever its effect may be, Rule 230.154 is not an exemptive rule. A controlling person will normally rely upon the exemption in the first clause of Section 4(1) which exempts transactions by a person other than an issuer, underwriter or dealer. A broker who sells for a controlling person must rely upon the exemptions in Section 4(2). This exemption is available only for a "brokers' transaction." If the broker is acting as an underwriter his transaction would be an underwriter's transaction rather than a broker's. In such case the transaction could not be exempt under Section 4(2).

The importance of Rule 230.154, therefore, is that it furnishes a standard for determining whether a transaction is that of a broker or an underwriter. This result is accomplished by defining the term “distribution.” It should be noted, however, that this definition is solely for the purpose of the rule and should not be applied, even by way of analogy, to the term “distribution” as used in Section 2(11) or the term “public offering” as used in the second clause of Section 4(1).

The rule warrants careful study. It distinguishes between casual trading and distributions. The casual trading in a six months’ period may not exceed 1% of the outstanding security. In the case of a listed security, such casual trading may not exceed the largest week’s trading volume on the exchange in the four weeks preceding the receipt of the order by the broker, if such volume is less than one per cent of the outstanding security.

One of the conditions set out in the rule is that to be a “brokers’ transaction” the broker must not solicit buyers. In the case of a listed security this would preclude the broker from writing up the security in a market letter. In the over-the-counter market the broker may list an asked price in the “Pink Sheets” of the National Daily Quotation Service but he may not solicit other brokers listing bids in the sheets.

The amount sold by a controlling person under a registration statement or an exemption must be included in determining whether the 1% limitation in Rule 230.154 has been exceeded. For example:

(a) C, the controlling person, has sold 2% of the outstanding stock of his corporation under Regulation A. He may not sell an additional 1% in a brokers’ transaction as defined in the rule.

(b) C has sold 3% in an intrastate offering exempt under Section 3(a)(11). He may not sell an additional 1% in a brokers’ transaction under the rule.

(c) C has sold 4% of the outstanding stock to a single insurance company in a private deal, which he himself negotiated. C may not sell an additional 1% in a brokers’ transaction under the rule.

(d) In January 1959, C through his broker B, sold 1% of the outstanding stock of a corporation. C relied on an exemption under the first clause of Section 4(1) and B relied on the exemption under Section 4(2) in a brokers’ transaction as defined in the rule. In August of 1959, C may sell, an additional amount not exceeding 1%.

Under Rule 230.154 a broker may sell for a controlling person in casual trading over a six months’ period, an aggregate amount not exceeding 1% of the outstanding securities or one week’s trading volume if it is listed. However, it might be possible to make a distribution of 3% of the outstanding security over an 18 months’ period by selling not more than 1% in any period of six months.

(3) What Constitutes an “Open”, or “Counter” Market?

The exemption is limited to transactions in the course of trading in outstanding securities. Purchases made directly from an issuer in the course of a primary distribution are, therefore, not to be regarded as transactions in the open or counter market.

(4) Extent of Exemption

This exemption relates to the entire course of the brokers' transaction including the use of the mails for the purpose of delivery of the securities to his principal after purchase by the broker.

(5) Exception as to Solicitation of Orders

Even if the solicitations were conducted without the use either of the mails or an instrumentality of interstate commerce, the subsequent use of such means in the execution of orders secured by such solicitation would not enjoy the immunity provided by Section 4(2) of the Act. Solicitation of the order by any means prevents the application of the exemption to any subsequent step taken to complete the sale or delivery after sale.

(6) What Constitutes a Solicitation?

Any attempt by a broker to induce the purchase of an identified security is a “solicitation” of an order within the meaning of this section. On the other hand solicitation of an order to buy unidentified securities (as solicitation of genuine discretionary accounts) is deemed not to defeat the exemption provided by this section.

Even though a broker gives no advice or recommendation concerning a security but merely advises his clients by letter that the security is being offered by a third party and proffers his service in purchasing the security, circularization by such a letter constitutes solicitation. Thus the ordinary broker's market letter would constitute the solicitation of a brokerage order. During the 40 day period therefore such a market letter must be preceded or accompanied by a prospectus.

It should be noted however, that the standard institutional advertisement by a brokerage firm is not considered to be a solicitation of an order in any particular security.

VIII: THE TESTS OF AN INTEGRATED OFFERING

Generally speaking, part of an integrated issue may not be sold under one exemption while the balance is sold under a registration statement or a different exemption.

The question of what constitutes an integrated offering was considered In the Matter of Unity Gold Corporation, 3 S.E.C. 618, 625 (July 19, 1938). The case involved an attempt to combine registration and an exemption under the former Rule 202. The precise

problem does not arise under the present Regulation A. However, the following excerpt from page 625 of the opinion is still of interest:

“. . . Thus, securities of the same class, offered on the same general terms to the public in an uninterrupted program of distribution, cannot be segregated into separate ‘issues’ merely by claiming an exemption for a limited portion of such shares . . .

“The determination whether securities are being offered as part of a single ‘issue’ will depend upon a consideration of various factors concerning the methods of sale and distribution employed to effect the offerings and the disposition of the proceeds. If the offerings may be segregated into separate blocks, as evidenced by material differences in the use of the proceeds, in the manner and terms of distribution, and in similar related details, each case must be determined upon the basis of its own facts.”

A question of integration may arise under Sections 3(a)(9), 3(a)(11), 3(b), or any of the clauses of Section 4(1). The major factors to be considered are:

- (1) Is the class of securities the same? If not, the offerings need not be integrated.
- (2) Are the offerings made at or about the same time?
- (3) Are the offerings for the same purpose?
- (4) Are the offerings made for the same type of consideration?
- (5) Are the offerings part of a single scheme of financing?

The following are illustrations of integrated issues:

(1) Corporation A needs \$400,000 to purchase a factory building. It plans to sell, interstate, \$300,000 of common stock pursuant to an exemption under Regulation A, and \$100,000 of common stock to residents of the state of incorporation under Section 3(a)(11). Here it seems clear that there would be an integrated issue of \$400,000 worth of common stock, since both blocks were sold at about the same time, the proceeds were to be used for the same purposes, and all of the stock would be sold as a part of the same general scheme of financing. It follows, therefore, that an exemption under Regulation A would not be available since the aggregate offering price of the integrated issue would be \$400,000 and the offering to residents of the state of incorporation would not be exempt under Section 3(a)(11) since part of the integrated offering would be made to non-residents.

(2) Corporation A has an authorized issue of \$1,000,000, principal amount, of debentures. It proposes to offer \$700,000 in exchange for an issue of presently maturing first mortgage bonds. The remaining \$300,000 of debentures are to be qualified for an

exemption under Regulation A and sold for cash in order to raise funds to pay off the first mortgage bonds not exchanged. This would be an integrated issue of \$1,000,000 of debentures since all of them would be offered at about the same time and as a part of the same scheme of financing. The offering of part of the integrated issue could not be made under Regulation A since the aggregate offering price of the integrated issue would exceed \$300,000; and the sale of part of the integrated issue for cash would defeat an exemption under Section 3(a)(9) for the \$700,000 principal amount, offered in exchange for the first mortgage bonds.

(3) Corporation A needs \$500,000 to purchase new equipment. A single insurance company after a complete investigation will purchase 10,000 shares of common stock at \$20 per share. The corporation proposes to sell 15,000 shares under Regulation A at the same price. There would be an integrated offering of 25,000 shares with an aggregate offering price of \$500,000 which could not be exempt under Regulation A; and the 10,000 shares sold to a single insurance company could not be exempt as a private offering under the second clause of Section 4(1) because of the public offering of the remaining 15,000 shares.

IX: THE REGISTRATION STATEMENT AND PROSPECTUS

Registration Statements are processed at the principal office of the Commission by the Division of Corporation Finance. This Division has prepared an Instructional Manual which deals in detail with its work. Our discussion will only spotlight a very few of the matters covered by the Division's manual.

(A) General

The form of registration statement of general application is known as Form S-1. The rules for the use of the forms applicable to specific types of issues can be found in Appendix II to the General Rules and Regulation under the 1933 Act. Part I of Form S-1 prescribes the contents of the prospectus; Part II prescribes the other material required to be in the registration statement but not in the prospectus.

Regulation C governs the form and content of the registration statement and prospectus. In this connection it should be noted that the definitions in Rule 230.405 of Regulation C apply only to registration statements. For example: The term "Control" is defined in Rule 230.405. This definition applies to the use of such terms in the registration statement but is applicable only by way of analogy to the question of whether a person is an underwriter within the definition in Section 2(11) and whether his transactions would be exempt under the first clause of Section 4(1). (See the opinion of Judge Ryan in SEC v. Micro-Moisture Control Corporation, 148 F. Supp. 558 S.D.N.Y. 1959).

(B) Financial Statements

The substantive requirements for certified and uncertified financial statements are contained in the instructions for the appropriate form. The form and content of the financial statements is governed by Regulation S-X.

In the usual case of a registration statement on Form S-1 the registrant is required to furnish a balance sheet as of the close of the last fiscal year and a profit and loss statement for each of the three years preceding the date of the balance sheet. These statements are required to be certified by an independent accountant.

In addition the registrant must include a balance sheet and part-year profit and loss statement as of a date within 90* days of the date of filing the registration statement. Such statements do not need to be certified. They may be based on company figures. [*In some cases this may be six months (see instructions on Form S-1).]

For example: Corporation A is a calendar year company. On June 15, 1959, it files a registration statement on Form S-1. The following financial statements would be filed:

- (1) A certified balance sheet as of December 31, 1958.
- (2) Certified profit and loss statements for the calendar years 1956, 1957 and 1958.
- (3) A balance sheet as of March 15, 1959, or some later date. This need not be certified.
- (4) A profit and loss statement for the period from December 31, 1958 to the date of the latest balance sheet. This statement need not be certified.

(C) Cost of Registration

The principal items of cost for marketing a registered issue arranged in order of size are as follows:

- (1) The underwriter's fee.
- (2) The attorney's fee.
- (3) The accountant's fee.
- (4) Cost of printing and distributing the preliminary and final prospectuses.
- (5) The filing fee. This is 1/100th of 1% of the public offering price. (See Sec. 8 of the Act and Rule 230.457).

(D) Effective Date of Registration Statement and Amendments

Sec. 8(a) of the 1933 Act specifies that a registration statement shall become effective 20 days after filing. However, if an amendment is filed it becomes effective 20 days after the

filing of the last amendment unless the Commission, by order, either: (1) directs that the amendment shall be deemed to have been filed as of the date of filing the registration statement; and/or (2) fixes an earlier date in accordance with the principles set out in Rule 230.460.

A routine filing might go like this: Corporation A files a registration statement on August first. If the corporation has ever filed anything with the Commission the corporation will already have been assigned to a group in the Division of Corporation Finance headed by one of the 12 Branch Chiefs. It will, also have been assigned to one of the four Assistant Directors, each of whom supervises the work of three Branches. The Branch will prepare a letter of comment after the examination has been completed.

At times the work load of the Division of Corporation Finance is such that it is virtually impossible to complete the examination of a registration statement and get out a letter of comment in 20 days. In order to avoid having the Commission enter a stop order under Section 8(d) on the basis of any deficiencies noted at that time, the registrant may be requested to file a telegraphic delaying amendment pursuant to Rule 230.473. This will have the effect of delaying the effective date for 20 days.

After receipt of the Letter of Comment the registrant files * * * a "Deficiency Amendment" to correct the matters upon which comment had been made. This will act to delay the effective date for 20 days from the date of filing the amendment.

Generally, neither the registration statement nor the Deficiency Amendment contains the offering price or the price data. This is for the reason that the underwriter does not like to change the offering price once it is known. He therefore waits until the registration statement is in form satisfactory to the branch and then files a price amendment giving the offering price and date related to the price such as interest rate, conversion rate, maturity, etc. Usually, however, this information will have been given to the Branch informally prior to formal filing of a price amendment. Since the registration statement is then complete and in satisfactory shape the Division can, and usually does, recommend that all amendments be filed as of the date of filing the registration statement and that it be declared to be effective as of a specified date.

In this connection the financial statements may present a problem. They are required to be as of a date within 90 days of the date of filing and, in the absence of an order of the Commission, the registration statement is deemed to be filed as of the date of filing the last amendment. Very frequently the last financial statement will not be within 90 days of the filing of the price amendment. In order to meet this situation the Commission may, by order, consent that a date within 90 days of the date of the financial statement shall be deemed to be the date of which any subsequent amendments including the price amendment, shall have been filed. The registration statement will accordingly be deemed effective on the twentieth day thereafter, or such other date as the Commission may fix by order. Thus where a registration statement is "effective on November 11, 1959 as of August 15, 1959" it means that the Commission's consent and order of acceleration were entered on November 11, 1959 but that the effective date for determining whether a

prospectus was used more than 9 months after the effective date, pursuant to Section 10(a)3 of the 1933 Act, was August 15, 1959.

(E) The Corporation Index

The Division of Corporation Finance has furnished this office and keeps up-to-date, an index of all corporations which have been assigned to a Branch. This index will show the name of the Branch Chief and Assistant Director assigned to the filings of each corporation. This index is kept for ready reference in the secretaries' room in the Branch of Public Information and Interpretation of the New York Regional Office. The name of such Branch Chief or Assistant Director may be given to any member of the public in response to any proper inquiry.

(F) Indentures Qualified Under the Trust Indenture Act of 1939

Debt securities registered under the 1933 Act are, generally speaking, issued under an indenture qualified under the 1939 Act. However, certain securities which are exempt from such registration must nevertheless be issued under a qualified indenture, as, for example, bonds issued under an exemption provided by Section 3(a)(9) or 3(a)(10). Debt securities exempt under Section 3(b) of the 1939 Act may have to be issued under an indenture if they cannot qualify for an exemption under Section 304(a)(8) of the 1939 Act which only exempts issues not exceeding \$250,000. In the case of an issue of \$300,000 of bonds under Regulation A, the bonds will have to be issued under an indenture. While the indenture may not have to be qualified under the 1939 Act because of an exemption under Section 304(a)(9), it must contain the provisions customarily contained in an indenture for the protection of bondholders in the event of default.

(G) Shelf Securities

The last sentence of Section 6(a) of the 1933 Act reads as follows: "A registration statement shall be deemed effective only as to the securities specified therein as proposed to be offered." This provision has been interpreted to mean "proposed to be offered within a reasonable time." As a rough rule of thumb a "reasonable time" has been held to be about 90 days.

From the foregoing it follows that a registration statement would not be effective if it attempted to register securities already outstanding. However, if securities have been sold in violation of Section 5 of the 1933 Act, a registration statement covering such shares may be filed if an offer of rescission is made. This is on the theory that the offer of rescission is, in effect, a re-offering of the outstanding securities.

Neither the issuer nor an underwriter may hold registered shares "on the shelf" which he does not intend to offer to the public within a reasonable time, to wit: about 90 days. However, it sometimes happens that the corporate issuer is in need of immediate funds and the underwriter is willing to purchase and pay for an immediate issue of securities to be offered to the public at an undetermined future date. In such a situation it is the policy

of the Commission not to raise any objection to the immediate purchase and delivery of the securities to the underwriter provided that the issuer and the underwriter agree to register the securities prior to any public offering of them. This policy is based largely on the premise that it is better not to have a registration statement filed too much in advance of a public offering. A contrary policy might result in having the statute of limitations in Section 13 run against any civil liability for a false statement in the registration statement, pursuant to Section 11, before the public offering was even made.

This policy is sometimes summed up in the expression “You cannot register shelf securities.”

(H) Bring-Up Prospectus

Section 10(a)(3) of the 1933 Act provides that a prospectus used more than 9 months after the effective date may not contain information which is more than 16 months old. While this requires no discussion it may be that an example will be helpful.

A registration statement contains a balance sheet as of December 31, 1957. It is made effective by order of the Commission on July 31, 1958, as of March 31, 1958, in order to protect the financials. After December 31, 1958, the prospectus may not be used if it contains information which is more than 16 months old. The prospectus containing the balance sheet as of December 31, 1957, may be used until April 30, 1959. After that date the prospectus must contain a similar balance sheet as of a date within 16 months of the date the prospectus is used. This, in effect, gives the issuer four months in which to prepare new financials as of December 31, 1958. The new prospectus is usually filed as a post effective amendment and in any case Rule 230.424(c) requires the filing of 25 copies.

(I) “Undertakings” To File Reports

Section 15(d) of the Securities Exchange Act of 1934, requires that under certain circumstances a registration statement under the 1933 Act shall contain an undertaking to file the same reports as are required in the case of a listed company. Such reports are:

- (1) An annual report on Form 10-K;
- (2) A semi-annual report on Form 9-K; and
- (3) Current reports on Form 8-K.

(the current report is filed by the tenth day of the month following that in which the event occurred which required the report).

The reports are required where the number of units covered by the registration statement, plus the number of units of the same class of securities outstanding, multiplied by the offering price per unit stated in the registration statement exceeds \$2,000,000.

The obligation to file reports pursuant to such undertaking continues until the number of units issued and outstanding, multiplied by such offering price is reduced to less than \$1,000,000.

Companies required to include such an undertaking are sometimes referred to as “Section 15(d) companies.”