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TEXAS EXEMPTIONS FOR SMALL OFFERINGS OF CORPORATE SECURITIES*

*by Alan R. Bromberg***

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* This Article is an expansion of Bromberg, *Securities Exemptions for Small Offerings in Texas*, 3 Bull. of Sec. on Corp., Bank. & Bus. L. (State Bar of Texas) 1 (No. 3, May, 1964), which was copyrighted 1964 by the author and which is reproduced by permission. Minor changes have been made throughout, particularly in Part 4 which has been augmented (*e.g.*, 4.2 and 4.10) and rearranged. Also Part 5 and all the footnotes have been added.

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[1] Unless otherwise indicated, "section" and "§" references are to sections of Texas Securities Act, Tex. Rev. Civ. Stat. Ann. art. 581 (1964).

Every issuance of a note, a share of stock, or any other security is potentially subject to the securities or blue sky laws. If no exemption is applicable, registration of the security is required. Issuance and sale without required registration permit buyers to recover their purchase money and have other serious consequences.

Exemptions suitable for small offerings exist in many states[2] and are undoubtedly the most widely used. They tend to leave businessmen in closely held corporations oblivious of the applicability of the securities laws. And they are taken for granted by many lawyers who are unfamiliar with their peculiarities.

This Article reviews the Texas small offering exemptions,[3] which were amended substantially in 1963.[4] The sources of interpretation are (1) direct statutory analysis, (2) impressions and experiences of practitioners, and (3) discussions with the Texas Securities Commissioner and his staff.[5] This explains the absence of conventional cita-

[2] For discussion and tabulation of the various provisions, see Loss & Cowett, Blue Sky Law 81-83, 369-74 (1958). Corresponding federal exemptions are summarized in 4.6 of the text of this Article.

[3] The discussion is limited to exemptions available to the corporate issuer. Substantially the same treatment is accorded to the noncorporate issuer (*e.g.*, partnership, trust, or joint stock company). Related exemptions for outstanding securities include §§ 5.C(1) for the investor and 5.0 for the dealer. For oil and gas interests, see § 5.Q which has features resembling both § 5.I(a) and § 5.I(c).

[4] Tex. Gen. & Spec. Laws 1963, ch. 170, § 4, at 474.

[5] An earlier version of this Article had the thoughtful and valuable comment of the Texas Securities Commissioner (William M. King), his Deputy (Truman G. Holladay), and members of their staff, as well as Marvin S. Sloman and George Slover, Jr. of the Dallas Bar and Frank M. Wozencraft of the Houston Bar. Although the Commissioner's views often have been mentioned and I have tried to state them accurately, the opinions and analysis are my own responsibility.

I should like to use this opportunity to salute the State Securities Board, the Commissioner, and the staff for their vigorous and intelligent administration of the Act. They have performed the exceedingly difficult task of being scrupulous servants of the public interest, yet have been able and willing to listen to the needs of business and, wherever proper, to cooperate in satisfying them.

tion for many statements. The Article also considers some aspects of the related federal exemptions. It closes with an estimate of how widely small offering exemptions are used and an inquiry into the policies underlying them.

1. THE "35-MAN EXEMPTION"—SECTION 5.I(a)

1.1 *General*

The familiar[6] "35-Man Exemption" for "the sale by any corporation of its securities . . . where the total . . . stockholders will not thereafter exceed thirty-five . . ." has been modified only slightly by the 1963 amendment. It now reads "the sale of any security by the issuer thereof so long as the total number of security holders . . . does not exceed thirty-five."[7] The main change was from "stockholders" to "security holders." The purpose was to eliminate doubts created by an Attorney General's dictum[8] that the word "stockholders" limited the exemption to sales of stock as opposed to debt. The 1963 amendment makes it clear that all forms of securities may be sold under the exemption. There is no limit on the dollar volume or number of shares. This is the exemption under which most closely held corporations are formed and capitalized.

1.2 *How To Count To Thirty-Five*

The number of security holders at the conclusion of the offering is determinative, not the number of sales. Thus, several sales to the same buyer are counted only once. Similarly, the exemption is exhausted when the number of security holders reaches thirty-five, re-

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[6] *History.* The first act extending registration to securities in general, Tex. Gen. & Spec. Laws 1923, ch. 52, at 114 (former arts. 579-600, Tex. Rev. Civ. Stat. (1925)), apparently had no small offering exemption. Tex. Gen. & Spec. Laws 1935, ch. 100 (former art. 600a, Tex. Rev. Civ. Stat. Ann. (1953)), §§ 3(j) and 3(k), at 255, provided exemptions for corporate sales of stock or other securities up to 25 holders, and for noncorporate sales up to 10 members. A prohibition on the use of agents and salesmen for corporate securities was dropped when the 1935 exemptions were carried forward by Tex. Gen. & Spec. Laws 1955, ch. 67, §§ 3(j) and 3(k), at 325-26 (former art. 579-3(j) and (k), Tex. Rev. Civ. Stat. Ann. (Supp. 1955)). Tex. Gen. & Spec. Laws 1957, ch. 269, § 5.I at 580 (former art. 581-5.I, Tex. Rev. Civ. Stat. Ann. (Supp. 1957)), combined the corporate and noncorporate exemptions and raised the limit to 35: "The sale by any corporation of its securities or by any unincorporated association or partnership of interests, where the total membership or stockholders will not thereafter exceed thirty-five (35), and where the sale is made without the use of advertisements or any form of public solicitation." The 1957 changes in this exemption are considered in Meer, *The Texas Securities Act—1957 Model: Facelift or Forward Look?*, 36 Texas L. Rev. 429, 434-35, 444-45 (1958). See also Comment, *Exemptions to the Securities Act of 1957 and Their Importance to Persons Dealing in Oil and Gas Interests*, 12 Sw. L.J. 359, 365-66 (1958).

[7] Section 5.I(a). The full text is: "Provided such sale is made without any public solicitation or advertisements, (a) the sale of any security by the issuer thereof so long as the total number of security holders of the issuer thereof does not exceed thirty-five (35) persons after taking such sale into account."

[8] Op. Att'y Gen. (Tex.) WW-564 (March 3, 1959), 3 Blue Sky L. Rep. ¶ 70412.

gardless of how many sales the corporation has made. For example, the corporation might sell to twenty-five and stop. If the number of security holders increases to thirty-five by "osmosis" (gifts, bequests, resales, etc. by the holders), the exemption no longer is available. On the other hand, a corporation might sell to thirty-five and stop. If the number of holders later is reduced to twenty-five by sales among existing holders or by resales to the corporation, the corporation then can sell to ten more.

It is not entirely clear whether sales past thirty-five destroy the exemption for all or only for the thirty-sixth purchaser and beyond. The statute speaks in the singular, using "sale" twice. This suggests that each transaction stands on its own and that excessive sales to additional security holders will not contaminate the first thirty-five.[9] However, it is quite possible that the question may be answered in terms of the "issue concept" that has grown up in federal law.[10] By this view, no part of an issue would be exempt if sold to more than thirty-five, but sale of a second issue beyond thirty-five would not affect a first issue within this limit.

a. *Location* The location of the security holders is immaterial. All must be counted, even though some might be outside the state or might have bought in transactions beyond the jurisdiction of the Texas Act.

b. *Security Holders* In one respect the 1963 version is narrower than its 1957 predecessor. Formerly, the exemption was valid for thirty-five *stock*holders. Now it is good only to thirty-five *security* holders, including holders of debt securities as well as stock.[11] Thus, a company with ten noteholders and twenty-five stockholders no longer can use the exemption; previously the company could have used it to sell stock to ten more stockholders. A person who is both a noteholder and a stockholder presumably is counted only once. It appears necessary to count the bank to which the corporation has given a short-term note and the insurance company to which it has given a mortgage note. These notes are securities[12] and fall literally

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[9] See Comment, *Exemptions to the Securities Act of 1957 and Their Importance to Persons Dealing in Oil and Gas Interests,* 12 Sw. L.J. 359, 365-66 (1958). Of course, the number of sales may be so great as to demonstrate that there was public solicitation; in this case, the exemption fails. See text, 4.1 *infra.*

[10] Roughly speaking, securities belong to different "issues" if they are different classes (*e.g.*, common v. preferred, stocks v. bonds) *or* "if they constitute separate plans of financing in time and circumstances." 1 Loss, Securities Regulation 578 (2d ed. 1961). The latter involves a difficult fact determination. For a summary of the SEC's views, see SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962, 1 CCH Fed. Sec. L. Rep. ¶¶ 2770-83, at 2684.

[11] This returns to the 1935-57 pattern when all security holders were counted together. See note 6 *supra.*

[12] Section 4.A.

within the enumeration, even though their issuance is separately exempt as sales to financial institutions[13] or of commercial paper.[14] Open account creditors need not be counted, but trade creditors who hold notes or acceptances probably should be. In this state of affairs, it may be possible to reinforce the exemption by paying off notes before making certain stock sales or by postponing some borrowings until stock sales are completed.

c. *Beneficial Owners* Uncertainty remains about beneficial (non-record) owners. One stockholder of record who really is holding for himself and two others should be counted as three. Otherwise the small number becomes a mockery and the presumed grounds for the exemption[15] are defeated. The difficulty, of course, is that the corporation may not know anything beyond the record ownership. There is reason to think that the corporation has a duty of inquiry on this matter. In any event, the corporation is well advised to obtain an investment letter to the effect that each purchaser is taking solely for his own account. A corporation so acting in good faith (*i.e.*, with no reason to doubt the truth of the letter) should be protected. But prompt resales increasing the number of holders beyond thirty-five will raise serious questions as to the validity of the exemption in the first place.

d. *Partnerships and Corporations* Since a partnership is an entity for most purposes (including property ownership),[16] it normally should be counted as one security holder, even though there are several partners. This assumes that the partnership exists in good faith for other purposes, and that it was not formed merely to circumvent the numerical limits of the exemption. A recently created partnership, or one with no substantial business activities, will be suspect. Sellers to partnerships under this exemption may want to consider transfer restrictions to counteract the easy distribution of partnership assets to partners. Sales to corporations should be regarded similarly, but with even greater emphasis on the separate entity.

e. *Trusts* In the case of a voting trust, the Commissioner's position is understood to be that each beneficial owner must be counted. On

[13] Section 5.H.

[14] Section 6.H. The result is somewhat absurd: reducing the scope of one exemption because of transactions otherwise exempt, presumably on separate policy grounds. See text, 5.1 - 5.3 *infra.* I doubt that this was "intended" in any realistic sense. But it is difficult to escape the negative implication of § 5.I(c), which expressly excludes from its count all sales and securities exempt under other provisions. See text, 3.5 *infra.* The Commissioner is unlikely to take action if 35 is exceeded only by a bank note, but this is no assurance against rescission suits by purchasers. See text, 4.8 *infra.*

[15] See text, 5.1-5.3 *infra.*

[16] Bromberg, *Source and Comments to Texas Uniform Partnership Act,* 17 Tex. Rev. Civ. Stat. Ann. 234-36 (1962).

the other hand, a testamentary or inter vivos trust used for genuine family purposes should be counted as one, regardless of the number of beneficiaries.

f. *Husband and Wife* If a security is community property, is the marital community counted as one holder or two? Practice here has been to say one, because only one investment decision has been made (through the husband's managerial powers).[17] The Commissioner agrees with this view. However, if a buyer sued, the seller might have difficulty sustaining this position against the general rule that each spouse has an equal, vested interest in the community property.[18] The issuer's position is stronger if the security is registered in the name of one spouse rather than both.

g. *Optionees* Another troublesome problem is whether optionees are to be counted. There can be little doubt that most options are securities.[19] But it is understood to be the Commissioner's position that only optionees who purchased their options must be counted. This is consistent with the purpose of the act to protect purchasers. Employees who are granted options as part of their compensation have been classified separately for purposes of the Employee Option Exemption (see below). It is reasonable to think they are distinct for this purpose too and need not be counted toward the thirty-five.

[17] Tex. Rev. Civ. Stat. Ann. art. 4619 (1960) provides that "during coverture the common property of the husband and wife may be disposed of by the husband only. . . . " This lighthearted solution in terms of a single investment decision ignores the intricate community property problems of management and ownership which are present. Huie, *Commentary on the Community Property Law of Texas*, 13 Tex. Rev. Civ. Stat. Ann. 1, 5-11, 34-45 (1960); Smith, *Legislative Note: 1963 Amendments Affecting Married Women's Rights in Texas*, 18 Sw. L.J. 70 (1964). On the other hand, it has long been the business custom to look primarily to record ownership. It is common knowledge that most record owners are individuals, that most individuals old enough to own securities are married, and that most property of Texas married couples is community property. In the face of this situation, of which the legislature must have been as aware as anyone else, it is not unreasonable to conclude that the marital community was intended to be treated as one. If a contrary result was intended, it might well have been specified by the legislature.

[18] All property acquired during marriage is community property except that acquired by gift, devise, or descent. Tex. Const. art. 16, § 15; Tex. Rev. Civ. Stat. Ann. arts. 4613, 4619 (1960), 4614 (Supp. 1963); Arnold v. Leonard, 114 Tex. 535, 273 S.W. 799 (1925). See Hilley v. Hilley, 161 Tex. 569, 342 S.W.2d 565 (1961), for a graphic illustration of the strength of the joint interest.

[19] The federal and Uniform acts include options as securities in the phrase "warrant or right to subscribe to or purchase" other securities. Securities Act of 1933, § 2(1), 48 Stat. 74, as amended, 15 U.S.C. § 77b(1) (1958); Uniform Securities Act § 401(l). There is nothing so specific in the Texas Act; if options are embraced, it is by catch-all language such as "any other instrument commonly known as a security." § 4.A. Although authority from other jurisdictions is dubious because of differences in statutory definitions (of "security," "sale," and "offer") and litigation context, the pattern seems to be to treat options as securities even though not explicitly so defined. See Link, Petter & Co. v. Pollie, 241 Mich. 356, 217 N.W. 60 (1928); Haddad v. Electronic Prod. & Dev., Inc., 33 Cal. Rptr. 89 (Dist. Ct. App. 1963) and cases there cited. On the other hand, some corporate lawyers feel that an option is not a security under the Texas Act if it is nontransferable and is not evidenced by a separate certificate (*e.g.*, if it is embodied in a contract for employment or for the sale of a business).

h. *Conclusion* One can only conclude that it is imprudent to push this exemption to the limit. Stopping at, say, thirty not only gives leeway for an overlooked beneficial owner or for a bank to which a note has been given, it also may be welcome evidence of good faith in a civil suit or an administrative proceeding.

2. The Employee Option Exemption—Section 5.I(b)

2.1 *General*

A new exemption was added in 1963 for "sales of shares of stock pursuant to the grant of an employees' restricted stock option as defined in the Internal Revenue Laws of the United States."[20] This exemption facilitates employee stock ownership and legitimizes a common type of transaction often formerly made in violation of the act. Although options usually are given only to "key" employees, this exemption places no limit on the number or kind of employees or on the number of shares optioned. Thus, it is not truly a small offering exemption.

The exemption does not cover sales to employees apart from options, or sales pursuant to other kinds of options. If these are exempt, it must be under some other provision; either the 35-Man or the 15-a-Year Exemption may be used in appropriate instances.

2.2 *Effect Of Tax Laws*

Because the exemption refers to the tax laws, the latter must be satisfied if the exemption is to apply. This means meeting numerous tax requirements including nontransferability, maximum ten-year duration of option, and minimum exercise price of eighty-five per cent of market value at the time of grant.[21]

a. *1964 Tax Changes* The language used in the Texas Act ("restricted stock options") is now confined by the tax law, with very limited exceptions, to options granted before 1964.[22] In its place are recognized two kinds of options, called "qualified stock options"[23] and "employee stock purchase plans."[24] Each of these is stricter in some respects than the former "restricted stock option." The "qualified" option has a maximum duration of five years (instead of ten) and a minimum exercise price of one hundred per cent of market value at date of grant (instead of eighty-five per cent); this option also requires shareholder approval and its exercise must be expressly

[20] Section 5.I(b).
[21] Int. Rev. Code of 1954, § 421(d) (prior to amendment by Revenue Act of 1964).
[22] Int. Rev. Code of 1954, § 424(b), added by Revenue Act of 1964.
[23] Int. Rev. Code of 1954, § 422, added by Revenue Act of 1964.
[24] Int. Rev. Code of 1954, §423, added by Revenue Act of 1964.

limited while prior options are outstanding.[25] The "employee stock purchase plans" resemble the old "restricted stock options," but are narrower in many respects and must be granted to all employees in a nondiscriminatory fashion.[26] Both the new plans are available only to employees, retain limits on options to major shareholders, and require that options be nontransferable.

b. *Old Options* Options granted before 1964 still may be exercised under the exemption, for they are within the literal language of the Texas Act.

c. *New Options* Options granted after 1963 raise more complex questions. If they are granted under plans which satisfied the old tax law but do not comply with the new, their exercise may be literally exempt. But they no longer coordinate with the tax law, and this may be grounds for destroying the exemption. Obviously the thing to do is update the plan or adopt a new one to satisfy the new tax law.

Options granted after 1963 under plans which meet the new tax law should qualify for the exemption. Any such option would have satisfied the old tax law, and it will fulfill the legislature's coordination purpose. In addition, such an option is more consonant with the Texas Securities Act because of the protection afforded by the new tax requirements already discussed (*e.g.*, shareholder approval, shorter duration, higher price, and nondiscrimination).

The State Securities Board, on May 22, 1964, interpreted "restricted stock option" to include "qualified stock purchase options and employees' stock purchase plans under the Internal Revenue Code as amended January [February] 1964" as well as "restricted stock options granted before 1964." A clarifying amendment by the legislature would be desirable.

2.3 *Granting Of Options*

The Securities Act is regarded as inapplicable to the grant of an employees' restricted stock option (as distinct from the offering of stock pursuant to the option). Although there must be consideration (*e.g.*, continued services) for the option to be valid in corporate

[25] Int. Rev. Code of 1954, § 422(b), added by Revenue Act of 1964. Additional requirements are imposed on the holder (rather than on the form of the option) if he desires capital gain treatment. In particular, he must hold the stock three years after exercising the option (instead of six months from exercise or two years from grant, whichever is later). Int. Rev. Code of 1954, § 422(a)(1), added by Revenue Act of 1964.

[26] Int. Rev. Code of 1954, § 423(b), added by Revenue Act of 1964.

law,[27] it generally has been thought to involve no "value" in the securities law sense. Since the Securities Act applies to sales and since sales are defined in terms of disposition for "value,"[28] the act does not apply to the grant of the typical employee option.

The number of options granted may be limited in practice by other considerations. Because of their dilution potential, options may prevent a later public offering from meeting the "fair, just and equitable" test for registration.[29] Although the official Statement of Policy says merely that employee options are justified "if reasonable in number and method of exercise,"[30] the rule of thumb seems to be that unexercised options should not exceed ten per cent of outstanding shares.

3. THE "15-A-YEAR" EXEMPTION—SECTION 5.I(c)

3.1 *General*

A badly needed[31] exemption was added in 1963 for "the sale by an issuer of its securities during the period of twelve (12) months ending with the date of the sale in question to not more than fifteen (15) persons . . . provided such persons purchased . . . for their

[27] See, *e.g.*, Kerbs v. California Eastern Airways, Inc., 33 Del. Ch. 69, 90 A.2d 652 (Sup. Ct. 1952), *petition for reargument denied*, 33 Del. Ch. 174, 91 A.2d 62 (Sup. Ct. 1952), *later proceedings on remand*, 33 Del. Ch. 395, 94 A.2d 217 (Ch. 1953); and cases collected in Annot., 34 A.L.R.2d 852, 855-67 (1954).

[28] Section 4.E. For further consideration of "value" in the definition of "sale" under the Federal Securities Act, see Bromberg, *Corporate Liquidation and Securities Law—Problems in the Distribution of Portfolio Securities*, 3 B. Coll. Ind. & Com. L. Rev. 1, 3-6, 12 (1961).

[29] Section 10.A.

[30] State Securities Board, Statement of Policy Regarding Options and Warrants (undated, issued early 1960, amended Oct. 29, 1962), 3 Blue Sky L. Rep. ¶ 46612, at 42506. "Warrants or . . . options . . . must be justified by the applicant" for registration. *Ibid.*

Board Statements. Although the administration of the Securities Act is vested in the Commissioner, § 3, the Board may exercise any power or perform any act authorized to the Commissioner, § 2.B. The Commissioner is appointed by, and serves at the pleasure of, the Board. § 2.B. Formal statements of policy, in practice, are published in the name of the Board rather than of the Commissioner.

The act gives no rule-making power to the Commissioner or the Board, and their pronouncements lack the force of law. The Attorney General has ruled that the Commissioner has authority to notify the industry what factors he will take into consideration. Op. Att'y Gen. (Tex.) WW-951 (Oct. 18, 1960), 3 Blue Sky L. Rep. ¶ 70504.

The Board's statements invariably are helpful. It is regrettable that statements have not been issued on more points, and that those issued have not been as widely disseminated as they might have been, *e.g.*, through the commercial publishers of blue sky law services.

[31] Committee on Securities and Investment Banking of the Section on Corp. Bank. and Bus. Law of the State Bar of Texas, *Comment—1963 Amendment [to § 5.I]*, 1B Tex. Rev. Civ. Stat. Ann. 18 (1964): "The urgent need for some form of private placement exemption in the Texas Securities Act, such as exists in the Federal and Uniform Securities Acts, has been apparent for some time. Under the previous law no such exemption existed once the corporation reaches 35 stockholders." See also Loss & Cowett, Blue Sky Law 372 (1958); Hill, *Pitfalls in the Texas Securities Act*, 10 Sw. L.J. 265 (1956), discussing the case which painfully dramatized the need, Brown v. Cole, 155 Tex. 624, 291 S.W.2d 704 (1956).

own account and not for distribution."[32] This exemption is designed primarily for private placement by a corporation which has exhausted its 35-Man Exemption. It may be used by a publicly held company. It applies to any kind of securities in any amount and may be used repeatedly at twelve-month intervals (*e.g.*, sales to fifteen on January 5 of one year and sales to another fifteen on January 6 of the next year). Or it can be employed more or less continuously, so long as the total in the latest twelve months does not exceed fifteen. Thus, it would cover one sale a month for an indefinite period.[33]

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[32] Section 5.I(c). The full text is:

> Provided such sale is made without any public solicitation or advertisements . . . (c) the sale by an issuer of its securities during the period of twelve (12) months ending with the date of the sale in question to not more than fifteen (15) persons (excluding, in determining such fifteen (15) persons, purchasers of securities in transactions exempt under other provisions of this Section 5, purchasers of securities exempt under Section 6 hereof and purchasers of securities which are part of an offering registered under Section 7 hereof), provided such persons purchased such securities for their own account and not for distribution.
>
> The issuer shall file a notice not less than five (5) days prior to the date of consummation of any sale claimed to be exempt under the provisions of clause (c), of this Subsection I, setting forth the name and address of the issuer, the total amount of the securities to be sold under this clause, the price at which the securities are to be sold, the date on which the securities are to be sold, the names and addresses of the proposed purchasers, and such other information as the Commissioner may reasonably require, including a certificate of a principal officer of the issuer that reasonable information concerning the plan of business and the financial condition of the issuer has been furnished to the proposed purchasers. The Commissioner may by order revoke or suspend the exemption under this clause (c) with respect to any security if he has reasonable cause to believe that the plan of business of the issuer of such security, the security, or the sale thereof would tend to work a fraud or deceit upon the purchaser or purchasers thereof, such order to be subject to review in the manner provided by Section 24 of this Act. The revocation or suspension of this exemption shall be inapplicable to the issuer until such issuer shall have received actual notice from the Commissioner of such revocation or suspension.

The provision is patterned on Uniform Securities Act § 402(b)(9) and Illinois Securities Law of 1953, Ill. Ann. Stat. ch. 121½, § 137.4G (Smith-Hurd 1960). See also Mo. Ann. Stat § 409.050(9) (Supp. 1963).

[33] *Date of Sale.* The sale of corporate securities by the issuer usually involves this sequence: negotiation; agreement on terms (*i.e.*, making of contract of sale or to sell); payment; execution and authentication of the security; and delivery. Which of these fixes the date of sale? In close cases, the dates of earlier and later sales may become critical. The Act is silent on when a sale is made, so the issue is left to general law. Nothing seems to be directly in point, and the possible analogies lead to diverse solutions:

(A) Corporate statutes frequently provide that stock is deemed issued when proper consideration is paid. Tex. Bus. Corp. Act. Ann. art. 2.16A (1956); ABA-ALI Model Bus. Corp. Act § 18 (1953). Provisions of this kind make execution, authentication, and delivery of certificates immaterial. They suggest that a sale typically is made when payment is received by the corporation. However, the payment generally must be of consideration fixed by the directors. Tex. Bus. Corp. Act Ann. art. 2.15A-C (1956); ABA-ALI Model Bus. Corp. Act § 17 (1953). Consequently, directors' action fixing the consideration may date the sale if it occurs after payment is received. Since these provisions apply only to shares of stock, they offer no guidance for debt securities. One blue sky case,

3.2 *The Investment Requirement*

This is the first time an explicit investment requirement has appeared in the Texas Act. It is found in the language "for their own account and not for distribution." Without such a requirement, any numerical limit is illusory. The criterion is the buyer's subjective intent to invest for the long haul rather than to trade or to speculate for the short run. Nonetheless, many persons (buyers and

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though not involving a corporate security, confirms the irrelevance of delivery. In Davis v. Walker, 170 Neb. 891, 104 N.W.2d 479 (1960), the sale of a working interest in an oil well was complete on the day a contract of sale was executed and payment made, not the following month when an operating agreement was delivered. Accordingly, no recovery could be had under the Blue Sky Law which became effective after the first date but before the second. See also Athas v. Day, 186 F. Supp. 385 (D. Colo. 1960), concerning limitations under the Securities Act of 1933. In that case a sale of outstanding securities was made when certificates and assignments were delivered by the seller to the buyer and payment was given by the buyer to the seller, not several months later when the certificates were transferred on the corporate books.

(B) Debt securities are often negotiable instruments, in which case a contract for their sale is "incomplete and revocable" until delivery. Uniform Negotiable Instruments Law § 16; Tex. Rev. Civ. Stat. Ann. art. 5932, § 16 (1962). Delivery in some instances may be constructive rather than actual. Uniform Negotiable Instruments Law § 191; Tex. Rev. Civ. Stat. Ann. art. 5948, § 191 (1962).

(C) The Uniform Sales Act, largely a codification of common law, gives the presumption that property in unascertained or future goods passes when the goods "in a deliverable state are unconditionally appropriated to the contract." Uniform Sales Act § 19, Rule 4(1). Although it seems clear that unissued securities are unascertained or future goods if securities are goods, there is conflict on the latter point. See cases cited 1A Uniform Laws Ann. 425 n. 11 (1950). If securities are goods, then execution and authentication should fix the date of the sale if they include registration in the owner's name because this is plainly an appropriation to the contract. In the case of debt securities payable to bearer, delivery appears to be the critical element, because there is not likely to be any prior appropriation. And see 2 Williston, Sales 60 n. 5 (1948), considering early holdings that one entitled to unissued securities may transfer an interest in them that is effective on his receipt of the securities without need of delivery by him to the transferee.

(D) The more recent and comprehensive Uniform Commercial Code lays down the general rule that title to goods passes when the seller completes physical delivery. Uniform Commercial Code § 2-401(2). But Uniform Commercial Code § 2-105(1) specifies that securities ("investment securities") are not goods. However, this exclusion is not intended to prevent application of the Sales portion of the Code (article 2) by analogy when sensible and not superseded by article 8 dealing with investment securities. Uniform Commercial Code, Comment to § 2-105. Article 8 is silent on when a sale is made in the original issue of securities, so it appears that article 2 will apply and that physical delivery is decisive. If article 8 is employed by analogy, the result is the same, for delivery is essential to the transfer of title in an outstanding security. Uniform Commercial Code § 8-301(1). *Accord:* Uniform Stock Transfer Act § 1; Tex. Rev. Civ. Stat. Ann. art. 1302-6.02 (1962).

One should not overlook the possibility that the date is computed differently for earlier and later sales. Section 2.E may permit this since it defines "sale" to include (among many other things) solicitations, contracts of sale, and transfers. The worst theory which results is that the earlier sales were not made until the securities were delivered, but that the later one was made when solicitation began. Symmetry and consistency weigh strongly against this argument. So does the language of § 5.I which calls for notice to the Commissioner of when and how the securities are "to be sold." Since we have observed that negotiations and commitments are permitted before the notice (see text accompanying note 41, *infra*) it would be virtually impossible to regard solicitation as a "sale" for this purpose. However, it remains possible that the sale was marked by delivery in the earlier instance and payment in the later. Since only a few days separate contract, payment, and delivery in most cases, caution in planning calls for taking the most unfavorable combination of dates.

lawyers alike) try to deal with the problem in terms of how long the security must be held. The Texas Commissioner, in his first published form[34] for use under the section, said thirteen months, but no time limit appears in the current version of the form.[35]

Federal precedents under the private offering exemption (from which the concept is drawn) permit no fixed limits. The federal idea is holding for an indefinite period unless there is a material change of circumstances not foreseeable at the time of purchase.[36] There was a stage when one year seemed like a good rule of thumb. Although there are current rumblings about five years, the predominant view is two years.[37] This view appears relatively safe, provided it is not applied automatically but is considered with other factors (*e.g.*, changing circumstances).

A private offering purchaser under federal law is not wholly locked in. He may resell to other persons who bought in the same offering, if they have the requisite investment intent. He may sell to third parties who have appropriate investment intent so long as the totality does not amount to a "distribution" (public offering). Or he may sell to the public at large if his securities are registered properly. These possibilities in general should carry over to the Texas situation.[38]

As a practical matter, resales are not a problem unless there is a public interest in the security or unless one quickly develops. Really closely held companies rarely will have to worry. But publicly held companies may want to take extra precautions (such as transfer restrictions or large denomination securities) in utilizing this ex-

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[34] State Securities Board, Issuer's Notice of Sales under Section 5.I(c) Article 581, Vernon's Annotated Texas Statutes, The Securities Act of Texas at 2 (undated, issued about Sept. 1963).

[35] State Securities Board, Issuer's Notice for Exemption to Sell Securities under Section 5.I(c) Article 581, Vernon's Annotated Texas Statutes, The Securities Act of Texas (undated, issued early 1964).

[36] See 1 Loss, *op. cit. supra* note 10, at 665-73; SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962, 1 CCH Fed. Sec. L. Rep. ¶¶ 2770-83; Israels, *Some Commercial Overtones of Private Placement,* 45 Va. L. Rev. 851 (1959). The statutory language of the federal private offering exemption is "transactions by an issuer not involving any public offering." Securities Act of 1933, § 4(1), second clause, 48 Stat. 77, as amended, 15 U.S.C. § 77d(1), second clause (1958).

[37] See Practising Law Institute, S.E.C. Problems of Controlling Stockholders and in Underwritings 29-31 (Israels ed. 1962).

[38] The first two situations correspond roughly with § 5.C(1) which exempts certain nonissuer, nondealer sales "in the ordinary course of bona fide personal investment . . . or change in such investment." The sales must not be "in the course of repeated and successive transactions of a like character." *Ibid.* This language effectively precludes a public offering, at least by a person in control of the issuer. Section 5.O, exempting secondary trading in certain outstanding securities, applies only to registered dealers. Thus, although the Texas Act nowhere expressly requires registration of outstanding privately placed securities before they are publicly distributed, it impliedly permits registration, and probably requires it in the case of controlling persons.

emption. At the least, the issuer must obtain from each buyer a statement that he is taking for his own account and not for distribution. (The Commissioner's form of notice[39] requires submission of the form of investment letter.) It remains to be seen how far behind this statement the issuer must inquire, or what happens to the exemption if the buyer does distribute later on. The issuer (as noted in 1.2 *supra*) ought to be protected if it acts in good faith and with reasonable diligence. But it cannot rely blindly on the formality of an "investment letter."[40]

3.3 *The Notice Requirement*

Unlike other exemptions, this one involves notice to the Commissioner. It must be given five days before "consummation" of sale. This permits negotiations and some kind of commitments before filing. Otherwise it would be impossible to supply the information called for in the notice, *e.g.*, names and addresses of proposed purchasers and the date on which the securities are to be sold.[41]

The Commissioner is authorized to require additional information. Under this provision, his form of notice[42] calls for considerable data, including: financial statements (audited if available, otherwise certified by the principal financial officer), a description of the plan of business, counsel's opinion on validity of the issue, and the relation of each purchaser to the issuer or to its officers and directors.

The Commissioner's form of notice, though not mandatory, should be used; it may be obtained by writing to the State Securities Board, P.O. Box 12306, Capital Station, Austin 11. The need for advance filing deserves re-emphasis.[43] There is no provision for curing by later action.

3.4 *The Information Requirement*

Federal law has set the pattern that small offering exemptions are available only to persons who have access to relevant investment information.[44] To safeguard the exemption (and to avoid making material omissions which might lead to civil liability), it has become customary to supply private offering purchasers with a substantial amount of in-

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[39] See note 35 *suhra.*

[40] For the same proposition in federal law, see SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962, 1 CCH Fed. Sec. L. Rep. ¶¶ 2770-83, at 2683; *In re The Crowell-Collier Publishing Co.*, SEC Securities Act of 1933 Release No. 3825, Aug. 12, 1957, CCH Fed. Sec. L. Rep. ¶ 76539 (Transfer Binder, 1957-61 Decisions).

[41] Section 5.I, second paragraph.

[42] See note 35 *supra.*

[43] In May, 1964, the Deputy Commissioner stated that § 5.I(c) filings were being made at the rate of about five a week. To that date, only one had been rejected.

[44] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

formation about the company, the security, finances, etc. The Texas Act has picked up this practice somewhat obliquely by requiring the notice to contain a certification that "reasonable information concerning the plan of business and the financial condition of the issuer has been furnished to the proposed purchasers."[45] The Commissioner's form of notice[46] implements this and requires inclusion of all material furnished to the buyers. Although not everything included in the notice form need be given to buyers, most of the things listed in it are relevant. Often it will be simpler to give all of the data to the buyers rather than to decide what can be omitted safely.

3.5 *How To Count To Fifteen*

The statute expressly excludes from the count sales that are exempt under other sections (but *not* other subsections of 5.I), *e.g.*, sales to financial institutions,[47] sales to existing security holders,[48] certain reorganizations and acquisitions,[49] sales of exempt securities,[50] and sales of registered securities.[51] The exemption, then, is essentially for sales to individuals or nonfinancial corporations. It is possible to make an exempt private placement just before or just after a registered public offering, in connection with a pre-emptive offering or in conjunction with an institutional financing. The fifteen, however, does include sales under the 35-Man and the Employee Option Exemptions. So a corporation which sells to thirty-five security holders immediately on organization must wait twelve months before using the 15-a-Year Exemption. Or if it sells stock to five employees on options during a given twelve months, a corporation can sell to only ten others under the 15-a-Year Exemption.

The legislative intent to stop at fifteen beneficial owners (regardless of record ownership) is manifest in the requirement that each buyer take for his own account and not for distribution. As suggested above,[52] the corporation presumably is protected if it relies in good faith on the buyer's representation, even though the representation later appears to have been false. It is a reasonable guess that other beneficial owner problems (partnerships, trusts, husband and wife) will be treated as under the 35-Man Exemption.[53]

As with the 35-Man Exemption, several sales to the same buyer

[45] Section 5.I, second paragraph.
[46] See note 35 *supra*.
[47] Section 5.H.
[48] Section 5.E.
[49] Sections 5.F and G.
[50] Section 6.
[51] Section 7.
[52] See text, 1.2 *supra*.
[53] *Ibid.*

are counted only once, and there is no distinction between sales inside or outside of Texas.[54] In contrast to the 35-Man Exemption, it is the number of purchasers (rather than the number of security holders at the conclusion of the offering) that is decisive. If a corporation sells to fifteen purchasers, five of whom resell to the remaining ten, the corporation can make no additional sales.

3.6 *Sophistication Of Purchasers*

The exemption for sales to banks, insurance companies, and other financial institutions[55] rather obviously rests on the sophistication of the purchasers. The 15-a-Year Exemption has no express requirement that the purchasers be sophisticated, and it would have been hard to fashion one.[56] The roughly comparable federal exemption for private offerings[57] has no express requirement of sophistication, but something of the sort has been inferred judicially and administratively.[58] The draftsmen of the Texas provision were fully aware of this as they wrote. One can fairly conclude that a part of the sophistication element has been quietly absorbed by the Texas provision from the federal one. This conclusion is suggested by the statutory requirement that the notice to the Commissioner identify the purchasers;[59] such information hardly would be necessary if only their number were material. The Commissioner's form of notice[60] goes further and calls for information on each purchaser's occupation and relation to the issuer. Quite properly, he will take these factors into consideration in deciding whether to exercise his unusually broad powers to suspend the exemption. He may do so if he has reasonable cause to believe that the transaction would tend to work a fraud upon the purchaser.[61] His large grant of discretion carries with it the authority to examine all relevant factors, whether or not specified by the act, in relation to each purchaser. Therefore, counsel would be well ad-

[54] If all the sales were made outside Texas, the Texas Act presumably would be inapplicable and the exemption unnecessary. Whether a Texas corporation, or one doing its principal business in the state, can completely shift the sale beyond the jurisdiction of the Act is an open question.

[55] Section 5.H.

[56] See text, 5.1(b) *infra.*

[57] Securities Act of 1933, § 4(1), 48 Stat. 77, as amended, 15 U.S.C. § 77d(1) (1958).

[58] From the legislative history, the United States Supreme Court concluded that an offering "to those who are shown to be able to fend for themselves" was exempt. SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953). For further discussion, see 1 Loss, *op. cit. supra* note 10, at 663-65. On administrative interpretation see, *e.g.*, Orrick, *Some Observations on the Administration of the Securities Laws*, 42 Minn. L. Rev. 25, 33-34 (1957); Victor & Bedrick, *Private Offering: Hazards for the Unwary*, 45 Va. L. Rev. 869, 871-72 (1959).

[59] Section 5.I, second paragraph, first sentence.

[60] See note 35 *supra.*

[61] See text, 4.7 *infra.*

vised to discourage the use of this exemption for sales to "widow and orphan" types.

4. Some Overlapping Questions

4.1 *Manner Of Offering*

All three of the Texas small offering exemptions are conditioned on the absence of "any public solicitation or advertisements."[62] These terms are not defined[63] and have not been construed fully. They obviously preclude mass media advertising and large-scale mail or telephone solicitation.

The federal private offering exemption imposes its nonnumerical limits on the offerees, even though the actual purchasers may be far fewer.[64] The Texas numerical limits (thirty-five and fifteen) apply only to purchasers, but the prohibition on public solicitation imposes nonnumerical limits on the offerees, with a result similar to the federal nonnumerical limits.[65] In the Commissioner's view, serious questions arise if an offering under any of the three exemptions extends beyond the issuer's (and its principals') business associates, friends, family, and the like.

4.2 *Convertibles And Warrants*

The Employee Option Exemption is limited to stock, which may be either preferred or common, although the former almost never is used. The other two small offering exemptions are good for any kind of securities, including convertibles and warrants. In contrast to

[62] Section 5.I, first clause.

[63] "Offer for sale" is defined to include every attempt to dispose of a security for value. § 4.E. Plainly, not every offer will be an advertisement or public solicitation. By § 22, it is unlawful "to issue, distribute, or publish . . . any circular, advertisement, pamphlet, prospectus, program or other matter, as to any security, unless *such advertising*" complies with certain requirements. (Emphasis added.) This is not a formal or general definition; even if it is, it defines "advertising" (rather than "advertisement," the word used in § 5.I and only one of the elements in the § 22 listing). Moreover, it turns as much on the method of dissemination ("issue, distribute or publish") as on the thing disseminated. (To the same effect is the criminal provision on advertising, § 29.H.) All in all, it sheds little light on the meaning of "advertisement" in § 5.I.

[64] The exemption is cast in terms of the "offering"; see the language quoted in note 36 *supra*. "You will note that this [the number of offerees] does not mean the number of actual purchasers, but the number of persons to whom the security . . . is offered. . . . Any attempt to dispose of a security should be regarded as an offer. . . . [P]reliminary negotiations or conversations with a substantial number of prospective purchasers would . . . cause the offering . . . to be a public offering. . . . " SEC Securities Act of 1933 Release No. 285, Jan. 24, 1935, 1 CCH Fed. Sec. L. Rep. ¶¶ 2740-44, at 2674.

[65] Logically, the number of permissible offerees under Texas law must be somewhat greater than the respective numerical limits (35 and 15) on purchasers or holders. It is common knowledge that not everyone who is approached will buy, and the legislature hardly could have intended to apply silently to offerees the numbers it sets out explicitly for buyers.

federal law,[66] the sale of a convertible or warrant does not constitute an offer or sale of the underlying security in Texas.[67] The actual conversion, or the exercise of a nontransferable warrant (each of which involves a sale of the underlying security) is separately exempt.[68] The exercise of a transferable warrant is not per se exempt, but it may qualify under the 35-Man or 15-a-Year Exemptions if the appropriate requirements are met.

4.3 *Role Of The Broker-Dealer*

The small offering exemptions contain no prohibition on payment of commissions or on the use of broker-dealers to assist in the offering. Nevertheless, the ban on public solicitation and advertising will compel the broker-dealer to act very discreetly.[69]

Selling to a broker-dealer for his own account is separately exempt,[70] but it presents difficulties because of the widespread feeling that persons in the business of selling securities do not take them "for investment."[71] Resales by a broker-dealer would be especially likely to destroy either the 35-Man or 15-a-Year Exemptions. Accordingly, extra precautions (like transfer restrictions) may be advisable, particularly since the Commissioner feels that the question of public solicitation arises whenever a broker-dealer is used.

4.4 *Interrelation Of Exemptions*

Although the three small offering exemptions are separate, a close reading of the statute reveals a number of interrelations and certain planning possibilities.

(A) Option sales to employees must be counted toward the limit in the 35-Man Exemption, but may continue on their own under the Employee Option Exemption. As a result, option sales should be postponed (insofar as possible) until all contemplated sales to non-employees have been completed. Indeed, against the possibility that

[66] Generally speaking, a warrant or convertible is an offer of the underlying security at all times when it is exercisable or convertible. See Securities Act of 1933, § 2(3), 48 Stat. 74, as amended, 15 U.S.C. § 77b(3) (1958); 1 Loss, *op. cit. supra* note 10, at 299-300.

[67] Section 4.E, sixth sentence.

[68] Section 5.E. It is a condition of the exemption that no remuneration (other than a stand-by commission) be paid for soliciting the conversion or exercise.

[69] For the comparable proposition under federal law, see SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962, 1 CCH Fed. Sec. L. Rep. ¶¶ 2770-83, at 2682-83. In general, see Stuebner, *The Role of the Investment Banker in Arranging Private Financing*, 16 Bus. Law. 377 (1961).

[70] Section 5.H.

[71] "[P]urchases by persons engaged in the business of buying and selling securities require careful scrutiny for the purpose of determining whether such person may be acting as an underwriter for the issuer"; *i.e.*, rather than taking for investment. SEC Securities Act of 1933 Release No. 4552, Nov. 6, 1962, 1 CCH Fed. Sec. L. Rep. ¶¶ 2770-83, at 2683. To the same effect, under the intrastate exemption, see SEC Securities Act of 1933 Release No. 4434, Dec. 6, 1961, 1 CCH Fed. Sec. L. Rep. ¶¶ 2270-77, at 2583.

an optionee is a security holder for purpose of the thirty-five,[72] it may be wise not even to grant employee options until all contemplated sales to nonemployees have been completed.

(B) The relation of the 35-Man and 15-a-Year Exemptions already has been noted:[73] *i.e.*, sales under the 35-Man Exemption in any given twelve months must be counted toward the 15-a-Year Exemption for the same twelve months. There is little room for planning in this situation. However, there may be rare instances of a happy combination of exemptions: *e.g.*, the 35-Man Exemption provides initial capitalization; institutional financing[74] and sales to existing security holders[75] carry for the next twelve months; and a private placement with new individuals follows under the 15-a-Year Exemption.

(C) The relation of the Employee Option and the 15-a-Year Exemption was mentioned in 3.5 *supra*: *i.e.*, option sales must be counted toward the 15-a-Year Exemption. The effect is to reduce the usefulness of the latter exemption for companies with extensive option plans (unless the plans are registered). Some control over this result may be accomplished by postponing the exercisability of options during periods in which exempt private placement is anticipated.

4.5 *Relation To Other Exemptions*

The 35-Man and 15-a-Year Exemptions can be followed by other exemptions, such as for sales to financial institutions[76] or to existing security holders,[77] or for reorganizations[78] and acquisitions.[79] If the order is reversed, the 15-a-Year Exemption is unaffected but the 35-Man Exemption is impaired; the degree of impairment will depend, of course, on the number of security holders involved in the other transactions. The Employee Option Exemption can be used independently of and in addition to exemptions in other sections, either before or after.

4.6 *Relation To Federal Exemptions*

Without a corresponding federal exemption, a local exemption is not worth much, for there still will be the delay and expense of registration with the SEC. Many purely local offerings by local com-

[72] See text accompanying note 19 *supra*.
[73] See text, 3.5 *supra*.
[74] Section 5.H.
[75] Section 5.E.
[76] Section 5.H.
[77] Section 5.E.
[78] Section 5.F.
[79] Section 5.G.

panies will be federally exempt as intrastate offerings,[80] although this exemption has far more limitations and pitfalls than is generally realized.[81] Another possibility is resort to Regulation A[82] which, however, is limited to issues of 300,000 dollars or less and which requires substantial filings with the SEC. The remaining (and most important) federal exemption is for private offerings.[83] Without attempting a detailed analysis, most 35-Man and 15-a-Year Exemptions will qualify federally as private offerings, although more "sophistication"[84] and "investment intent"[85] are probably necessary for the federal than for the 35-Man. Also, thirty-five at one time would dangerously stretch the rule of thumb of twenty-five which has grown up around the federal exemption[86] (and which is none too reliable there). The Employee Option Exemption has no analogue in federal law, and offerings of this sort must be registered with the SEC (or qualified under Regulation A) unless they are sufficiently limited geographically to be intrastate or numerically to be private.

4.7 *Revocation Of Exemptions*

Only one of the small offering exemptions has (like the secondary trading exemption[87]) a built-in power of revocation by the Commissioner. This is the 15-a-Year Exemption.[88] The Commissioner may revoke or suspend the exemption if he has reasonable cause to believe that the plan of business or the sale of the security would tend to work a fraud. No notice or opportunity for hearing is required, but his order is not effective until the issuer has received actual notice. The issuer may request a hearing before the Commissioner. After the hearing, the Commissioner must issue a written decision stating his reasons;[89] it is subject to judicial review.[90]

Quite apart from this summary power to revoke or to suspend,

[80] An intrastate offering is "any security which is a part of an issue offered and sold only to persons resident within a single State . . . where the issuer . . . is . . . incorporated by and doing business within such State. . . . " Securities Act of 1933, § 3(a)(11), 48 Stat. 75, as amended, 15 U.S.C. § 77c(a)(11) (1958).

[81] In Texas, the federal intrastate exemption can be used only by a concern incorporated in Texas and performing substantial operations in the state. A single reoffer out of state, even though not by the issuer and not resulting in a sale, may destroy the entire exemption. SEC Securities Act of 1933 Release No. 4434, Dec. 6, 1961, 1 CCH Fed. Sec. L. Rep. ¶¶ 2270-77.

[82] SEC Rules 251-63, 17 C.F.R. §§ 230.251-230.263 (1964), pursuant to Securities Act of 1933, § 3(b), 48 Stat. 75, as amended, 15 U.S.C. § 77c(b) (1958).

[83] Quoted in note 36 *supra.*

[84] See text, 3.6 *supra.*

[85] See text, 3.2 *supra.*

[86] 1 Loss, Securities Regulation 660-65 (2d ed. 1961).

[87] Section 5.0.

[88] Section 5.I, second paragraph.

[89] Section 24.

[90] Section 27.

the Commissioner has general authority, after notice and opportunity for hearing, to prohibit the sale of any security. Here he operates with somewhat broader criteria; he may prohibit the sale if he finds that it would tend to work a fraud or would not be "fair, just and equitable."[91]

In addition to being swifter, the summary power to suspend has a lower threshold than the general power to prohibit: to suspend the Commissioner need only have "reasonable cause to believe"; for the general power he must "determine." These differences indicate that the legislature was particularly concerned over possible abuses of the 15-a-Year Exemption and armed the Commissioner accordingly.

4.8 *Failure To Comply With An Exemption*

Each of the three small offering exemptions has enough technicalities or uncertainties to make violation a real possibility. The consequences may include: (A) rescission or damage recoveries by purchasers;[92] (B) insistence that the issuer show in its financial statements a contingent liability for such rescission or damages;[93] (C) injunction or stop order against further sales;[94] (D) criminal conviction;[95] or (E) if a securities dealer is involved, revocation of his license.[96] The issuer has the burden of proving exemption if it is questioned.[97]

Many practical factors enter into a realistic appraisal of the risks. Buyers are unlikely to sue if their securities are worth more than they paid for them.[98] Criminal and administrative proceedings are improbable except in willful cases. Violations often go undiscovered.[99] Purchasers may not know of the technical requirements or suspect that there has been noncompliance. State officials have little occasion

[91] Section 23.A.

[92] Section 33.

[93] This sanction, without explicit statutory authority, is imposed in connection with the required contents of financial statements in a registration. § 7.A(1)f. For federal practice, see Israels, When Corporations Go Public 147-49 (1962).

[94] Sections 32, 33.

[95] Section 29.

[96] Section 14.

[97] Section 37.

[98] This is particularly true of employees who have bought on options. They probably will not have exercised the options unless the option price is below the going market for the security. Moreover, the pressures of employment (so long as they continue) will deter litigation.

[99] In a rescission action for failure to register, limitations are three years from the contract of sale. For material misrepresentations or omissions, they are three years from the time the buyer "in the exercise of ordinary care should have discovered that [the] sale was made in violation." § 33.C. Assuming that the only violation was failure to register, the buyer has three years in which to sue; this is much more generous than the one year available under federal law. Securities Act of 1933, § 13, 48 Stat. 84, as amended, 15 U.S.C. § 77m (1958). Criminal prosecutions must be brought within three years. Tex. Code Crim. Proc. Ann. art. 180 (1954) (nonenumerated felonies).

to investigate sales unless complaints are made or unless a registration statement is filed later for a public offering.

Thus, the odds are against serious repercussions for violations where the law is not interpreted (*e.g.*, certain counting problems) or from actions over which the issuer has little control (*e.g.*, resales or reoffers despite investment representations). This is especially true if the issuer has made a good faith attempt to comply.[100] But there is no excuse for trifling with the exemptions, which represent limited exceptions to registration laws embodying a vital policy of investor protection.

The Commissioner takes the position that the act makes no distinction between willful and nonwillful violation. In furtherance of his policy of preventing violations, he and his staff encourage inquiries and pre-filing conferences.[101]

4.9 *Extent Of Exemption*

It should be emphasized that the exemption is from the registration and prospectus requirements.[102] By a literal reading, the exemption extends (illogically) to the criminal provisions.[103] But there is no exemption from the stop order or injunction sections, or (more important) from civil liability for material omissions or for misstatements in the sale of securities.[104] And, of course, there is nothing in the Texas Act which assures exemption from federal law.[105]

[100] An opinion of counsel often is sought, both for its analytical value and as evidence of good faith. Since the availability of an exemption often depends heavily on facts, some of which are unknown or have not yet occurred, counsel may have difficulty giving a firm opinion. He faces the dilemma of investigating the facts to his satisfaction (which he may not be equipped to do) or so qualifying his opinion by assumed facts that it is more hypothetical than real.

[101] Many lawyers are hesitant to ask the Commissioner about borderline cases. They fear that government officials incline toward assertion of jurisdiction and are likely to require registration or to impose regulation that might be avoided by a calculated risk. Undoubtedly, there is basis for such apprehension. On the other hand, an informal inquiry may give both assistance and reassurance in many instances. Note, however, that a favorable opinion by the Commissioner or his staff is of little or no help in a civil liability (rescission) action by a purchaser claiming that there was no exemption.

[102] By § 5, first paragraph, the exemption lets the issuer avoid being a dealer, which otherwise it probably would be under the broad definition of § 4.C. Thus, it is relieved from the necessity of registering as a dealer under § 12.

[103] The opening language of the sections on exempt transactions and exempt securities (§§ 5, 6) states that "the provisions of this Act shall not apply" to the enumerated items "except as hereinafter in this Act specifically provided." In cognizance of this, § 23.A (stop orders), § 32 (injunction), and § 33 (civil liability) in varying phraseology specifically provide that they operate regardless of exemptions. (Before the 1963 amendment, civil liability was cut off by exemptions; see Committee on Securities and Investment Banking of the Section on Corp., Bank. and Bus. Law of the State Bar of Texas, *Comment — 1963 Amendment* [*to Sec. 33*], 1B Tex. Rev. Civ. Stat. Ann. 69-70 (1964).) But there is no such specific provision in § 29 (penal provisions) or § 22 (advertising). On the latter point, recall that some exemptions have their own prohibitions on advertising. See text, 4.1 *supra*.

[104] See note 94 *supra*.

[105] See text, 4.6 *supra*.

4.10 *Cautions On The Federal Analogy*

Anyone looking at the Texas small offering exemptions is tempted to interpret them in the light of the federal private offering exemption, and this Article often has yielded to the temptation. It is a natural thing to do because of the much greater experience with and jurisprudence on the federal exemption. But a critical difference must be taken into account if the tendency is to be kept within rational bounds. The difference is the obvious one that the principal Texas exemptions are numerical (fifteen and thirty-five) and objective but the federal exemption is not.

Specificity in the small offering exemptions has been an overwhelming wish of blue sky lawyers in general[106] and of the members of the State Bar Committee who drafted section 5.I in the form passed by legislature. In recognition of this deliberate choice of specificity in the face of the federal precedent, it is proper to draw on the federal analogy only to the extent that is consistent with the objective, numerical character of the state provision. There is no reason to import all the nebulous features which complicate and confuse the federal exemption.

5. THE RATIONALE FOR SMALL OFFERINGS EXEMPTIONS

Although exemptions permeate the securities laws, there has been little attempt to examine why they are there or whether they should be.[107] The small offering exemptions discussed in this Article should be among the easiest to explore in this respect. Yet, even here, divergent factors can be cited and widely different emphases placed upon them. No clear theoretical pattern emerges. And in most states (including Texas) there is no real legislative history to guide us.[108]

[106] Loss & Cowett, Blue Sky Law 373 (1958).

[107] Among the attempts are: Bromberg, Book Review, 12 J. Legal Ed. 127, 130 (1959); Hill, *Some Comments on the Uniform Securities Act,* 55 Nw. U.L. Rev. 661, 690-94 (1961); Raines, Exemptions Under the Texas Securities Act: A Critique 22-24 (1962-63, unpublished Seminar Paper in Securities Regulation, SMU Law School Library). Probably the most comprehensive, drawing on many sources, is Note, *The Uniform Securities Act,* 12 Stan. L. Rev. 103 (1959); *Id.* at 146-51 (small offerings).

A sharp argument against the federal private offering exemption, on grounds of its anti-competitive effects, is Steffen, *The Private Placement Exemption: What to Do about a Fortuitous Combination in Restraint of Trade,* 30 U. Chi. L. Rev. 211 (1963).

[108] The legislative history of the federal private offering exemption is meagre and general; the private offering was said to be a transaction "where there is no practical need for [the bill's] application or where the public benefits are too remote." H.R. Rep. No. 85, 73rd Cong., 1st Sess. 5 (1933). The implications are examined and formulated in the leading case of SEC v. Ralston Purina Co., 346 U.S. 119, 125 (1953): "[T]he applicability of [the exemption] should turn on whether the particular class of persons affected needs the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering' "; hence it is exempt.

Like many arguments about government activity,[109] this one can be discussed conveniently in terms of benefit and burden. We first discuss them separately, and then weighed against each other.

5.1 *Benefit*

We assume that securities registration brings diverse benefits,[110] such as preventing fraud,[111] disclosing relevant information, and (in states like Texas) setting some minimum qualitative standards for salable securities.[112] It follows that an exemption is justified if registration would produce little or no benefit. This leads us to consider who is benefited by registration, and to what extent.

a. *Quantitative Considerations* Let us make the fairly reasonable additional assumption that the benefits of registration are proportional either to the dollar volume of securities or to the number of buyers. To justify the small offering exemptions, it would suffice to show that registration would not provide significant benefit to the various groups we might select for consideration.

(1) If it is the community and the economy at large which benefit from registration (say, through better capital instruments or more

[109] Compare Blum & Kalven, The Uneasy Case for Progressive Taxation 35-39, 100-03 (1953).

[110] A statistically oriented economist has questioned the whole policy of registration with data which "suggest that the S.E.C. registration requirements had no important effect on the quality of new securities sold to the public." Stigler, *Public Regulation of the Securities Markets,* 37 J. Bus. U. Chi. 117, 120-24 (1964). He has compared market performances of registered and nonregistered public issues. The market performances compared were, respectively, before (1923-28) and after (1949-55) the SEC went into operation. A comparison of contemporaneous registered and nonregistered public issues obviously is impossible since virtually all public issues have been registered since 1933. Nevertheless, his use of such different time periods weakens his argument. In addition, he makes the questionable assumption that the proper test of public policy here is whether investors have made money. Some states are oriented this way, but the federal policy has been not so much to help investors make money (or to keep them from losing it) as to have a more informed basis for their investment judgments. Thus, Stigler ignores the possibility that, post-SEC, the losses may have been incurred by people who are better equipped, financially or psychologically, to bear them as a result of the SEC process. Nevertheless, Stigler's is a refreshing approach to testing public policy. Stigler's theories, data, and conclusions have been scrutinized and rejected by Friend & Herman, *The SEC through a Glass Darkly,* ___ J. Bus. U. Chi. ___ (Oct. 1964).

[111] The costs of preventing securities fraud are certainly lower than the losses and the civil and criminal enforcement costs occasioned by fraud.

[112] In general, see Loss & Cowett, Blue Sky Law 67-79 (1958); Uniform Securities Act § 306(a)(2)(E) & (F) (registration may be denied if the offering would tend to work a fraud or would involve unreasonable compensation to promoters or underwriters). In Texas, see § 9.B (commissions and marketing expenses limited to 20%), § 19.A (permit granted if plan of business and consideration paid by promoters are fair, just and equitable); State Securities Board, Administrative Interpretation of Section 7C(2) and Section 10A of the Securities Act of Texas (undated, issued about June, 1961) (price paid by promoter ordinarily must be at least 4/5 the price paid by the public; ordinarily, not more than 90% of capital may be sought from the public); State Securities Board, Statement of Policy Regarding Options and Warrants (undated, issued early 1960, amended Oct. 29, 1962), 3 Blue Sky L. Rep. ¶ 46612 (general limits on options to employees; specific limits on and terms of options to underwriters).

efficient allocation of funds), we must look to the aggregate effect of small offerings. It is difficult to gauge their volume. We can start with figures published by the SEC which show that more corporate securities are now placed privately than publicly.[113] However, the great majority of these securities are bonds or notes of relatively established concerns that are sold to insurance companies and other institutional investors.[114] These buyers presumably are quite able to fend for themselves, and neither they nor the economy would derive much benefit from registration. An exemption for such sales is thus easy to justify in qualitative terms.[115]

But the SEC's figures omit private offerings under 100,000 dollars,[116] which are precisely the ones that must be justified separately if the present form of the small offering exemptions is to withstand criticism. These offerings are made mainly by less-established issuers to individuals, and probably tend more heavily to stock than to debt. No doubt, the SEC's failure to tabulate them is due to the difficulty of obtaining information about them; they are unlikely to be registered in the states or announced in the financial press, and, because they are private, they are not registered with the SEC.

Other data suggest that these nontabulated or "small-small" offerings are of the order of 400-500 million dollars and 500,000-600,000 buyers a year in the nation,[117] including 20 million dollars and 25,000

[113] 6.4 billion dollars privately and 5.8 billion dollars publicly in 1963 (total 12.2 billion dollars). SEC Statistical Series Release No. 1953, Jan. 28, 1964.

[114] In 1963, 89% of all corporate offerings were bonds and notes (10.9 billion out of 12.2 billion dollars); in 1961 it was 72% (9.4 billion out of 12.1 billion dollars). SEC Statistical Series Release No. 1953, Jan. 28, 1964. The debt proportion in private placements was probably still higher, although figures are not available for these years. For 1951, 1953, and 1955, debt represented 96% of private placements (9.2 billion out of 9.5 billion dollars), but only 75% of all corporate offerings (20.2 billion out of 26.9 billion dollars). SEC Cost of Flotation of Corporate Securities 1951-1955, at 62-63 (1957); 22 SEC Ann. Rep. 234 (1956). In years for which reported private placements have been classified by types of purchasers, life insurance companies have bought nearly 90% and other financial institutions most of the rest. SEC, Privately-Placed Securities—Cost of Flotation 6 (1952). Life insurance companies almost everywhere must limit their investments in corporations to those of substantial size, age, or demonstrated earning capacity.

[115] Exemptions for sales to financial institutions are widespread. Loss & Cowett, Blue Sky Law 367 (1958); Uniform Securities Act § 402(b)(8); Texas § 5.H. There is no such provision in the federal law.

But see, on the anticompetitive effects of the federal private offering exemption, Steffen, *supra* note 107.

[116] 28 SEC Ann. Rep. 178 (1962). This same limitation carries over to other figures based on the SEC data, *e.g.*, U.S. Dep't of Commerce, Historical Statistics of the United States Colonial Times to 1957, 652, 658 (1960); U.S. Dep't of Commerce, Statistical Abstract of the United States 624 (1963).

[117] *Volume of Small-Small Offerings.* New business corporations are formed at the rate of 16,000 a month (seasonally adjusted) or 185,622 for 1963. Wall Street Journal, June 10, 1964, p. 1, col. 4 (Southwest ed.); Survey of Current Business, Feb., 1964, p. S-7. To find those not tabulated by the SEC, we eliminate by two adjustments those which the SEC does tabulate. First, we subtract 2,000 (the total number of registrations). Second, we eliminate those who made private offerings over $100,000 (which are tabulated by the

buyers in Texas.[118] If these estimates are at all accurate, it is hard to say that the community and the economy would not benefit by having them registered. The figures are large in themselves, and they

SEC). No direct figures are available for current years. The last available appear to be 2,613 private offerings totalling 10.1 billion dollars for 1951, 1953, and 1955 combined. SEC, Cost of Flotation of Corporate Securities 1951-1955, at 25 (1957). The average size then was 4 million dollars. Assuming no change in the average size, about 1,600 issuers would have accounted for the 6.4 billion dollars of private offerings tabulated by the SEC for 1963. See note 113 *supra*. (This is corroborated by an industry publication's figures showing 1,388 private placements totalling 7.3 billion dollars in 1963. Investment Dealers' Digest, Corporate Financing Directory, § II, p. 94 (Feb. 3, 1964). The exact coverage is not stated, but they seem to be large issues sold through brokers or to institutions. *Id.* at 82-91, 94-96.)

The two groups of SEC-tabulated offerings total 3,600 in number. Undoubtedly most of these are established companies, not new ones. Yet even if they were all new, their elimination leaves over 180,000 new corporations which somehow were financed in 1963, presumably by private offerings under $100,000.

We assume an average of $2,000 capitalization for each of these corporations. This is a modest figure for many enterprises, and is only twice the legal minimum in some twenty states. See 2 Model Business Corporation Act Annotated 183-85 (1960). 180,000 corporations at $2,000 each would indicate 360 million dollars of nontabulated financing by new companies. In addition, a quite substantial amount must be done by companies formed in previous years. Thus, it seems reasonable to suppose that offerings not tabulated by the SEC are of the order of 400 to 500 million dollars a year. These are the "small-small" offerings necessary to an appraisal of the state small offering exemptions.

If new corporations had an average of three investors each (probably a low guess), 540,000 sales would have occurred. The number of buyers may have been smaller, because some invested in several companies. But others might have taken small offerings in older companies. Altogether, it seems reasonable to suppose that the number of buyers in "small-small" offerings is in the range of 500,000 to 600,000 a year.

Our figures for small-small offerings thus represent 4% by dollar amount and 98% by number of securities offerings.

The proportion of buyers represented is harder to determine but probably is rather high. A revealing comparison is with the dynamic broad-based, highly regulated mutual fund industry. Its accounts (shareholders) increased by a net of 241,480 in 1963. Investment Company Institute, Mutual Funds—A Statistical Summary, 1940-1963, at 1. The gross number of buyers must have been somewhat higher, since an unspecified number of accounts were closed by complete redemption. Even assuming .6 redeemer for each buyer (this is the *dollar* ratio of redemptions to sales, *Id.* at 2, ignoring partial redemptions which probably predominated), we would have net buyers equalling .4 (*i.e.*, 1 - .6) of gross. This generous estimate gives 603,700 mutual fund buyers, the same size as the group we have found buying in small-small offerings.

[118] 9,444 firms were incorporated in Texas in the fiscal year ended August 31, 1962. Martin, Common Problems of Corporation Lawyers in Texas 3 (Speech to State Bar of Texas, Section on Corporation, Banking and Business Law, July 5, 1963). During the same period, the Commissioner received only 911 applications for registration, covering 412 million dollars, of which he granted 695 for 357 million dollars. Of the granted permits, only 128 for 108 million dollars were for Texas issuers; not all of these were corporations and probably relatively few of them were new corporations. Thus, at most 1.5% of the newly chartered Texas corporations received permits, probably less than 1%.

Assuming, as in note 117 *supra*, $2,000 and 3 investors per new corporation, some 18 million dollars were obtained from nearly 28,000 investors by new corporations under the small offering exemptions. This is in addition to amounts (perhaps much larger) similarly obtained by older corporations. Not all of this amount may have been raised in Texas, but the non-Texas portion was probably more than offset by funds raised in Texas by non-Texas corporations (which have not been included in this estimate).

Inclusion of offerings by older corporations probably brings the totals over 20 million dollars. Texas small offerings, therefore, represent some 6% by volume and 92% by number of total offerings (ignoring offerings under other exemptions, for which no figures are available).

represent some four per cent by volume and well over ninety per cent by number of corporate offerings, and an unknown (but probably rather high) proportion of buyers.[119]

(2) If the benefit of registration is thought to go to purchasers in the aggregate (say, through protection from fraud or through information for more intelligent investment choices), the reasoning and results would be the same as in (1) above.

(3) If the benefit is thought to go to purchasers individually, then because each purchase is relatively small in dollar amount, it becomes reasonable to apply a de minimis theory and to say that there would be no significant benefit in registering any particular "small-small" offering. It also becomes more convincing to argue that protection is afforded by factors other than registration, such as the buyer's proximity to and familiarity with the issuer. This may be true, but it is hardly a complete justification for existing numerical exemptions which are not limited to such situations. Nevertheless, the argument of proximity and familiarity does go a long way to justify the Employee Option Exemption, especially if taken in conjunction with the tax benefits and price advantages supplied by the options and with the potential improvement of the employment relation.

Pointing the other way is the traditional view that new and small ventures carry higher investment risks. One can argue from this view that the benefits of registration would be greatest in this area, and that exemption would be justified least.[120]

None of these approaches offers any ready dividing line between what should be exempt and what should not—whether the exemptions are measured in dollars, number of purchasers, type of issuer, or otherwise. Even if the line is drawn arbitrarily, it is only a convention to say that one side of the line is private and the other is public.

b. *Qualitative Considerations* Another approach looks to see whether the purchasers are the kind of persons (rather than the number) who would benefit from registration. This view leads to the already

[119] See note 117 *supra*, last two paragraphs.

[120] Although nearly half of the states have no exemption for small offerings, Loss & Cowett, Blue Sky Law 369 (1958), apparently only California seriously requires registration. Some 80% of the permits issued there are for "close" corporations, often with escrow requirements to prevent later distribution of stock; see Smith, *The California Corporate Securities Law and the "Close" Corporation*, 32 L. A. Bar. Bull. 227 (1957). The California treatment of small offerings is discussed further in Jennings, *The Role of the States in Corporate Regulation and Investor Protection*, 23 Law & Contemp. Prob. 193, 217-18 (1958). The futile attempt to relax it and the effective way to circumvent it are described in Jennings & Marsh, Securities Regulation Cases and Materials 501-02 (1963).

In other states without a small offering exemption, the administrator is likely to say, "the act is not intended for this kind of case," and to look the other way. Loss & Cowett, Blue Sky Law 82 (1958).

familiar idea that exemption is proper for sophisticated, informed investors—*i.e.*, those able to fend for themselves. But this idea cannot be equated with a purely numerical exemption because numbers alone are no guarantee of either sophistication or information. Information requirements can be built into an exemption to some degree, as they have been in the Texas 15-a-Year provision.[121] But sophistication is hardly measurable as a quality or enforceable as a requirement.

In many small-small offerings, there is a real identity of interests between the issuer and the investors, *e.g.*, when proprietors or partners incorporate. Viewing a very close corporation as the "alter ego" of its shareholders is an imprecise and largely discredited way of imposing individual liability on shareholders in corporation law, but it makes sense in the context of small offering exemptions. Who benefits if a man registers shares which in effect he is selling to himself?[122] Once again, the difficulty is not in the theory but in its lack of correlation with any of the existing formulations of the small offering exemption. Sales can be made to complete strangers under the present exemptions, and undoubtedly they are, although we do not know how extensively. But it would not be easy to devise a test that sharply distinguishes investors from participants.

Since much of the disclosure in registration concerns past operating and financial history of the issuer, it might appear that registration offers little protection to investors when the issuer is so new that it has no history. The argument overlooks the many relevant aspects of a new company that registration normally would reveal (and that private negotiation often would not), particularly those relating to promotion of the company and to management's experience, security holdings, remuneration, and transactions with the company. Other important ones would include industry conditions (*e.g.*, competitive factors) and relatively detailed plans for the use of the proceeds of the offering and for operation of the business.[123]

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[121] See text, 3.4 *supra*.

[122] For a judicial statement of this view, see Durham v. Firestone Tire & Rubber Co., 47 Ariz. 280, 55 P.2d 648, 651 (1936) discussing the reason for the creation of Arizona's exemption for "close" corporations.

[123] Of the rag bag of information required by statute in a Texas registration, § 7.A(1), very little is of this sort. See, *contra*, subparagraph (d) (promotional compensation). Rather, such data is elicited by the State Securities Board's Suggested Outline to Assist in Preparing Prospectus for Local Texas Offerings Only (undated, issued about 1962), issued pursuant to the authority in § 9.C to require prospectuses. The Suggested Outline is much more pointed than the Act and closely follows SEC Form S-1, 1 CCH Fed. Sec. L. Rep. ¶ 7121-29, which is the basic form for registration under the federal law.

For a classic analysis of inadequate disclosure concerning a new business, see Texas Glass Mfg. Corp., 38 S.E.C. 630 (1958).

5.2 *Burden*

The burdens of securities registration include (A) delay; (B) legal, accounting, and other professional fees; (C) printing costs; and (D) possible modification in the terms of the offering to satisfy the administrator. For smaller businesses and offerings, these burdens are likely to be proportionately greater.[124] They are felt also in a lower rate of return for investors (whether the additional costs are passed on to them or absorbed in the enterprise's own expense). These burdens make it harder for small business to attract capital, a job which already is difficult because of high risks and vulnerabilities.[125]

Since small business is extolled as a prime virtue of the United States economy and democracy,[126] it is not hard to see why a legislature would be prone to relieve it from the burdens of securities registration. But an exemption does much more than grant this relief

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[124] *Delay.* Delay might be no greater on small offerings than on large, although smaller companies often have business and accounting practices which call for greater scrutiny of their financial statements and other documents. In the aggregate, registration of small offerings would greatly tax the administrators and slow down all offerings, except in the unlikely event of a proportionate increase in agency staff.

Costs. Some of the costs of tabulated registrations are more properly attributable to the public distribution of the securities than to registration per se. Obvious examples are printing of prospectuses and engraving of stock certificates or bonds. But many substantial expenses are precipitated by registration itself. See SEC, Cost of Flotation of Corporate Securities 1951-1955, at 6-8, 25-34 (1957), and *compare* Table 15 at 54-55 *with* Table 25 at 68-69; Tables 16-17 at 56-59 *with* Table 28 at 72-73. See also 1 Loss, *op. cit. supra* note 86, at 370-73. On costs of underwriting small issues, see Flink, Equity Financing of Small Manufacturing Companies in New Jersey 76-84 (1962).

An investigator who concluded that state securities regulation "does not seriously impede the financing of small business" was looking at a pattern which widely exempted small offerings. And he found that federal registration had impeded in many instances, even with the private offering exemption. Margraf, *Does Securities Regulation Hinder Financing Small Business?*, 11 Law & Contemp. Prob. 301, 319 (1945).

Modification. Modification by the administrator is far more likely to be urged on a small company. The administrator may think the price is too high because there is little or no earnings history or book value. The promoter's share, though small in absolute value, may look large in relation to that of other investors. The untried business may call for more protective provisions for investors, or (in the eyes of some administrators) militate against the use of senior securities. Other devices (like escrow of promoters' securities or limitation on options, executive compensation, or selling expense) may be required for their own sake or as a way of exerting pressure to achieve other concessions. Often the small issuer is so weak or short of funds that it will yield to the administrator rather than negotiate. On the conditions which may be imposed in registration, see Loss & Cowett, Blue Sky Law 67-79 (1958); California Corporation Manual §§ 258-64 (1961); see also the Texas references in note 112 *supra.*

[125] See, *e.g.*, Mayer & Goldstein, The First Two Years: Problems of Small Firm Growth and Survival 117-33 (Small Business Research Series No. 2, 1961); Cahn, *Capital for Small Business: Sources and Methods*, 24 Law & Contemp. Prob. 27, 66-67 (1959).

[126] "It is the declared policy of the Congress that the Government should aid . . . small-business concerns in order to preserve free competitive enterprise . . . and to maintain and strengthen the over-all economy of the Nation." Small Business Act of 1953, 67 Stat. 232, as amended, 15 U.S.C. § 631 (Supp. V, 1964).

if it bears no relation to the size of the issuer or of the offering.[127] Such is the case with the Texas 35-Man and 15-a-Year Exemptions (although there will not be many large businesses with fewer than thirty-five security holders).

The burden argument also can be made in terms of the cost to government of its regulatory action.[128] If the cost is greatly disproportionate to the benefits afforded, then it is reasonable to disconnect the government by an exemption.

Another burden of registration, about which one can be less sympathetic, is the liability incurred by the unwitting violator. Such violations are much more likely to occur among small issuers who simply are not cognizant of the securities laws and who obtain little or no legal advice. Small offering exemptions were designed in large measure for such people, and they undoubtedly would suffer if the exemptions were eliminated. However, we cannot sympathize too much with the businessman who violates the law, even if uninten-

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[127] Legislation directed more specifically at small business has come up with a number of different tests:

(A) For income tax purposes, ordinary rather than capital loss deductions are permitted for certain securities originally offered in amounts up to $500,000 by corporations with equity capital under $1,000,000. In addition, more than half the corporation's income must be from active rather than passive sources. Int. Rev. Code of 1954, § 1244.

(B) Another type of corporation may elect to have its income taxed to the shareholders rather than to the corporation if it has no more than 10 shareholders, at least 80% of its income is from active rather than passive sources, and certain other conditions are met. Int. Rev. Code of 1954, §§ 1371-77.

(C) For loans from the Small Business Administration and assistance in government procurement and subcontracting, small business is defined in various industries by number of employees (usually 500 to 1,000) or annual sales or revenues (usually 1 to 2 million dollars). 13 C.F.R. §§ 121.3-8, 121.3-10, 121.3-12 (1963). In addition, the concern must be "independently owned and operated and . . . not dominant in its field of operation." 72 Stat. 384 (1958), 15 U.S.C. § 632 (1958).

(D) To be eligible for investment by an SBA-licensed Small Business Investment Company, a concern must not exceed 5 million dollars in assets, 2.5 million dollars in net worth, and $250,000 in taxable income, as well as certain levels of employment and sales. 13 C.F.R. § 121.3-11 (1963).

(E) Federal law provides a somewhat simplified form of securities registration (technically a qualified exemption) for issues under $300,000. Securities Act of 1933, § 3(b), 48 Stat. 75, as amended, 15 U.S.C. § 77c(b) (1958). An even simpler technique is available if the offering is $50,000 or less. SEC Securities Act Rule 257, 17 C.F.R. § 230.257 (1964). The evolution of this provision, and various attempts to enlarge it, are presented in 1 Loss, *op. cit. supra* note 86, at 605-09.

[128] Published figures permit only a rough guess at government costs. Texas figures do not divide costs between registration and other aspects of administering the Securities Act (such as licensing and enforcement). The former preponderates in most states, Loss & Cowett, Blue Sky Law 57-58 (1958), and might be around 80% in Texas. For the fiscal years 1961-62 and 1962-63, respectively, this would indicate costs of $173 and $255 per registration application and 33¢ and 56¢ per thousand dollars of securities for which registration was sought. State Securities Board [Texas], Annual Report to the Governor [for] Fiscal Year Ended August 31, 1963, at 6, 11. These costs are more than passed on to the applicant for registration, who pays a fee of $1.00 per thousand. § 35.G. The United States and many states have fees only 1/10 as large, *i.e.*, 10¢ per thousand. If their costs are comparable to Texas, they are incurring substantial net expense in the administration of their securities registration provisions.

tionally. The solution to this problem is better education about and administration of whatever laws are in force.

If we have little sympathy for the unwitting violator, we will have still less for the witting but nonfraudulent violator who may not think it is worth the trouble to register, *e.g.*, in one of several states where an offering is being made.[129]

The burden analysis gives no more exact basis for exemptions than does the benefit analysis. However, the former does permit some further differentiation. Since burden appears to vary inversely with size of the issuer and size of the offering, these factors would be more useful tests than number of purchasers.

5.3 *Balance*

Seen in terms like these, the ultimate policy job is balancing the benefits against the burdens and finding the point at which the latter outweigh the former; ideally, this is where exemptions should be created.

One of the difficulties of policymakers in this area is the lack of empirical or statistical evidence. Here are some of the questions it would be useful to have answered. What is the volume and character of small business financing, about which the last few pages have conjectured? What are the sources—institutions or individuals? Are the individuals professional investors, business associates, friends, or unrelated? How extensively are broker-dealers and other intermediaries used? What information and sales pitches are used? How close to the business do the investors become, *e.g.*, in terms of operation and information? How do all these vary with the type and size of the business, the size of the financing, and the later history of the business? Have state-to-state differences in small offering exemptions had any identifiable differences in impact? Are state laws in fact obeyed?

Even without the answers, a good general argument can be made for the present small offering exemptions. It is a compound one: the exemptions primarily eliminate registration which would be of no benefit to many purchasers (because of their close relation to the issuer or because of their general sophistication) and which would be a considerable burden (economically and otherwise) to the smaller issuer. Although large issuers may use the exemptions, they do so mostly to purchasers too sophisticated or informed to need the protection of registration. And though small issuers undoubtedly use them for sales to some persons who would profit from protection, the

[129] This argument is offered and rejected in Note, *The Uniform Securities Act*, 12 Stan. L. Rev. 105, 148-49 (1959).

burdens on such issuers probably would outweigh the benefits to the buyers.

On the other hand, given a clearer idea of what justifies a small offering exemption (or given the facts on which to make a sounder judgment), a more precise exemption might well be possible. Until we reach this stage, the present ones will prove useful and are likely to cause little damage.