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Recapitalizations Under Section 3 (a) (9) of the Securities Act of 1933

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RECAPITALIZATIONS UNDER SECTION 3(a)(9) OF THE SECURITIES ACT OF 1933

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The Securities Act of 1933[1] requires that all securities sold in interstate commerce[2] be registered with the Securities and Exchange Commission (SEC) unless the security or transaction is exempted. Section 3(a)(9) of that Act exempts from this registration requirement[3] certain bona fide recapitalizations,[4] specifically,

> [a]ny security exchanged by the issuer with its existing security holders exclusively where no commission or other renumeration is paid or given directly or indirectly for soliciting such exchange.[5]

Determining which transactions qualify under the Section 3(a)(9) exemption has often been difficult[6] since its legislative history is

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[1] 15 U.S.C. §§ 77a *et seq.* (1970).

[2] Section 2(7) of the Act defines "interstate commerce" as "trade or commerce in securities or any transportation or communication relating thereto among the several States . . . ." 15 U.S.C. § 77b(7) (1970).

[3] The exemption provided by Section 3(a)(9) applies only to the registration requirements of Section 5 of the Act. The antifraud and civil liability provisions of the Act, 15 U.S.C. §§ 77q, 77*l*(2) (1970), respectively, remain applicable if the issuer utilizes the requisite jurisdictional means, *see* note 2 *supra*.

[4] As used in this article, the term "recapitalization" has a meaning different from that associated with tbe term "reorganization." A "reorganization" is a term of art under the federal tax laws and refers to transactions involving two or more companies. *See* INT. REV. CODE OF 1954 §§ 354-68. A "recapitalization," on the other hand, is a reshuffling of the capital structure of a corporation or other business entity within the framework of the existing entity. Technically, most of the excbanges that are effected under Section 3(a)(9) are recapitalizations.

[5] 15 U.S.C. § 77c(a)(9) (1970). *See generally* H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 4.06, at 4-42.25 (1975); 1 L. LOSS, SECURITIES REGULATION 573-84 (2d ed. 1961); 4 *id.* 2596-97 (Supp. 1969); H. SOWARDS, FEDERAL SECURITIES ACT § 3.10, at 3-18 (1974).

[6] Tbis uncertainty has carried with it some serious consequences for those contemplating recapitalizations without registering their plans. An issuer who misuses any exemption under the Act, including Section 3(a)(9), is subject to one or more administrative sanctions. The SEC can (1) seek an injunction to prohibit further sales of securities until a registration statement is filed, 15 U.S.C. § 77t(b) (1970); (2) require disclosure of the issuer's contingent liability, *id.* § 77*l*(1), with respect to those securities already sold in violation of Section 5; (3) insist on an offer of rescission and redemption for all securities sold illegally; and (4) recommend criminal prosecution to the Justice Department, *id.* § 77x. The irresolutions generally in Section 3(a)(9) have been offset somewhat by the availability of SEC staff advisory opinions in private pre-transaction correspondence, but such opinions are confined to the precise facts as stated in the future issuer's inquiry.

sparse,[7] judicial interpretation virtually non-existent,[8] and, until recently, administrative guidelines rather limited.[9] Some of the uncertainty surrounding the exchange exemption, as Section 3(a)(9) is sometimes called,[10] has now disappeared with changes in SEC procedures regarding its interpretative advice and its so-called no-action letters.[11] Since December 1, 1970, the SEC has opened for

[7] *See* H.R. REP. No. 152, 73d Cong., 1st Sess. (1933). *See also* note 18 *infra*. *See generally* Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 89, 96-102 (1937); Sargent, *Questionable Uses of the "Exchange" Exemption to Securities Registration: A Caveat*, 44 VA. L. REV. 703 (1958).

[8] Judicial interpretation of Section 3(a)(9) has heen limited to the case of *Reserve Life Ins. Co. v. Provident Life Ins. Co.*, 499 F.2d 715 (8th Cir. 1974), *cert. denied*, 419 U.S. 1107 (1975). *See* text accompanying note 89 *infra*. *See also* dictum in Browning Dehenture Holders' Comm. v. DASA Corp., CCH FED. SEC. L. REP. ¶ 95,071 (S.D.N.Y. April 16, 1975).

[9] The SEC to date has issued the following releases on Section 3(a)(9): SEC Securities Act Release No. 646 (February 3, 1936), 1 CCH FED. SEC. L. REP. ¶ 2136; SEC Securities Act Release No. 2029 (August 8, 1939), 1 CCH FED. SEC. L. REP. ¶ 2140; The Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825, [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,539 (August 12, 1957). And it has promulgated two rules that apply to Section 3(a)(9) transactions: Rule 149, 17 C.F.R. § 230.149 (1974), and Rule 150, *id.* § 230.150 (1974), both of which are discussed in the text accompanying note 106 *infra*. Finally, the Commission has interpreted the section in Thompson Ross Securities Co., 6 S.E.C. 1111 (1940).

[10] The exemption under Section 3(a)(9) is also occasionally referred to as the voluntary exchange exemption. *See, e.g.*, 1 L. LOSS, *supra* note 5, at 573.

[11] Prior to December 1970, neither SEC interpretative letters, no-action letters, nor tbe inquiries upon which they were based were generally available to the public. The staff adhered to this policy of confidentiality for several reasons. (1) A member of the public, it was felt, deserved the right to obtain the advice of the staff "without fear that information provided to the staff for that purpose might be made public in a manner that might adversely affect his lawful business activities or invade his personal privacy." SEC Securities Act Release No. 4924, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,606 at 83,294 (September 20, 1968) [hereinafter cited as *Release 4924*]. (2) The staff feared that untimely disclosure of certain information contained in such letters might "prejudice the interest of others and in some instances could have an unwarranted impact upon the public securities markets." *Id.* (3) Public disclosure might cause undue significance to be attributed to the positions reflected in no-action letters and interpretive letters "by persons overlooking the context in which they were given, particularly if all relevant facts are not included or policy considerations are not articulated." *Id.* (4) Under a policy of public disclosure, "[s]ome persons also might not appreciate the fact that not all no-action letters reflect an interpretation of the statute or rules, since in some instances no interpretation is involved but merely the expression of a judgment with respect to enforcement policy." *Id.*

On September 20, 1968, the Commission requested comments as to whether its policy of non-disclosure should be changed. *Id.* at 83,295. Tbe overwhelming majority of responses favored some form of public disclosure of the matters treated in no-action and interpretative letters, and the Commission responded with a formal proposal, SEC Securities Act Release No. 5073, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,838 (July 14, 1970), which was adopted in SEC Securities Act Release No. 5098, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,921 (October 29, 1970).

public inspection the correspondence between persons who seek official opinions regarding the application of federal securities law to contemplated transactions and SEC staff members who render such legal interpretations[12] or who state, alternatively, that the staff will not recommend enforcement action if the transaction is consummated in the manner contemplated.[13] During the past four and a half years, many of these requests and staff responses have related to Section 3(a)(9).[14]

This article will examine Section 3(a)(9), its traditional interpretations, and the "informal policy"[15] reflected in SEC staff interpretative letters and no-action letters. Part I considers some of the

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[12] "Interpretative letters" is the term used by the SEC for the informal advice rendered by Commission staff members to the public.

[13] A no-action letter may, in fact, be an interpretation of the statute; most often, however, it is something entirely different. It may be a policy decision in a particular case, after considering the priorities and problems before the agency, the manpower available [and] the effects on the public . . . , whether it is necessary to crank up a proceeding if someone should proceed in the manner suggested.

Release 4924, *supra* note 11, at 83,294 n.3, *citing Panel Discussion, Public Information Act and Interpretative and Advisory Rulings*, 20 AD. L. REV. 1, 24 (1967). The SEC staff response will occasionally state the narrow scope of its position. *See, e.g.*, Pacesetter Financial Corp., [1974] CCH SEC "NO ACTION" LETTERS, roll 2, frame 01618, 01619 (January 23, 1974), where the staff agreed that Section 3(a)(9) applied to the facts outlined in the letter of inquiry but added, "Further, this letter only expresses the Division's position on enforcement action and does not purport to express any legal conclusion on the questions presented"; Midwest Stock Exchange Serv. Corp., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,657 at 83,775 (December 27, 1973), where the staff cautioned the issuer, "We should emphasize that the foregoing position [concurring in the availability of Section 3(a)(9)] is limited to the Securities Act aspects of your proposal. Before implementing the proposal, you should discuss the Securities Exchange Act aspects with our Division of Market Regulation."

[14] Commerce Clearing House has reproduced on microfilm, entitled CCH SEC "NO ACTION" LETTERS [hereinafter cited as "NO ACTION" LETTERS], all the no-action letters and interpretative letters made available by the Commission for public inspection. According to this correspondence, the following number of requests for staff response relating to Section 3(a)(9) have been answered since 1971:

Year	Number of Letters
1971	12
1972	22
1973	30
1974	24
1975	6 (as of February, 1975)

[15] According to Professor Kenneth Culp Davis, ". . . some of the most important law of the SEC is embodied in this batch of no-action letters. This is law. The interpretations are law." *Release 4924*, *supra* note 11, at 83,294, *citing Panel Discussion, supra* note 13, at 29. After quoting from Professor Davis' statement, the SEC replied, "While the Commission does not agree that this much significance should be attached to views expressed by the staff, it may nevertheless be true that practitioners might find these letters helpful . . . ." *Release*

permissible uses[16] of the exemption. Part II focuses on some specific interpretative problems that it raises. Finally, Part III assesses the wisdom of the present exemption in view of the Commission's recent efforts to coordinate and integrate a continuous disclosure system with the various exemptive provisions provided by the federal securities laws.

I. Various Uses of the Section 3(a)(9) Exemption

The legislative history of Section 3(a)(9) is closely tied to that of Section 3(a)(10),[17] which provides an exemption for securities exchanged in the process of reorganization under the supervision of a court or an appropriate administrative agency.[18] Both exemptions reflect a legislative concern for the financially troubled issuer who is attempting an internal readjustment without complying with the expensive registration requirements of the 1933 Act. The Section 3(a)(9) exemption specifically has been seen as resting

> on a balancing of interests between the corporation and its security holders, and to indicate a recognition that the burden of delay and expense involved in registration might well be disproportionately

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4924, supra note 11, at 83,294. For a critical analysis of the Commission's informal method of modifying substantive law through the publication of no-action responses, see Lowenfels, *SEC No-Action Letters: Conflicts with Existing Statutes, Cases, and Commission Releases*, 59 Va. L. Rev. 303 (1973).

[16] In all of the no-action letters cited in Part I of this article, the SEC staff concurred in the opinion of counsel for the issuer that a Section 3(a)(9) exemption was available. But such letters have limited precedential value. *See* note 13 *supra*.

[17] 15 U.S.C. § 77c(a)(10) (1970).

[18] An early draft of Section 3(a)(9) in fact allowed the exemption where the company exchanged securities (or securities and cash) for the claims of its creditors. S. 875, 73d Cong., 1st Sess. § 12(d) (1933); H.R. 4314, 73d Cong., 1st Sess. § 12(d) (1933). In the course of redrafting the language, the Senate and House each passed different bills which would have exempted intracorporate readjustments only in cases where they were effected under court supervision. As finally adopted by Congress, the Securities Act of 1933 included Section 4(3), which retained the language as to readjustments under court supervision but further exempted

> . . . [the] issuance of a security of a person exchanged by it with its existing security holders exclusively, where no commission or other remuneration is paid or given directly or indirectly in connection with such exchange.

When the Act was amended in 1934, this provision was replaced by Section 3(a)(9) in its present form. Congress repositioned the exchange exemption to rest under Section 3 in order to codify an interpretation of Section 5(c) rendered by the Federal Trade Commission that securities exempted on original issuance by Section 5(c) would retain that exemption when in the hands of dealers. H.R. Rep. No. 1838, 73d Cong., 2d Sess. 40 (1934).

> heavy in a purely intracorporate readjustment where the very fact of the readjustment would tend in the majority of instances to indicate an embarrassed financial condition. In such cases, it may be supposed, the interest of the security holders in being afforded full information as to the corporate affairs is made to yield to their interest, in common with the issuer itself, in expeditious and economical readjustment.[19]

This balancing rationale has not, however, limited the permissible scope of the provision. If Section 3(a)(9) were designed primarily for recapitalizations by issuers in "an embarrassed financial condition," SEC interpretations of it would have probably so limited its use. In fact, no such constraints exist. A review of pertinent no-action letters indicates a variety of motivations for exempting recapitalizations and an assortment of techniques for accomplishing them. The financial status of the issuers involved, whether a source of embarrassment or pride, does not, in fact, affect availability of exemption.[20]

A. Reasons for an Exchange

The importance of Section 3(a)(9) to an issuer can be demonstrated by illustration. Where corporation *A* has two classes of securities issued and outstanding, common and preferred stock, and decides to retire all of its preferred for one or more of the reasons discussed below, it might well prefer to do so without disturbing its cash reserve, instead offering an exchange of the old security for a new one. For example, *A* might offer each holder of its preferred

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[19] Throop & Lane, *supra* note 7, at 98.

[20] Professor Loss believes that the following excerpt from the conference report indicates that Section 3(a)(9) "may represent little more than a horse-trade compromise between the two houses," 1 L. Loss, *supra* note 5, at 573.

> The House provision . . . exempting . . . the sale of stock to stockholders is omitted from the substitute . . . . Sales of stock to stockholders become subject to the Act unless the stockholders are so small in number that the sale to them does not constitute a public offering. The Senate agreed that the mere exchange with its security holders of one form of security for another by an issuer where no commission or other remuneration is paid, shall be exempt. This exemption is considered necessary to permit certain voluntary readjustment of obligations. Inasmuch as any exchange that involves the payment of a commission of any sort is not exempt, there is no danger of the provision being used for purposes of evasion.

H.R. REP. No. 152, 73d Cong., 1st Sess. 25 (1933). It should be noted that in fact Section 3(a)(9) may very well not be available to an issuer involved in bankruptcy. *See* text accompanying note 103 *infra*.

stock the opportunity to exchange that security for two shares of common stock. Although a holder of *A* preferred stock could reject the offer and remain a preferred stockholder, the more attractive the exchange terms, the more difficult rejection would become. Since corporation *A*'s recapitalization plan involves an offer and sale of a security,[21] *A* common for *A* preferred, registration of the common stock will be required unless an exemption exists. Section 3(a)(9) can offer corporation *A* the exemption it desires.[22]

Issuers embark on exempted recapitalizations under Section 3(a)(9) for various reasons, including the following.

1. To Comply with Contractual Obligations

An issuer may face a legal obligation to exchange one type of its securities for another.[23] This obligation could arise from an agreement with the holders of its securities establishing the terms of the original issuance of the security and the option of subsequent exchange or redemption. For example, company *B* has issued and outstanding 200,000 shares of common stock and 50,000 shares of convertible preferred. Later, the board of directors of company *B* authorizes the issuance and sale of 10,000 convertible subordinate debentures. The terms of sale of the *B* convertible subordinate

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[21] A threshhold question in any exchange of securities is whether the transaction will be deemed the sale of a new security. If the new security represents a material change from the old one, the transaction will usually be treated as a sale. It is not clear, however, what position the SEC staff will take if the new security is not significantly different from the old one, or if the new one adds to and does not detract from the rights of the holders of the old securities. In Browning Debenture Holders' Comm. v. DASA Corp., CCH FED. SEC. L. REP. ¶ 95,071 (S.D.N.Y. April 16, 1975), the issuer offered to reduce the conversion price of its debentures —an action which the staff contended was a "sale" by the issuer, without the required registration of a new security. When subsequently litigated, the court decided otherwise, emphasizing that the necessary indenture amendments would be beneficial to the debenture holders. *Id.* at 97,754.

The requests for no-action treatment under Section 3(a)(9) suggest that some counsel assume a "sale" and structure their transactions within the limitations of the exemption. *See, e.g.*, notes 33-35 *infra*.

[22] As noted, Sections 3 and 4 of the 1933 Act provide certain specific exemptions from the registration requirement of Section 5. While the heading for Section 3, "[e]xempted securities," suggests that all the securities included under it are exempt *per se*, only securities covered by Sections 3(a)(2) through 3(a)(8) are so treated. Sections 3(a)(1), 3(a)(9), 3(a)(10), 3(a)(11), and 3(b) are, in reality, transactional exemptions, treated like those listed under Section 4. This distinction between exempt securities and exempt transactions has special significance for those selling securities in non-issuer transactions. See text accompanying note 144 *infra* for a discussion of resales of securities received hy security holders in a Section 3(a)(9) exchange.

[23] *See* text accompanying notes 42-53 *infra*.

debentures may require company B to exchange one of its securities for another.

A contractual obligation to exchange securities can also arise under the terms of a merger agreement. Assume, for example, that company C proposes to merge company X into C's wholly-owned subsidiary, company CC.[24] Company X has outstanding at the time of the proposed merger $5,185,000 principal amount of certain convertible debentures. As part of the merger agreement, company CC, the subsidiary, agrees to assume the primary obligation to repay on these convertible debentures of company X, and company C, the parent, agrees to guarantee that obligation. Furthermore, the debentures will now be convertible into shares of company C, after adjusting the original conversion price to conform to the exchange ratio which governs the merger. Company C will look to Section 3(a)(9) to exempt the issuance of its common stock upon conversion of the debentures.

2. *To Eliminate Outstanding Securities*

An issuer might also consider an exchange under Section 3(a)(9) because it wants to eliminate certain outstanding securities. Elimination of an entire class of securities might be desirable where (a) they handicap the issuer with their burdensome interest,[25] dividend,[26] or redemption[27] rights; (b) they carry an artificial price since without a market no reasonable basis exists for computing their value;[28] (c) the issuer wants to replace debt securities with

[24] *See* Downe Communications, Inc., [1973] "No Action" Letters, roll 6, frame 10565 (May 2, 1973); Greater Jersey Bancorp., [1972] "No Action" Letters, roll 4, frame 05788 (March 15, 1972). A recapitalization involving a merger raises a special problem under Section 3(a)(9) that is discussed in text accompanying note 72 *infra*.

[25] *See, e.g.*, Decraform, Inc., [1973] "No Action" Letters, roll 5, frame 08813 (May 1, 1973).

[26] *See, e.g.*, Diverse-Graphics, Inc., [1972] "No-Action" Letters, roll 7, frame 11465 (June 20, 1972). *But see* text accompanying note 110 *infra*.

[27] *See, e.g.*, Four-Phase Systems, Inc., [1973] "No Action Letters, roll 12, frame 20368 (November 8, 1973).

[28] *See, e.g.*, USM Corp., [1973] "No Action" Letters, roll 5, frame 08807 (April 27, 1973), discussed in note 75 *infra*. *Cf.* Knoxell Corp., [1972] "No Action" Letters, roll 11, frame 17521 (October 24, 1972), where the issuer had two classes of common stock. Most of the issuer's common stock was nonvoting, class B, for which a trading market existed. Since there was little class A voting common stock, holders had difficulty selling it, other than to the company itself. To provide a market for the class A common stock, the issuer proposed a charter amendment granting holders of class A common stock an option to exchange on a share-for-share basis an equivalent number of shares of class B. The SEC staff agreed with

common stock to broaden its equity base;[29] (d) the issuer wishes to replace equity with debt in a "going private" transaction; (e) future financing hinges on the retirement or liquidation of certain securities;[30] or (f) the overhang of a conversion privilege on certain securities adversely affects the market price of the underlying security.

3. *To Revitalize Outstanding Securities*

Changes in business or in the economy or the psychology of the securities markets could prompt an issuer to modify the terms of some of its outstanding securities.[31] For instance, assume that corporation *D* has issued 3,000 five-year warrants and 200,000 shares of common stock. Each warrant entitles the holder to acquire one share of *D* common stock at an exercise price of $12 per share. Although *D* common was trading at $11 per share when the warrants were sold, the bid price in the over-the-counter market for *D* common stock has now leveled off at $8 per share with little hope for a major upturn in the foreseeable future. Since warrant holders are unlikely to exercise their warrant right in such circumstances, the issuer might consider decreasing the exercise price of its warrants to reflect more closely the market value of its common stock.[32] An

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counsel that the 3(a)(9) exemption would apply to the exchange.

[29] *See, e.g.*, Graphic Arts Center, Inc., [1974] "No Action" Letters, roll 8, frame 10928 (July 22, 1974), in which the issuer planned to offer to the trustees of its employee profit-sharing plan a maximum of 65,000 shares of common stock in exchange for certain notes of the issuer held hy the trust. The exchange was proposed as a result of requests from employee participants in the profit-sharing plan, who wanted to acquire equity ownership in the corporation. *See also* Midwest Stock Exchange Serv. Corp., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,657 (December 27, 1973).

[30] *See, e.g.*, Canrad Precision Indus., Inc., [1973] "No Action" Letters, roll 10, frame 17562 (August 28, 1973) (letter of corp. counsel) (Dividend arrearages on preferred stock "make it difficult for Canrad to obtain favorable financing."); Wright Air Lines Inc., [1973] "No Action" Letters, roll 9, frame 16134 (August 23, 1973) (exchange was a condition precedent to an arrangement with issuer's principal creditor for the refinancing of issuer's indebtedness); American Electronic Laboratories, Inc., [1972] "No Action" Letters, roll 4, frame 05777, 05781 (March 3, 1972) (letter of corp. counsel) (Warrants rendered valueless by market price of underlying security could "possibly impair the Company's future ahility to raise capital.").

[31] *See, e.g.*, Peahody Galion Corp., [1973] "No Action" Letters, roll 9, frame 16129 (August 16, 1973); Earth Sciences, Inc., [1972] "No Action" Letters, roll 9, frame 14881 (August 20, 1972) (warrant "split"); Magic Marker Corp., [1971] "No Action" Letters, roll 4, frame 08150 (June 30, 1971).

[32] At least two factors would prompt such a decision. First, corporation *D*'s future ability to raise capital through offerings of its securities in the puhlic market might be impaired if it allows present warrants to become valueless. *See, e.g.*, American Electronic Laboratories,

issuer could accomplish the same result by increasing the interest rate[33] or by extending the term[34] or maturity date.[35]

4. To Reduce Taxes

The Internal Revenue Service has taken the position that the expiration of unexercised warrants for which consideration has been received creates ordinary income to the issuer to the extent of such consideration.[36] Faced with this prospect, an issuer might wish to extend the expiration date of its outstanding warrants.[37] If extended warrants are exchanged for the warrants about to expire, an issuer at least gains valuable time. And it may avoid the tax entirely if the warrant holders exercise all their rights prior to the new expiration date.

5. To Maintain Control

Finally, insurgent stockholders or outsiders anxious to wrest control can pose a threat to management. Incumbents, so challenged, may find a safe harbor in recapitalization. This defensive tactic was utilized in 1971 by IBI Security Service, Inc., a corporation with 700,000 shares of outstanding common stock which was traded on the over-the-counter market.[38] The founders of IBI, hoping to

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Inc., *supra* note 30. Second, with a more realistic exercise price corporation *D* might raise additional funds if its common stock appreciates sufficiently to induce warrant holders to exercise their new warrants. *See, e.g.*, Instruments Sys. Corp., [1973] "No Action" Letters, roll 2, frame 01796 (January 24, 1973). *Cf.* Colorado Cent. Mines, Inc., [1972] "No Action" Letters, roll 5, frame 07352 (March 28, 1972), where the exercise price on the new warrants was higher than that on the existing ones.

[33] *See, e.g.*, Daitch Crystal Dairies, Inc., [1972] "No Action" Letters, roll 11, frame 17514 (October 12, 1972).

[34] *See, e.g.*, Magic Marker Corp., *supra* note 31.

[35] *See, e.g.*, Peahody Galion Corp., *supra* note 31.

[36] *See* Int. Rev. Code of 1954 § 1234; Treas. Reg. § 1.1234-1(b) (1975). Additional problems can arise if the issuer of unexercised warrants is a registered real estate investment trust ("REIT"). The expiration of such warrants could result in the receipt of substantial income by a REIT in the year the warrants expire which would not qualify as REIT income for purposes of federal income taxes. This in turn could preclude the trust from qualifying as a REIT for tax purposes during that year, thereby resulting in severe adverse tax and cash flow consequences. *See* Citinational Dev. Trust, [1975] "No Action" Letters, roll 2, frame 01198 (January 2, 1975), where Section 3(a)(9) was used to exempt an exchange of new warrants for the outstanding warrants of a REIT to avoid such tax consequences.

[37] *See, e.g.*, American Electronic Laboratories, Inc., *supra* note 30, at frame 05781 (letter of corp. counsel); Unicare Services, Inc., [1974] "No Action" Letters, roll 8, frame 10935, 10938 (July 22, 1974) (letter of corp. counsel).

[38] IBI Security Servs., Inc., [1971] "No Action" Letters, roll 6, frame 12621 (August 3, 1971).

protect their voting control and guard against expensive take-over bids, proposed a recapitalization by which two new classes of common stock, *A* and *B*, would be authorized by charter amendment and exchanged under Section 3(a)(9) for the outstanding common. Class *A* common, with one vote per share, was to be issued to those security holders of IBI not among the original investors. Class *B* common, with 11 votes per share, was to be issued to the insiders and their families and was convertible into Class *A* common pursuant to the terms of the reorganization agreement. Such disparity in voting rights was expected to assure the insiders continued control of their company.[39]

B. Method of Exchange

A recapitalization under Section 3(a)(9) will take the form of either an exchange offer or an exchange agreement.

1. Exchange Offer

An exchange offer by an issuer presents two choices to an offeree. He can reject the offer and continue holding the outstanding security, or he can accept the issuer's offer and become the holder of a new security. Given the statutory purpose behind the federal securities laws of ensuring informed investment decisions by the public, it is important to see whether and when a Section 3(a)(9) exemption for an exchange offer would jeopardize meaningful investor choice. If the outstanding security is valueless, the holder's choice does not really involve an investment decision, although tax considerations may pertain. The holder of a warrant, for instance, with an exercise price significantly higher than the market price of the underlying security and with an imminent expiration date is unlikely to balk at an exchange that offers a new warrant with a lower exercise price and an extended expiration date, especially when the exchange involves no cost to him. But an investment decision is required of the

[39] *Id.* at frame 12624. The IBI exchange offer involved a potential conflict of interest, since those who were instrumental in effecting the plan of reorganization were the very ones with the most to gain. Proxy materials explaining the purpose and consequence of the plan were to be sent to the IBI stockholders since the plan was subject to their approval at the annual meeting. *Id.* at frame 12623. The SEC staff was, no doubt, aware of the special problems in disclosure, and cautioned counsel for IBI that "Section 17 of the Securities Act as well as Section 10(b) of the Securities Exchange Act of 1934, or Rule 10b-5 are applicable." *Id.* at frame 12621.

outstanding security holder in at least two situations, and where the exchange is effected pursuant to Section 3(a)(9) disclosure of information that could assist an offeree in making his choice correctly is unrequired.

In the more obvious case, if the outstanding security has any value, the exchange offer will force the offeree to evaluate the relative merits of the securities involved. In the other case where the outstanding security is valueless, an issuer can still place the offeree in a position of making an investment decision by extending simultaneous offers.[40] Such a difficult investment decision was faced in 1974 by the common stockholders of Charan Industries, Inc.,[41] even though its common stock was not without value. Charan proposed an exchange of non-convertible subordinated debentures for its outstanding common stock to be made simultaneously with an offer to accept tenders of common stock for a cash amount less than that to be used in computing the exchange ratio in the exchange offer. Section 3(a)(9) was available to exempt the exchange from 1933 Act disclosure.

2. *Exchange Agreement*

Alternatively, recapitalizations can be accomplished through an exchange agreement, which reduces or eliminates the uncertainty necessarily present when management presents security holders with the decision to accept or reject an exchange offer. Three different forms of exchange agreement have been used in connection with Section 3(a)(9).

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[40] *Cf.* Canrad Precision Indus., Inc., *supra* note 30, for an example of simultaneous offers in a charter amendment where the outstanding security had lost some of its value. Canrad had three classes of securities outstanding: common stock, 6 percent cumulative convertible junior preferred, and 7 percent cumulative convertible senior preferred. Both classes of preferred stock were convertible into common at $7.50 per share, but none had been converted since the common stock was trading in the range of $2.50 to $3.00 per sbare. The board of directors decided to modify or eliminate both classes of outstanding preferred by offering the preferred stockholders an opportunity, contingent upon the.approval by two-thirds of the preferred stockholders, either to exchange their existing preferred stock for a new class of preferred which would provide for non-cumulative dividends and be convertible at the more favorable price of $6.00 per share of common stock or simply to adjust the conversion price of existing preferred from $7.50 to $6.00, subject to the stockholders' agreeing to convert their stock immediately. Section 3(a)(9) was available to exempt Canrad from registration requirements under either option.

[41] Charan Indus., Inc., [1974] "No Action" Letters, roll 2, frame 01623 (January 29, 1974).

a. Redemption Agreement

As noted earlier, when originally issuing securities, the corporation may obligate itself to exchange that class for another that has been or will be issued. The terms of the original stock purchase agreement,[42] merger agreement,[43] repurchase contract,[44] or other understanding[45] will, of course, dictate the circumstances under which the exchange occurs.

b. Charter or Contract Amendment

The terms delineating the relationship between an issuer and its security holders might not include such an authorization for an exchange of securities. But an exchange might later be authorized by security holders' amendment of the issuer's charter[46] or the contract under which the securities were originally issued.[47] After either such amendment, a dissenting security holder might be forced to surrender his original security for a new one issued in the recapitalization. This type of involuntary exchange might have occurred in the plan of Steiner American Corp.[48] to reclassify its preferred stock

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[42] *See, e.g.*, Foster Wheeler Corp., [1973] "No Action" Letters, roll 8, frame 14113 (July 2, 1973); Squibb Corp., [1971] "No Action" Letters, roll 4, frame 08144 (June 23, 1971).

[43] *See, e.g.*, Koch Indus., Inc., [1974] "No Action" Letters, roll 4, frame 05133 (March 6, 1974); Downe Communications, Inc., *supra* note 24; Greater Jersey Bancorp., *supra* note 24.

[44] *See, e.g.*, Alpex Computer Corp., [1974] "No Action" Letters roll 7, frame 09383 (May 31, 1974); Florida Tel. Corp., [1972] "No Action" Letters, roll 10, frame 16090 (September 22, 1972); Bath Indus., Inc., [1971] "No Action" Letters, roll 5, frame 10270 (July 21, 1971).

[45] *See, e.g.*, Cooky's Steak Pubs, Inc., [1972] "No Action" Letters, roll 3, frame 03958 (February 18, 1972). Here, the issuer had 726,000 shares of common stock outstanding: 250,000 owned by the estate of a Mr. Shapiro; 250,000, by a Mr. Rachelson; and 226,000, by some 900 other persons. The issuer entered into a redemption agreement with the estate, by which the issuer was to redeem a maximum of 250,000 shares of common stock from its shareholders in exchange for cash and non-negotiable notes. The agreement also provided that Rachelson would tender none of his shares and that, if none of the minority shareholders tendered their shares, then all of the estate's shares would be redeemed. However, if the minority shareholders accepted the offer of redemption to the extent of more than 25,000 shares, then, at the estate's option, the redemption agreement could be cancelled and no shares would be redeemed. If the minority stockholders accepted the offer of redemption to the extent of 25,000 shares or less, or if the acceptances totalled more than 25,000 shares but the estate decided not to cancel the agreement, then the number of shares to be redeemed by the company from the estate would be reduced by the number of minority shares tendered so that the total number of shares redeemed would not exceed 250,000 shares.

[46] *See, e.g.*, Knoxell Corp., *supra* note 28.

[47] *See, e.g.*, B.M.C. Indus. Inc., [1972] "No Action" Letters, roll 9, frame 14889 (August 30, 1972); Daitch Crystal Dairies, Inc., *supra* note 33.

[48] Steiner American Corp., [1973] "No Action" Letters, roll 5, frame 08791 (April 4, 1973).

into shares of common, which would then be split on a 10-for-1 basis. Under the applicable state law, the amendment and resulting recapitalization could have been authorized by the vote or written consent of the holders of a majority of the common stock and of two-thirds of the preferred stock outstanding.

c. Standby Agreement

A redemption standby agreement between an issuer and an investment banking firm can be combined with an exchange of securities under Section 3(a)(9).[49] Suppose that corporation *E* proposes to call in all of its $100 convertible debentures at a redemption price of $105. The debentures are convertible into four shares of *E* common stock for each $100 of debentures, with the common stock selling at approximately $30 per share and the debentures, consequently, at approximately $120. Wishing to preserve its cash position, corporation *E* hopes that its debenture holders will choose to convert into common stock. But the issuer may be concerned about an unanticipated decline in the market price of its common stock between its notice of redemption and the redemption date, a period usually of about 30 days. If the common stock during that period dropped in value to $23 per share with a likely corresponding decline in the market value of the debentures to $92, the debenture holder would choose to redeem his debentures for cash rather than convert. A standby agreement offers corporation *E* the protection it needs against the risk of deteriorating conditions.[50] The investment banker

[49] *See generally* Schmults, *Convertible Securities, Debentures, Warrants and Hybrid Securities, Rule 155 Under the Securities Act of 1933*, in PLI, FIRST ANNUAL INSTITUTE ON SECURITIES REGULATION 207, 11-13 (R. Mundheim & A. Fleisher, Jr. eds. 1970); McDowell, *Rule 10b-7: Stabilization*, in PLI, SECOND ANNUAL INSTITUTE ON SECURITIES REGULATION 155, 166-68 (R. Mundheim & A. Fleischer, Jr. eds. 1971). The SEC's application of Section 3(a)(9) to standby arrangements has drawn criticism. *See* Gadsby, *Private Placement of Convertible Securities*, 15 BUS. LAW. 470, 490 n.59 (1960); Sargent, *supra* note 7, at 710-12.

[50] In practically all standby arrangements, such as the one involving corporation *E*, if the market price of the underlying security remains above the effective conversion price, virtually no debentures will be tendered to the standby purchasers. Not surprisingly, the opposite is true where the market price falls below the effective conversion price. In this situation, "the purchasers [investment bankers or securities dealers] normally anticipate having to acquire and convert virtually all of the outstanding debentures." Salomon Bros., [1972] "No ACTION" LETTERS, roll 9, frame 14884, 14887 (August 29, 1972) (letter of corp. counsel).

[51] A standby agreement between an issuer and an investment banker resembles an underwriting agreement for a primary distribution of securities. Investment bankers usually retain the right to stabilize, to overallot, and to offer the underlying securities to the public after conversion. Purchases and sales for stabilization purposes must satisfy Rules 10b-6 and 10b-

agrees,[51] for a fee,[52] to purchase at a price slightly above the redemption price all of the debentures that are offered to it before the redemption date and then to convert those debentures into the issuer's common stock, thus preserving the corporation's cash position. The issuer may rely upon Section 3(a)(9) to exempt the exchange of its common stock for the debentures acquired by the investment banker.[53]

C. *Terms of Exchange*

Regardless of the method employed in accomplishing a 3(a)(9) exchange, an issuer may not require its security holders to part with anything besides the issuer's own securities.[54] This limitation does not apply, however, to the issuer, which may employ a variety of inducements to realize a successful recapitalization. The most common exchange involves a single new security that may[55] or may not[56]

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7 under the Securities Exchange Act of 1934. *See* McDowell, *supra* note 49, at 168. On the other hand, the practice of overallotment (selling more shares than there are in the issuer to ensure that the issue is all sold) may not fall within Rules 10b-6 or 10b-7, but the general prohibitions against manipulation still apply. *See id.* For a discussion of resales by the purchasers under a standby agreement, see text accompanying note 143 *infra*.

[52] Methods for computing the compensation for the investment banker's services under a standby agreement vary. *See, e.g.*, Heublein, Inc., [1972] "No Action" Letters roll 6, frame 09604 (May 22, 1972) (issuer to pay standby purchasers a fee plus approximately $1.25 per share for each share of common stock acquired on conversion in excess of an amount equal to about 5 percent of the total number of shares into which the debentures were convertible); American Broadcasting Cos., [1972] "No Action" Letters, roll 6, frame 09600 (May 15, 1972) (issuer to pay standby purchasers a fee of 0.7 percent of the principal amount of the debentures outstanding on the last day preceding the giving of notice of redemption by the issuer); Bath Indus., Inc., *supra* note 44 (issuer to pay 0.36½ cents per share of cumulative convertible preferred stock outstanding plus $2.31 for each preferred share purchased pursuant to the standby agreement in excess of 5 percent of the total outstanding).

[53] *See, e.g.*, Foster Wheeler Corp., *supra* note 42; Kewanee Oil Co., [1973] "No Action" Letters, roll 3, frame 04119 (February 5, 1973).

[54] *See* text following note 104 *infra*.

[55] The security issued in the exchange might be identical to the outstanding security except for those changes needed to revitalize the existing security for the reasons explained in note 32 *supra*. *See* note 21 *supra*.

[56] Neither Section 3(a)(9) itself nor administrative interpretations of it require that the securities involved in the exchange have similar characteristics. Issuers have, in fact, structured their recapitalizations to include the following combinations of securities:
(1) *Equity for equity. See, e.g.*, Tele-Metropol, Inc., [1973] "No Action" Letters, roll 10, frame 17578 (September 21, 1973) (common for common); Foster Wheeler Corp., *supra* note 42 (common for cumulative convertible preferred); Equimark Corp., [1973] "No Action" Letters, roll 3, frame 04127A (February 26, 1973) (common for preferred).
(2) *Equity for debt. See, e.g.*, Wright Air Lines, Inc., *supra* note 30 (common for debenture); Decraform Inc., *supra* note 25 (preferred for debenture); Infotronics Corp., [1972] "No

resemble the outstanding security it would replace. But occasionally an issuer's contribution to the exchange is a package consisting of two or more different securities[57] or a single security and cash.[58]

II. Requirements for the Exemption

Any issuer claiming the recapitalization exemption of Section 3(a)(9) must satisfy all of its requirements. The interpretative problems raised by each of these requirements are considered below.

A. Identity of Issuer

Section 3(a)(9) exempts any security exchanged by the issuer with "its" security holders. The Commission has interpreted this language as requiring that both the security issued and the security surrendered in the exchange be those of the same issuer.[59] This construction, which comports with the legislative history of the section,[60] does not hinder such obvious intra-corporate transactions as

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Action" Letters, roll 4, frame 05784 (March 2, 1972) (common for note and warrant).

(3) *Debt for equity. See, e.g.*, Consolidated Oil & Gas, Inc., [1974] "No Action" Letters, roll 10, frame 13488 (September 10, 1974)(convertible debenture for common); Charan Indus., Inc., *supra* note 41 (debenture for common).

(4) *Debt for debt. See, e.g.*, Model Fin. Co., [1973] "No Action" Letters, roll 12, frame 02381 (November 27, 1973) (debenture for debenture).

[57] *See, e.g.*, WECO Dev. Corp., [1973] "No Action" Letters, roll 2, frame 01802 (January 24, 1973), where the recapitalization plan provided that convertible subordinated debenture holders would be entitled upon conversion to acquire a unit consisting of one share of WECO common and one WECO common stock purchase warrant. *See also* Midwest Stock Exchange Serv. Corp., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,657 (December 27, 1973). The issuer proposed a refinancing program designed to reduce long-term debt (by eliminating most, if not all, withdrawal deposits) and to increase its equity base. The program called for an increase in the number of authorized common shares through a stock split of 20-for-1, a contribution of $1 million by the Midwest Stock Exchange, its parent, and an exchange offer under Section 3(a)(9) to each depositor-subscriber. Subscribers were permitted to deposit a maximum of $75,000, in units of $3,000. Each unit entitled the participant to receive a cash discount on certain fees charged by the issuer. The issuer also planned to offer to each of the 52 depositor-subscribers an opportunity to exchange one $3,000 unit of deposit (there were 805 units outstanding) for one $1,500 principal amount "discount certificate" and 30 shares of its common stock. The certificates were to have a maturity date of December 31, 1983, at which time the principal amount was due without interest and would entitle each depositor to receive during the ten-year period a specified cash discount on the service corporation's fees. Upon successful completion of the refinancing program, the parent Midwest Stock Exchange would own approximately 80.5 percent of the outstanding common stock of the issuer subsidiary.

[58] *See, e.g.*, USM Corp., *supra* note 28; Cooky's Steak Pubs, Inc., *supra* note 45.

[59] *See* releases cited in note 9 *supra*.

[60] This language ["exchanged by the issuer with its existing security holder"] does

stock splits.[61] But the availability of the exemption may be uncertain in other situations.

1. Old Wine in a New Bottle

If an issuer with securities outstanding changes its legal form, issues new securities in exchange for those outstanding, and continues its original business, can it qualify as the "same issuer" for 3(a)(9) purposes? The staff faced this issue in a no-action inquiry from Cedar Point Oil and Gas Co.[62]

On May 19, 1950, to facilitate the dissolution and liquidation of the Salt Dome Oil Corp., all of its properties and assets were assigned in trust to the South Texas National Bank of Houston. The bank was designated trustee, with the 3,500 stockholders of Salt Dome becoming the trust beneficiaries. Subsequently, Salt Dome was dissolved, certificates of beneficial interest were issued to former stockholders,[63] and the bank continued to act as trustee pursuant to the term of the trust indenture. The life of the trust assets was limited, and since the trustee was prohibited from acquiring any new or additional properties, the trust was destined to eventual termination. The trust indenture permitted a meeting of the certificate holders to be called by the trustee or by holders of not less than five percent of the shares represented by the then outstanding certificates for the purpose of considering disposition of the trust assets. One certificate holder, eligible under the indenture to call such a meeting, formed Cedar Point Oil and Gas Co. and intended to propose that all trust assets be transferred to Cedar Point in exchange for Cedar.

> not in terms require that the securities surrendered in exchange for the new securities shall be securities of the same issuer, nor even that the exchange be one of security for security, but merely that the transaction shall be by way of "exchange" and shall be with persons who at the time of the exchange are security holders of the issuer of the new securities. However, to give to the term "exchange" its broadest possible sense, which might cover the issuance of securities for other species of property, or even for cash, would clearly extend the operation of the section beyond its contemplated bounds; and some limitation must therefore be found appropriate to the purpose sought to be accomplished.

Throop & Lane, *supra* note 7, at 100.

[61] For examples of permissible exchanges under Section 3(a)(9), see text following note 41 *supra*.

[62] Cedar Point Oil & Gas Co., [1973] "No Action" Letters roll 3, frame 04131A (February 27, 1973).

[63] The certificates were publicly traded. *Id.*

Counsel for Cedar Point argued that Section 3(a)(9) would exempt the exchange as "only the domicile of the entity is being changed by the proposed transaction, with no new investment decision of certificate holders being involved."[64] The staff disagreed, however, and described the issuance of Cedar Point common stock as "a registerable event which may be registered pursuant to Rule 145, if all of the requirements of that Rule are complied with, or on Form S-1."[65] The staff's position seems correct. When the stockholders acquired trust certificates, they could reasonably have contemplated a limited investment in a trust, supervised by a bank, that would terminate upon the dissolution of the trust assets. They should not be forced to decide whether to change their investment status from beneficiaries under a trust to stockholders in a corporation without the disclosure protections of the Act.

Had the stockholders been fully informed of the trust reorganization plans prior to receipt of their certificates, would the staff position have been different? The staff's subsequent response to the inquiry of the Recreation Ventures[66] suggests not. Recreation Ventures was a limited partnership which had 774.60 limited partnership interests outstanding, held by 113 partners. The partnership was organized pursuant to an agreement which provided in detail for its prospective reorganization into a different form. The limited partners, upon joining the partnership, specifically agreed upon the details of the new corporate form, including the state of incorporation, the form of the certificate of incorporation and by-laws, the new ownership interests and the conditions for the reorganization. Under the agreement, Recreation Ventures, as managing general partner, would organize a new Delaware corporation with the consent of holders of two-thirds of the limited partnership interest. When so organized, all limited partners were required to exchange their limited partnership interests, and all of the stockholders of the general partners were required to exchange their stock for stock of the new corporation. Furthermore, the likelihood of this recapitalization had been disclosed in the final prospectus.[67] The managing

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[64] *Id.* at frame 04136 (letter of corp. counsel).

[65] *Id.* at frame 04132A.

[66] Recreation Ventures, [1973] "No Action" Letters, roll 5, frame 08798 (April 13, 1973).

[67] In the registered offering of the limited partnership interests, the prospectus explained that the partnership expected to propose the exchange when losses were no longer available for deduction by limited partners or the financial requirements of the partnership dictated a corporate rather than partnership form.

general partner determined in 1973 that because losses were unlikely to be available for deduction in that year, it would be appropriate to ask the holders of limited partnership interests for their consent to the change. In claiming an exemption under Section 3(a)(9), counsel took the position that all partners had specifically agreed to the recapitalization at the time of their original investment decisions.

> The partners, therefore, were investing in an entity whose legal form they agreed might change into a form in which their relative rights and interests were known. In effect they agreed the Company [partnership] and the Corporation were the same entity.[68]

The staff response was brief and emphatic. The exemption was "not available since [Section 3(a)(9)] requires that the securities to be issued be of the same issuer as that received in the exchange. Such is not the case in this instance."[69]

The lesson from these and other no-action letters is obvious. The staff's strict construction of Section 3(a)(9) when determining issuer identity does not allow for exceptions based on policy[70] or

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[68] *Id.* at frame 08804. Counsel for the partnership also asserted at any rate that the contemplated transaction should not be considered in a class with the usual exchange offer, where a new investment decision must be made on the terms of the offer. *Id.* (letter of corp. counsel). Here, they argued, the investment decision was made at the time of investment in the partnership, when the partners specifically agreed to the terms of the change with the sole exception of the number of shares to be received.

> Therefore, their investment decision upon purchasing a limited partnership interest was also a decision to purchase a share or shares in the Corporation. In effect, in other words, the partners agreed to accept an exchange subject only to the reaffirmation of their consent. Therefore, their agreement now to accept the change of form of ownership should not be considered the "sale" of a new security within the meaning of Section 2(3) of the Act.

Id. at frame 08805 (letter of corp. counsel). To this argument, the staff simply stated that it took the opposite position. *Id.* at frame 08799.

[69] *Id.* at frame 08799.

[70] The no-action letter request by Niagara Frontier Transit Sys., Inc., [1975] "No-Action" Letters, roll 1, frame 00200 (December 11, 1974) contemplated an exchange which from a policy perspective would seem to have produced a sympathetic response from the staff. Niagara had 318,886 shares of common stock outstanding which were held by approximately 1,425 shareholders. On March 29, 1974, at the company's last annual meeting of shareholders, the shareholders authorized the sale of substantially all the assets of the company and adopted a plan of complete liquidation pursuant to Section 337 of the Internal Revenue Code. On April 1, 1974, all of the operating assets of the company were sold to a public authority, leaving primarily cash, certificates of deposit, and government securities.

Section 337 required the company to complete its liquidation by March 28, 1975, one year after the adoption of the plan. In order to facilitate compliance, a provision of the plan

authorized the company to make a liquidating cash distrihution, not to exceed $5.00 per share of outstanding common stock, in trust for its shareholders. One purpose of such a liquidating trust was to provide funds to satisfy any liabilities of the shareholders, as transferees of the company, which could not be ascertained accurately during dissolution. The principal reason, bowever, was "that certain of the Company's federal and state tax returns have not yet heen audited and the Directors consider it necessary to make provision for the possible payment of additional taxes, should they be assessed." *Id.* at frame 00205.

Pursuant to the plan, the company made a partial cash distribution to its shareholders in the amount of $17.50 per share on May 31, 1974. As part of the final cash distribution to be made prior to March 28, 1975, the company proposed to distribute to a liquidating trust the equivalent of $4.75 per outstanding share of common stock. As a result, the shareholders were to be issued, in conjunction with the final distribution of the company's assets, units of beneficial interest on a pro rata basis. Corporate counsel argued that the exchange of certificates for units was exempt by reason of Section 3(a)(9) since both "represent only their proportionate interest in the liquidation value of the net assets of the Company." *Id.* at frame 00208.

The staff disagreed hecause the company "would not he the issuer of the heneficial interests," *id.* at frame 00202, despite the following factors. (1) The plan provided that the terms of the liquidating trust were subject to shareholder approval. The company had called a special meeting of shareholders to approve the terms of the trust, to appoint a corporate trustee and to elect a shareholder's committee to act on behalf of the shareholders in connection with the trust, and intended to solicit proxies with respect to that meeting. (2) The liquidating trust funds could only be used for payment of liabilities of the shareholders, as transferees of the company, or of trust expenses, or to the shareholders in a final cash distribution once all claims and expenses had been satisfied. The trust agreement was to provide that with rcspect to such payments the trustee was to be directed by the shareholders' committee. (3) No trading market would have developed in the units, as they were non-negotiable. (4) The only purpose for the liquidating trust, which was to be the issuer of the units, was to assure compliance with federal tax laws.

The staff bas, however, used policy to support its narrow interpretation of Section 3(a)(9). *See, e.g.*, Kanawha Cauley Coal & Coke Co., [1974] "No Action" Letters, roll 9, frame 12324 (August 5, 1974). The company was a West Virginia corporation having one class of common stock with 5,174 shares outstanding. It did not mine coal; its only business consisted of leasing its real estate. The company did not envision changing its basic activity of collecting coal royalties from its properties and distributing the entire net profits to its stockholders.

For tax reasons, the company proposed changing its legal form from a corporation to a limited partnership. A plan called for transfer of the assets to a limited partnership, formed hy the company, in exchange for participation interests as limited partners, each stockholder exchanging one share of stock for one participation interest as either a general or limited partner. There were to be no other limited or general partners. The percentage of ownership of each stockholder would remain the same, and the general partners would not obtain any increased economic benefit from or interest in the partnership. The capital of the business was to remain the same. One critical difference between the two entities did exist. While the limited partners would have the power to replace any general partner and appoint a successor, the remaining general partners retained the ultimate power as general partners to decide whether to continue the business and accept the appointee as a general partner.

Counsel for the company believed that Section 3(a)(9) provided an exemption for the proposed exchange between the company and its stockholders since the proposed change in the legal form of doing business would "not change the rights or economic interest of any stockholders in the business." *Id.* at frame 12328. The staff concluded otherwise, stating that the exemption was unavailable because of "the significant legal and practical effects upon present stockholders [*e.g.*, personal liahility, tax exposure] that a change in the Company's

contractual consent. The old wine must flow from the old bottle itself.[71]

2. Assumption of Obligations

Interpretative problems also arise when the original issuer has been merged out of existence and its obligations to outstanding security holders assumed by the acquiring corporation.[72] In such a case, the question may arise as to who is the issuer of those original securities for purposes of Section 3(a)(9).

This issue was raised in connection with a no-action letter request by Heritage Bancorporation.[73] In March 1969, the First National Iron Bank of New Jersey issued $4 million in convertible notes due in 1994 to seven purchasers in reliance on the bank registration exemption in Section 3(a)(2).[74] In November 1971, Heritage acquired Iron Bank, assuming all liability and obligation on the notes and making them convertible into common stock of its own. The SEC granted the no-action request, which relied on Section 3(a)(9). Although the notes were originally securities issued by Iron Bank, the staff reasoned, the obligations ceased to exist upon merger, and new securities with identical characteristics had been issued by Heritage when it assumed all liability and obligation on them. Therefore, holders of the notes were considered Heritage's "existing security holders."[75] The section is also available in a straight subsidiary

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form of business may have and because of the absence of an identity of issuers of the securities to be exchanged as required by Section 3(a)(9)." *Id.* at frame 12324.

[71] Even if the entity making the exchange offer has the same legal form as the entity that issued the original securities, Section 3(a)(9) is available only if they are in fact the same entities. *See, e.g.*, Artistic & Leisuretime Prods., Inc., [1974] "No Action" Letters, roll 9, frame 12330 (August 15, 1974). Artistic contemplated a plan in which it would become the wholly-owned subsidiary of Great Northern, a corporation formed for this specific purpose. The stockholders of Artistic would then exchange their shares for a like number of Great Northern's shares. The staff refused to issue a no-action letter under Section 3(a)(9) since "[t]he issuer in this instance (i.e., Great Northern) will be exchanging its shares, not with its own security holders, but with the security holders of another entity (i.e., Artistic)." *Id.* *See also* Grossbard Sec. Corp., [1973] "No Action" Letters, roll 5, frame 08795 (April 10, 1973).

[72] Section 3(a)(9) does not exempt the exchange of securities under a merger agreement. The merger transaction may qualify under another exemption or under Rule 145, 17 C.F.R. § 230.145 (1973).

[73] Heritage Bancorporation, [1973] "No Action" Letters, roll 2, frame 01793 (January 15, 1973).

[74] Section 3(a)(2) exempts from the registration requirements of Section 5 securities issued or guaranteed by a domestic governmental body or by a national or state bank. 15 U.S.C. § 77c(a)(2) (1970).

[75] *See also* USM Corp., *supra* note 28. In 1964 the shareholders of Nylock Corp. adopted a

merger where the acquired corporation is merged into a subsidiary of the acquiring corporation and the latter becomes the primary obligor on outstanding obligations of the former.[76]

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plan of complete liquidation and dissolution which provided for the transfer of its patents and licenses to USM Corp. Under an agreement between Nylock and USM, the latter agreed to pay Nylock shareholders, over a period of 25 years, 50 percent of the royalties from the patents and licenses after first deducting $100,000 and expenses. Nylock shareholders received as part of their liquidating dividend negotiable certificates evidencing this right to receive future royalty payments from USM. Certificates representing 120,793 units of participating interest in the payments were distributed through the aid of Morgan Guaranty Trust Co. by Nylock to its shareholders upon liquidation in 1965 and were outstanding at the time of the letter of inquiry to the SEC. A total of $11.47 per unit had been distributed, and the certificates had been publicly traded.

Certificate holders, representing a substantial number of units, decided with USM to assign a minimum value to each unit and to reduce or eliminate the certificates' remaining 16-year life. Their plan called for USM to offer to acquire the certificates representing all of the 120,793 units originally distributed, but not less than 75 percent of all outstanding units, for $4.50 per unit plus the nonassignable right to receive continuous payments of a four-year period equal to the royalty income which the certificate holder would have otherwise received.

Since USM expected to rely on Section 3(a)(9) for its exchange exemption, it had to determine whether it or Nylock was the issuer of the outstanding certificates. Counsel for USM argned that

> holders of the Nylock Certificates should be considered to be USM's 'existing security holders' solely for the purposes of permitting USM to acquire the Certificates upon the terms referred to above in reliance on the exemption contained in section 3(a)(9) of the Act without registering whatever document may evidence USM's obligation to make royalty payments for an additional three years.

Id. at frame 08812 (letter of corp. counsel). The staff agreed and granted the requested no-action letter.

[76] *See, e.g.*, WECO Dev. Corp., *supra* note 57. WECO planned to merge Petro-Dynamics, Inc. into a wholly-owned subsidiary of WECO. Petro had outstanding a class of convertible subordinate debentures which, under the terms of the proposed plan of recapitalization, were to be convertible into shares of WECO common stock. WECO intended to execute a supplemental indenture with the indenture trustee under which WECO would assume the obligations under the Petro debentures and become the primary obligor. *See also* Pacesetter Fin. Corp., *supra* note 13. Here, two different banks with certain convertible debt securities outstanding formed Pacesetter as a holding company to acquire the two banks. Their plan called for the creation of two pbantom banks, wholly-owned subsidiaries of Pacesetter, which would receive the two predecessor banks under the consolidation agreements. Each consolidation agreement was to be a three-party contract under which Pacesetter would agree to issue its common stock to the shareholders of the old bank pursuant to Rule 133. The phantom bank-subsidiary and Pacesetter were to assume joint and several liability for the due payment of the principal and interest of the convertible debt securities of the old bank and Pacesetter was to agree to exchange its common upon any conversion of the debt securities.

For a discussion of the problems in availability of Section 3(a)(9) where the parent is not the primary obligor, as in *WECO*, or jointly and severally liable, as in *Pacesetter*, but merely guarantees an obligation of its subsidiary, see Downe Communications, Inc., *supra* note 24, discussed in note 87 *infra* and accompanying text. *See also* Throop & Lane, *supra* note 7, at 101.

A different result follows, however, in the reverse merger situation. Assume that corporation *F* and corporation *G* sign a merger agreement requiring *F* to merge its wholly-owned subsidiary, corporation *FF*, into *G* which has issued common stock and convertible debentures. Under the terms of the merger agreement, common stock of *F* will be exchanged for all the *G* common, and *G* convertible debentures will become convertible into *F* common. Upon consummation of the agreement, *F* will own *G*, *FF* will be merged into *G*, and the former stockholders of *G* will be stockholders of *F*. But what of the debentures originally issued by *G*? Although by virtue of the merger they will become convertible into common stock of *F*, they will remain *G*'s securities since *G* still exists. In this situation Section 3(a)(9) is unavailable to *F* when its common stock is issued upon conversion.[77]

3. Guaranteed Obligations

The 1934 amendments to the Securities Act broadened the definition of a security to include guarantees[78] and included a guarantor as an "issuer."[79] Thus, the presence of a guarantee in a transaction, otherwise qualified under Section 3(a)(9), raises some troublesome questions.[80]

The staff has had the occasion of a no-action request to consider whether a guarantor may claim the underlying securities as his own for the purposes of claiming an exemption under Section 3(a)(9) for a subsequent exchange.[81] National Can Corp.'s wholly-owned subsidiary, National Can Overseas Corp., sold $7 million in bonds to underwriters in England for resale exclusively outside the United States, to persons other than American citizens or residents.[82] National, the parent, guaranteed the bonds as to principal and interest, also making them convertible into shares of its own common

[77] *See generally* Schmults, *supra* note 49, at 217.

[78] Act of June 6, 1934, ch. 404, § 201, 48 Stat. 905, *codified at* 15 U.S.C. § 77b(1) (1970).

[79] *Id.* § 201, *codified at* 15 U.S.C. § 77b(4) (1970).

[80] *See generally* 1 L. Loss, *supra* note 5, at 574-75.

[81] National Can Corp., [1973] "No Action" Letters, roll 10, frame 17585 (September 28, 1973).

[82] The bonds were not registered under the Act in reliance upon Registration of Foreign Offerings by Domestic Issuers, SEC Securities Act Release No. 4708, 1 CCH Sec. L. Rep. ¶ 1361 (July 9, 1964), concerning exemption for a foreign sale of securities, discussed in note 150 *infra*.

stock, so as to enable Overseas to obtain an acceptable interest rate. National claimed an exemption under Section 3(a)(9) for later issuance of its common stock upon exercise of conversion rights by the bondholders,[83] asserting that its unconditional guarantee of the principal and interest of Overseas' bonds transformed them into securities of National.[84] The staff rejected this theory, responding:

> Although the guarantee of Overseas' Bonds by National may in itself be deemed to be a security of National under Section 2(*l*) of the Act, the Bonds themselves are not thereby considered a security of National under this Section solely by reason of the guarantee.[85]

Since the issuer of the bonds, Overseas, could not be described as defunct or without substantial assets, holders of the guaranteed bonds who chose to convert would have been required to part with two valuable securities, each of a different issuer.[86] Such a transaction could not satisfy the exemption's identity-of-issuer requirement.[87]

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[83] National had filed a registration statement on Form S-7 that covered a portion of the shares of National common stock issuable upon conversion of the outstanding bonds of Overseas. Counsel for National was of the opinion that because an exemption existed under Section 3(a)(9), National had no obligation to keep in effect an updated prospectus covering the remaining shares to be issued upon conversion. National Can Corp., *supra* note 81, at frame 17591.

[84] *Id.*

[85] *Id.* at frame 17586.

[86] The staff rejected National's request for a no-action letter on another ground as well. The staff was unwilling to permit the issuance of National's common stock without an updated prospectus in view of "the likelihood that National's common stock will flow back into the hands of American investors since National's shares are currently traded on several U.S. stock exchanges." *Id.*

[87] *But cf.* Downe Communications, Inc., *supra* note 24. Downe proposed to acquire Bartell Corp. in compliance with Rule 145. Under the terms of the proposed merger agreement, Bartell was to be merged into a wholly-owned suhsidiary of Downe. The Downe suhsidiary was to assume the primary obligation to repay on Bartell's outstanding convertible debentures. The parent corporation, Downe, was to guarantee these obligations but was not to be jointly and severally liable with its subsidiary on the debentures, which were to become convertible into shares of Downe common stock.

Counsel for Downe argued that Section 3(a)(9) exempted the exchange of Downe common to be issued upon conversion of Bartell debentures—assumed by Downe's subsidiary—even though Downe was not to become a primary obligor. In agreeing to issue a no-action letter, the staff took a position that appears inconsistent with earlier statements suggesting that a parent corporation's guarantee of payment would not qualify it as an issuer for purposes of the exemption. *See, e.g.*, WECO Dev. Corp., *supra* note 57, where counsel for WECO had apparently heen advised that Section 3(a)(9) would be available only where that issuer became the primary obligor on the acquired company's debentures. *Id.* (letter of corp. counsel)

Still unresolved is the converse situation, where the request for exemption comes from the issuer of the underlying security. There are two possible plans in this regard. In the first, corporation *H* offers to exchange its common stock for its outstanding debentures, which are guaranteed by corporation *I*. Technically, the exchange offer is not being made "by the issuer with its existing security holders exclusively." *H* is asking its debenture holders to relinquish *H*'s debenture together with a separate "security," the guarantee of a different issuer. But, if *I*'s guarantee is worthless, either because *I* is defunct or with substantially inadequate assets to honor its obligation to *H*'s debenture holders, form should yield to substance, as suggested by the language of *National Can*, and the exemption should apply. In the second situation, *H* offers to exchange new debentures, guaranteed by *I*, for outstanding debentures that, in this case, have carried no guarantee.[88] Since *I*'s guarantee is a separate security of a different issuer, Section 3(a)(9) does not apply. Disclosure of the guarantor's financial condition would aid in the debenture holder's investment decision.

4. Voting Trusts

Renewal of a voting trust through issuance of new voting trust certificates in exchange for the old could be viewed as a change of issuer identity. The SEC advanced just this theory as amicus curiae in *Reserve Life Insurance Co. v. Provident Life Insurance Co.*,[89]

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at frame 01803. The distinction seems to be the existence of an agreement between Downe and its subsidiary under which Downe was to pay the debenture obligations and to reimburse the subsidiary for any payments it might have to make under the debentures or the supplemental indenture. Downe Communications, Inc., *supra* note 24, at frame 10569.

[88] According to one authority, Section 3(a)(9) would be available for *H*'s exchange but not for the issuance of *I*'s guarantee. 1 L. Loss, *supra* note 5, at 575. Such an interpretation

> seems to be sticking a bit close to the letter of the law in a case where the investor is presumably "getting a break" — and to be basically inconsistent with the Commission's view [reflected in Rule 150] . . . which permits the issuer to offer cash along with its new securities under the exemption.

Id. at 575. It would seem, however, that a security holder who is asked to accept a guarantee of a different issuer, as part of the exchange package, is not in the same position as the exchangee who is offered cash plus new securities. Consider the investor who is asked to exchange his 6 percent subordinated notes for 4 percent subordinated notes guaranteed by a different issuer. If the investor decides to relinquish the 2 percent annual return by accepting the exchange offer, it will probably be because he believes the guarantee is equivalent to the 2 percent differential. Assuming that the 6 percent notes have value, the investor is required to consider the financial prospects of two different issuers, one of which may be unknown to him.

[89] 499 F.2d 715 (8th Cir. 1974), *cert. denied*, 419 U.S. 1107 (1975).

contending that Section 3(a)(9) did not exempt such an exchange. Provident's management had joined with its stockholders in 1955 to create a voting trust to stabilize control as a defensive measure against corporate raids and take-overs. Provident filed a registration statement for the voting trust certificates, and approximately 64 percent of its stockholders eventually joined the trust, depositing their stock with the trustees and receiving voting trust certificates in exchange. Prior to the scheduled expiration of the trust in 1970, Provident's directors, as trustees of the voting trust, obtained permission from the certificate holders to extend the trust for an additional 10 years, as permitted by the terms of the original instrument. Neither the trustees nor Provident, itself, filed a registration statement for the extended voting trust certificates. Meanwhile, Reserve Insurance Co. and Midland Life Insurance Co., unsuccessful bidders in a take-over attempt of Provident, brought suit to declare invalid the trustees' actions in obtaining consents for the extension of the voting trust and to require its dissolution — an action which rested, in part,[90] on the federal law allegation that Provident had issued securities in violation of the 1933 Act.

While Provident and the trustees argued that Section 3(a)(9) exempted the exchange, Reserve, Midland, and the SEC in its amicus brief[91] argued that the renewal of the voting trust and the resulting issuance of amended certificates amounted to the issuance of a new security by a new issuer, even though state law might characterize both trusts as a single continuing entity.[92] The rationale here was that since trustees of the original trust could not compel any certificate holder to participate in extension, the trust terminated as an

[90] Reserve and Midland contended that Section 6 of the 1933 Act and Section 12 of the 1934 Act required the filing of registration data, that the solicitation of consents to the extension of the voting trust violated the SEC rules governing proxy solicitation, and that registration was required in all the states in which solicitations were made hy the trustees. *Id.* at 719.

[91] Brief for SEC Staff as Amicus Curiae, Reserve Life Ins. Co. v. Provident Life Ins. Co., 499 F.2d 715 (8th Cir. 1974), *summarized at* [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,409.

[92] The SEC staff brief responded to a suggestion that its position could imply a federal law relating to voting trust extension. The staff recognized the preeminence of state law for determining whether and under what circumstances a voting trust might be extended, but it argued that state law should not be considered relevant in determining whether securities issued in connection with the extension should be registered under the Act or exempt under Section 3(a)(9). That determination, it urged, turned only on the federal law meaning of the terms "issuer" and "existing security holder" in Section 3(a)(9). Reply Memorandum of SEC Staff as Amicus Curiae, Reserve Life Ins. Co. v. Provident Life Ins. Co., *summarized at id.* ¶ 94,433.

entity in 1970. The Commission pointed to the beneficient purpose of the Act in promoting full disclosure of information believed necessary for informed investment decisions:

> the § 3(a)(9) exemption ought to be construed narrowly in order to protect investors such as the present holders of extended trust certificates who should be entitled to the same safeguards afforded shareholders who contemplated exchanging shares for the original voting trust certificate.[93]

Nonetheless, the Eighth Circuit upheld the district court's finding that a single continuing trust existed and that the exchange of securities thus fell within the meaning of Section 3(a)(9).[94] The court stated, however, that it would have agreed with the SEC's position had the 1955 voting trust not contained an express provision for extension.[95] The terms of the initial trust, the court reasoned, "added an element of flexibility to the initial 15-year time period" and, when the parties first exchanged their shares of Provident stock for voting trust certificates, they "evidenced an intent to participate in the voting trust arrangement for such time period as might be reasonably necessary to protect against corporate raiding."[96] The court noted that the following factors influenced its determination: (1) the trustees solicited only the holders of existing voting trust certificates; (2) the voting trust did not issue new certificates but, rather, the trustees simply stamped the old ones with the new trust termination date; (3) each certificate holder retained the same equitable interest in the corporation as before; (4) the voting trust itself was not materially altered except for its extension; and (5) no remuneration was paid for soliciting the exchange.

The holding in *Provident Life* on the exchange exemption issue seems correct in view of the district court's fact finding that the decision to extend the life of the voting trust "was influenced in part" by announced takeover attempts so that the original purpose of the voting trust was furthered and the intention of its members

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[93] 499 F.2d at 721-22.

[94] *Id.* at 722-23.

[95] The court noted, *id.* at 722 n.8, that two leading authorities on securities law believed that Section 3(a)(9) covered an extension of a previously existing voting trust, when the original trust agreement contained a provision for renewal and the other requirements of the exchange exemption were met. *See* 1 L. Loss, *supra* note 5, at 574; H. Sowards, *supra* note 5, § 3.10 at 20-21 n.56.

[96] 499 F.2d at 722.

satisfied.[97] On the other hand, had the trustees' decision to extend the voting trust been predominately influenced by objectives not originally contemplated by members of the initial trust, the decision should properly have been treated as authorizing the creation of a new voting trust with different objectives. In that event, the SEC's argument becomes persuasive and the new and old trusts should be considered separate legal entities under the Act.[98]

5. Bankruptcy

Creditors of a bankrupt corporation frequently establish a special committee, which itself can take the form of a corporation, to purchase assets of the bankrupt. Holders of first lien mortgage real estate bonds, for example, might incorporate as the most appropriate means to dispose of a large, diversified piece of property owned by the bankrupt. If the lien creditors then have their corporation exchange its debentures or other securities for the bonds held by the creditors—thereby leaving their new corporation as the principal or only secured creditor to purchase the bankrupt's property in its entirety—would the exchange of securities be exempt under Section 3(a)(9)?

In response to a no-action letter inquiry by O'Neill Bondholders Committee,[99] the staff stated that the 3(a)(9) exemption did not apply. The Committee, a group of creditors of a bankrupt which had as its major asset a tract of land, contended that the liquidation of the property parcel by parcel would have left no equity for the general creditors and that if the various parcels were sold as one, some equity might well remain for them. The Committee then argued, *inter alia*, that Section 3(a)(9) exempted the exchange of its debentures for the bonds of the bankrupt even though its new corporation was not the same issuer as the bankrupt. It attempted to justify exemption by reconciling Section 3(a)(9) with certain special principles of bankruptcy law:

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[97] *Id.* at 718.

[98] *Provident Life* should be compared with the staff's position in *Recreation Ventures, supra* note 66, which also dealt with security holders who understood the nature of the issuer and approved the future plans for its operation. In *Provident Life*, the legal form of the issuer (a voting trust) did not change; it simply continued to exist. In the recapitalization contemplated by Recreation Ventures, on the other hand, a limited partnership was to be transformed into a corporation.

[99] O'Neill Bondholders Comm., CCH FED. SEC. L. REP. ¶ 79,947 (SEC July 10, 1974).

> [I]t is our belief that such an implication [that two different issuers are involved] overlooks one important consideration and rationale behind the bankruptcy laws. This rationale is that the creditors of the bankrupt in essence [step] into the shoes of the bankrupt. In other words, it is our belief that the bankruptcy of O'Neill Enterprises, Inc., results in the secured bondholders on the Willoughby Tract in effect taking the place of the bankrupt itself in its relationship to the secured property, in that they become the equity holders as to this part of the Bankrupt's property.[100]

The staff rejected the Committee's interpretation of 3(a)(9)'s "same issuer" requirement, construing the exemption literally. It responded to the attempted statutory reconciliation in broad terms:

> [W]e wish to point out that the reorganization chapters of the Bankruptcy Act are drawn to effect the type of transaction you describe and contain appropriate provisions for the protection of public investors and correlative exemptions from the registration provisions of the Securities Act. In our view, the difficulties involved in the instant situation appear to have been created by the use of a proceeding which is not intended for the purpose you are attempting to accomplish.[101]

Although this opinion was addressed to the specifics of the Committee inquiry, such a message, when read with earlier staff pronouncements,[102] can be generalized: Section 3(a)(9) is narrowly construed

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[100] *Id.* at 84,443. Counsel for the O'Neill Bondholders Committee relied on Helvering v. Alahama Asphaltic Limestone Co., 315 U.S. 179 (1942), as authority for its position regarding identity of issuers under Section 3(a)(9). The staff did not discuss this decision, although it is distinguishable in any case. The issue involved there was the meaning of the term "reorganization" in Section 112(i)(1) of the Revenue Act of 1928, as applied to an acquisition of all of the assets of the bankrupt corporation. The Court held that it was immaterial that the transfer shifted the ownership of the equity in the property from the stockholders to the creditors of the old corporation, since effective equity ownership had already passed to the creditors, who "stepped into the shoes of the old stockholders" when they "took steps to enforce their demands against their insolvent debtor." *Id.* at 183-84. It is hard to justify *Alabama Asphaltic* as supporting the O'Neill Bondholders' position that by assuming effective control of the bankrupt's property, their corporation could be considered "the same issuer" as the bankrupt in issuing new debentures. *Alabama Asphaltic* was a tax case where the consequences of an issuer identity determination were limited to a tax advantage or disadvantage. In *O'Neill*, a determination as to identity of the issuers would essentially force the bondholders of the bankrupt to make a hard investment decision without the disclosure protection of the Securities Act or the special safeguards of the Bankruptcy Act.

[101] O'Neill Bondholders Comm., *supra* note 99, at 84,440.

[102] *See, e.g.*, Sequential Information Sys., Inc., [1972] "No Action" Letters, roll 12, frame 19103 (November 3, 1972); Seaferro, Inc., [1970-1971 Transfer Binder] CCH Fed. Sec. L.

in all cases; where an insolvent or bankrupt issuer is involved, the exemption assumes an even narrower dimension.[103]

B. "Exclusively" by Exchange

The word "exclusively," appearing in the middle of Section 3(a)(9), modifies the phrase "existing security holders." This syntax clearly establishes a requirement for exemption that the issue be offered solely to the issuer's security holders.[104] But the term "exclusively" signifies considerably more. SEC interpretation in effect holds that it also modifies the requirement of *exchange*, that Section 3(a)(9) reads, "Any security *exclusively* exchanged by the issuer with its existing security holders exclusively." The effect of this second requirement of exclusivity is that security holders in a 3(a)(9) transaction may not be asked to part with anything other than their old securities. If, for example, an issuer offers to exchange new securities upon the security holder's exercise of warrants (thus requiring cash payments), the exemption is not available.[105]

This prohibition is not absolute. Two limited exceptions to the "clean exchange" requirement are found in the SEC's interpretative rules. Rule 149 permits the *security holder* in a Section 3(a)(9) exchange to make whatever cash payments may be necessary "to effect an equitable adjustment, in respect of dividends or interest paid or payable on the securities involved in the exchange, as between such security holder and other security holders of the same class accepting the offer of exchange."[106] The second liberalizing interpretation, Rule 150, allows the *issuer* to make payments to its security

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REP. ¶ 78,097 (SEC 1971).

[103] *See* Sequential Information Sys., Inc., *supra* note 102, where the company proposed an exchange of its securities for outstanding certificates of indebtedness issued and sold by the company, as dehtor in possession, during the proceeding for arrangement under Chapter XI of the Bankruptcy Act. In denying the request for a no-action letter, the Chief Counsel stated:

> The Division [of Corporation Finance] does not accept the suggestion that Sections 3(a)(9) and 3(a)(10) of the Securities Act of 1933 provide an independent basis for the exemptions you seek. . . . Both sections 3(a)(9) and 3(a)(10) exclude public offerings of securities to new investors and are limited to holders of preexisting investments. We, therefore, regard Section 393 of the Bankruptcy Act as a specific application of the previously enacted Securities Act exemptions to the Chapter XI context, and conclude that, in Chapter XI proceedings, corresponding Securities Act exemptions must be construed to conform to the more specific terms of Section 393.

Id. at frame 19105.

[104] *See* text accompanying notes 114-26 *infra*.

[105] *See, e.g.*, The Bank of California, Nat'l Ass'n, [1972] "NO ACTION" LETTERS, roll 5, frame 07362 (April 18, 1972).

[106] 17 C.F.R. § 230.149 (1973).

holders "in connection with an exchange of securities for outstanding securities, when such payments are part of the terms of the offer of exchange."[107] In short, the security holders may not make cash payments to the issuer[108] except where necessary to achieve an "equitable adjustment"; but the issuer, for its part, is free to include cash payments to its security holders.

The Commission's insistence on an exclusive exchange is certainly warranted for some recapitalizations. Assume, for example, that corporation *J* has five stockholders, each owning five shares of common stock and five shares of preferred stock purchased for a total of $10,000 during the formative corporate stages. Later, each stockholder purchased 10 debentures in the aggregate principal amount of $10,000. A 3(a)(9) recapitalization is proposed, calling for *J* to issue 3 additional shares of the common stock in exchange for one debenture and $1,000 in cash. It is clear that, if exempt from registration requirements, *J*'s exchange offer would require each of its five stockholders to make a hard investment decision without the

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[107] 17 C.F.R. § 230.150 (1973). *See, e.g.*, Steiner American Corp., *supra* note 48, where the issuer relied upon Rule 150 for its planned payment of cash to security holders for the dividend accruing to the date of reclassification. It has heen noted that "[t]o the extent that cash is paid by the issuer, the issuer is *buying*, rather than selling, securities." Throop & Lane, *supra* note 7, at 101 n.29 (emphasis in original). No attempt will be made here to assess the potential problems for such an issuer under Rule 10b-6. But the staff has had at least one occasion to respond to an inquiry about the applicability of that rule to a Section 3(a)(9) transaction. In a request by American Electronic Laboratories, Inc., *supra* note 30, counsel for the issuer argued that the word "distribution," as used in Rule 10b-6, sbould be defined so as "not to ensnare within its scope transactions which bear no relationship to ahuses which the rule was designed to prevent." *Id.* at frame 07360 (letter of corp. counsel). The staff offered no response.

[108] Rule 152A, 17 C.F.R. §230.152a (1973), which governs the offer or sale of certain fractional interests, qualifies this requirement of an exclusive exchange, however, as sbown by Equimark Corp., *supra* note 56. The issuer, Equimark, had outstanding common and convertible preferred stock, convertible into common at the conversion ratio of 4½ shares of common for each share of preferred. Equimark planned to rely upon Section 3(a)(9) to exempt tbe issuance of its common upon conversion of the preferred. Instead of issuing any fractional shares or any other fractional interest which a holder of a preferred share might otherwise be entitled to receive upon conversion, Equimark planned to make a cash payment to such holders in an amount equal to the same fraction of the market price for such sbares of common stock, or a cash payment in an amount equal to the same fraction of the market value for such other interest on the day such rights were exercised. Alternatively, it planned to offer the holders of preferred stock the privilege of purchasing whatever fractional interest was necessary to round off. The staff agreed with Equimark that Section 3(a)(9) was available for the proposed exchange and that the proposed offer to the preferred stock holders to purchase necessary fractional interests would be exempt under Section 4(1) and Rule 152A. *See generally* 4 L. Loss, *supra* note 5, at 2627-29.

benefit of the Act's disclosure protections. That difficulty alone, of course, is an inadequate justification for denying the benefits of Section 3(a)(9); as has been observed, use of the exemption is not limited to those transactions where security holders possess detailed information about the issuer.[109] Disqualification arises here because the issuance of *J*'s new securities is not exclusively an "exchange" but is in part a "sale." *J* essentially is soliciting its security holders for another cash investment—exactly the sort of transaction which the 1933 Act intended to protect by free disclosure.

The clean exchange requirement, however, becomes more difficult to justify the less the transaction involves a purchase and sale of securities for cash and the more it approaches a security-for-security exchange. Suppose, for example, that *J* had offered its security holders the opportunity to acquire one share of common stock in exchange for an outstanding debenture. If one share of *J* common stock is worth less than one *J* debenture, is the debenture holder who accepts *J*'s exchange offer parting with something of value in addition to the old security? Or, if *J* asks its security holders to surrender one share of preferred stock and waive all unpaid accrued dividends attributable to that share in exchange for two new shares of preferred, is the exclusive exchange requirement under Section 3(a)(9) satisfied?[110]

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[109] Throop & Lane, *supra* note 7, at 97, *citing* H.R. REP. No. 85, 73d Cong., 1st Sess. 16 (1933).

[110] In Diverse-Graphics, Inc., *supra* note 26, the staff granted a no-action letter on the basis of Section 3(a)(9) where all unpaid accrued interest and dividends on preferred stock were to be waived by security holders. *See also* Canrad Precision Indus., Inc., *supra* note 30, where the staff agreed not to recommend that action be taken against an issuer who wished under the protection of Section 3(a)(9) to modify or eliminate its outstanding preferred stock as a result of exorbitant dividend arrearages. The proposed exchange offer was to give the preferred stockholders an opportunity either to exchange their existing preferred for a new class of non-cumulative convertible preferred or to adjust the conversion price of existing shares of preferred from $7.50 to $6.00, subject to the shareholders' agreeing to convert their shares immediately. *Cf.* Four-Phase Sys., Inc., *supra* note 27, in which a no-action letter was again granted to an issuer who proposed to exchange new preferred and common stock for old preferred with arrearages. The staff characterized the settlement of the accrued cash dividends with common stock as not the primary purpose of the exchange offer which was, rather, to eliminate the substantial continuing burdens of the cash dividend and redemption provisions of the old preferred. *Id.* at frame 20374. *But cf.* Masters Communications, Inc., [1971] "NO ACTION" LETTERS, roll 1, frame 00891 (April 13, 1971), in which an individual stockholder sought a no-action letter for a proposed unregistered sale of securities. In explaining how he had acquired his shares, the stockholder described a "stock split" purportedly under Section 3(a)(9), in which all the security holders "forgave" certain debentures amounting to $105,000, which were then cancelled by the issuer. The staff challenged the issuer's use of the exchange

In each case, one could certainly argue that the security holder is being asked not only to relinquish the old security but also implicitly to forego other valuable property.[111] Yet the preferable interpretation would not disqualify every such exchange in which a security holder's consideration includes the relinquishment of a right to receive or recover property from the issuer. Nothing in Section 3(a)(9), or in the SEC's interpretation of it, limits its use to exchanges involving clear economic equivalents.[112] An issuer might decide to offer its warrant holders new warrants with a greater market value than those outstanding because the issuer wishes to retain the support and good will of all its security holders.[113] Similarly, a security holder might decide to surrender a security that contains no voting rights if the issuer is offering in exchange a security which has less market value but possesses voting rights. A 3(a)(9) exchange confronts participants with the same calculus of considerations present in any bargain and exchange; as noted previously, difficulty of choice on the part of the security holder will not make Section 3(a)(9) inapplicable.

Furthermore, waiver of unpaid accrued interest and dividends or discharge of indebtedness will not add to potential investment losses of the security holders. In the case of corporation *J*, each stockholder has already invested $20,000. If *J* asks its security holders to accept three shares of common in exchange for one debenture plus $1,000, each cooperating security holder who participates fully in the exchange plan will be investing an additional $10,000 in a business venture that could now result in a total loss for him of $30,000. Such a recapitalization scheme should not be exempt from registration. But if *J* asks its security holders to accept three shares of preferred in exchange for one share of preferred and waiver of accrued dividends, or makes the same offer for one debenture that has a market value in excess of the combined value of three shares

exemption and refused to grant a no-action letter to the selling stockholder. *See generally* 1 L. Loss, *supra* note 5, at 576.

[111] The Georgia securities act limits its recapitalization exemption to those recapitalizations "for which the recipient does not pay any consideration or surrender the right to a distribution in cash or property other than such securities." Ga. Code Ann. §97-109(f) (Cum. Supp. 1974).

[112] *See, e.g.*, Wright Air Lines, Inc., *supra* note 30, where the issuer proposed to exchange its common stock for subordinated notes that were in default and planned to rely upon Section 3(a)(9). A no-action letter was granted.

[113] *See* text accompanying note 31 *supra*.

of stock, the security holder's exposure remains only $20,000. In short, although disclosure might seem necessary regardless of the consideration requested from a security holder, since otherwise it becomes difficult to assess the post-exchange value of the investment package, under present interpretations of Section 3(a)(9) the inquiry is only whether new consideration is moving from security holders to the issuer, and not whether security holders have lost something which they might have recovered from the issuer. Thus, if an exchange offer requires a security holder to deliver his old security and perform certain services for the benefit of the issuer, Section 3(a)(9) would not be available. The security holder is not being asked to make a cash investment, but he is being required to contribute new consideration, presumably having a cash value, as part of the exchange.

C. *"Exclusively" with Security Holders*

The 3(a)(9) exemption can apply only where an issuer's exchange is limited to its security holders.[114] The significance of this particular requirement results from the comprehensive concept of an "issue." Under certain circumstances, two or more apparently unrelated securities offerings by an issuer will be viewed by the SEC or the courts as integral parts of a single issue for Section 3(a)(9) purposes.[115] Such a constructive integration of offerings may mean that a prior or subsequent offering to persons who are not already security holders of the issuer (even if made pursuant to a registration statement or to an offering circular under Regulation A) will destroy the exemption even though the principal offering is so limited.

Consider, for example, company *K*, which has an "open-end" mortgage upon its properties that secures its only issue of bonds, series *A*. *K* then proposes to create two new series of bonds, *B* and *C*, under the same mortgage, in order to redeem the outstanding series *A* bonds. The series *B* and *C* bonds will differ substantially

[114] This does not mean, however, that an exchange offer must be extended to *all* of the issuer's security holders or, even, to all members of a particular class. It means only that the issue must be exchanged with *some or all* of the issuer's existing security holders. Such a construction of the section, which does not contain the word "issue," is necessary to avoid use of the word "exclusively," which does appear in the exemption, as mere surplusage. SEC Securities Act Release No. 33-2029, 1 CCH FED. SEC. L. REP. ¶ 2140 (August 8, 1939). *See also* Throop & Lane, *supra* note 7, at 97.

[115] *See generally* Shapiro & Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always . . . .*, 31 MD. L. REV. 3 (1971).

from each other with respect to maturity date, interest rate, redemption prices, and default provisions. The series *B* bonds will be offered, under 3(a)(9), in exchange to the holders of the outstanding series *A* bonds at equal principal. Cash needed to redeem any unexchanged series *A* bonds will be raised by the private placement[116] of series *C* bonds to 12 insurance companies. Since the *B* and *C* offerings are to occur more or less simultaneously, *K* wonders if the SEC will view the two as a single issue.

The SEC General Counsel addressed this question as early as 1939.[117] He noted that since the *B* and *C* bonds seemed in this particular situation to be securities of different classes, there were two issues, not one, and thus the *B*-for-*A* exchange qualified for exemption under Section 3(a)(9). In so observing, however, he noted that the larger question of definition was left unresolved:

> In expressing this opinion I do not mean to imply that any difference in the incidents of two blocks of securities, however trivial, renders the blocks separate classes and consequently separate "issues" for the purpose of tbe Act.[118]

Although identifying those elements in one offering that separate it from another is not at all easy, the Commission has since suggested certain guidelines[119]:

> The determination . . . will depend upon a consideration of various factors concerning the methods of sale and distribution employed to effect the offerings and the disposition of the proceeds. If the offerings may be segregated into separate blocks, as evidenced by material differences in the use of the proceeds, in the manner and terms of distribution, and in similar related details, each offering will be a separate "issue." In the main, of course, each case must be determined upon the basis of its own facts.[120]

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[116] 15 U.S.C. § 77d(2) (1970).

[117] SEC Securities Act Release No. 33-2029, 1 CCH FED. SEC. L. REP. ¶ 2140 (August 8, 1939).

[118] *Id.* at ¶ 2141.

[119] The doctrine that offerings under more than one exemption, or under an exemption and a registration statement, may be "integrated" arises in connection with Sections 3(a)(9), 3(a)(11), 3(b) [Regulation A], and 4(2). The Commission has recently adopted rules to establisb more objective standards for interpreting and applying the federal securities laws. The rules pertaining to Sections 3(a)(11) and 4(2) include provisions that identify certain types of offers and sales of securities that will be deemed not part of an issue. Rule 146, 17 C.F.R. § 230.146 (1974); Rule 147, 17 C.F.R. § 230.147 (1974).

[120] Unity Gold Corp., 3 S.E.C. 618, 625 (1938).

More than two decades later, the SEC listed, in *Securities Act Release No. 33-4434*,[121] five factors that relate to the single issue requirement:

(1) Are the offerings part of a single plan of financing;
(2) [D]o the offerings involve issuance of the same class of security;
(3) [A]re the offerings made at or about the same time;
(4) [I]s the same type of consideration to be received; and
(5) [A]re the offerings made for the same general purpose.[122]

A recent no-action request by Four-Phase Systems, Inc.[123] demonstrates the interplay between the above guidelines for determining integration under Section 3(a)(9) and the particular facts of related transactions. Systems planned to issue $14 million in convertible subordinated notes in a private placement contingent upon the modification of its four outstanding series of preferred stock to provide, among other things, for an adjustment of the registration rights of the preferred and to make the preferred dividends payable, at its option, in common stock. Systems intended to rely upon Section 3(a)(9) to exempt the modification of the old preferred and the payment of stock dividends.

Even though Systems expected to issue its new, modified preferred and common stock dividends concurrently with the offering of its notes, counsel for Systems, referring to *Release No. 33-2029*, advanced several reasons why the two offerings should not be considered part of the same issue.[124] First, the two offerings involved the issuance of entirely different securities, preferred stock and notes. Second, the consideration flowing from the investors was different. The consideration in the exchange offering consisted principally of the amendment of the old preferred's provisions, whereas it was cash and cancellation of indebtedness in the sale of the notes. Third, the two offerings were not for the same general purpose. Systems was embarking on the exchange offer to defer or eliminate certain continuing cash burdens and to simplify its capital structure. The notes offering, on the other hand, was aimed at raising funds to repay bank borrowings used to finance the present and future costs of equipment. Fourth, the manner and the respective distributions

[121] 1 CCH FED. SEC. L. REP. ¶ 2270 (1961).
[122] *Id.* at 2608. The same factors are set out in preliminary note 3 to Rule 147.
[123] Four-Phase Systems, Inc., *supra* note 27.
[124] *Id.* at frames 20375-76.

were materially different. The exchange required shareholder action (approval of a charter amendment) not required for the issuance and sale of the notes, which were to be sold, on the other hand, under more comprehensive purchase agreements that provided for commission payments. Fifth, integration of the offerings would not further the policy objectives of the Securities Act since Systems' offerings did not constitute a single plan of financing artificially segmented to avoid the rigors of the statute; the exchange, as distinct from the private placements, would not provide cash or other payments. Sixth and last, integration of the offerings would conflict with a policy reflected in recent SEC releases. Systems was not registered under the 1934 Act. Registration under the 1933 Act would thus apply to securities otherwise restricted, "and a thin and unrealistic market in the securities of the Company could develop."[125] Faced with these considerations, the staff agreed that the two offerings should not be integrated.[126]

D. The Absence of Remuneration or Commissions

An issuer undertaking a 3(a)(9) exchange must ensure that "no commission or other remuneration is paid directly or indirectly for soliciting such exchange." The phrase "commission or other remuneration" has never been construed[127] as prohibiting an issuer from compensating those who assume ordinary transactional expenses.[128] But when do expenses cease to be ordinary? The Chief of the Securities Division of the Federal Trade Commission has responded:

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[125] *Id.* at frame 20376.

[126] *See also* Model Fin. Co., *supra* note 56, where the issuer planned to offer a series of new junior subordinated debentures in exchange for certain outstanding debentures, some of which had heen sold in a Regulation A offering. The issuer planned the exchange under Section 3(a)(9), although it would commence ten and one-half months after completion of the first offering. The staff was persuaded that the two offerings were for different purposes and issued a no-action letter—a result also reached on an integration question in Credithrift Fin. Corp., [1971] "No Action" Letters, roll 7, frame 14745 (September 22, 1971).

[127] Prior to the relocation of the exchange exemption from Section 4(3) to Section 3(a)(9), the exemption was dependent upon the absence of any payment of remuneration "in connection with" the exchange.

> However, to have construed that language as covering all payments made in connection with the exchange would in suhstance have rendered the exemption inoperative, as all exchanges must call for some measure of remuneration, at least for routine and mechanical services. The obvious impracticability of the restriction in its literal application was recognized in the amendment, and the words "for solicitation" were substituted for the words "in connection with."

Throop & Lane, *supra* note 7, at 102.

[128] *See* the discussion of Rule 150 in text accompanying note 107 *supra*.

> The dividing line to be drawn between "commission or other remuneration," which necessitates registration of such an exchange, and "expenses," the payment of which would not withdraw the exemption from an otherwise exempt exchange, must have regard to the purpose of this particular exemption.
> . . . [T]he Act recognizes that one of the causes for governing the flotation of securities lay in the excessive promoters' or sponsors' interests that were too often concealed from the investor. The dividing line would thus distinguish between payments which are in essence for promotional activity as distinguished from payments which cover the expenses incident to such an exchange. These expenses would, of course, include such matters as engraving costs, clerical costs, but in addition could include a payment to third persons for services in connection with effecting *but not promoting* such an exchange.[129]

Thus, the remuneration limitation in Section 3(a)(9) speaks to three separate issues: the nature of the services performed, the method of compensating for those services, and the relationship between the issuer and the person furnishing the services.

Officers, directors, and employees in a continuing employment relationship with an issuer are naturally permitted to solicit and even recommend a Section 3(a)(9) exchange, but only so long as they are not rewarded with a bonus or special commission.[130] To avoid any inference of special compensation for soliciting the exchange, the employees involved should receive only their regular salaries and maintain their usual duties.[131]

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[129] Letter from Chief of the Securities Division of the Federal Trade Commission, quoted in 1 CCH FED. SEC. L. REP. ¶ 2165 at 2588-89 (emphasis in original).

[130] *See, e.g.*, Chris-Craft Indus., Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,052 (SEC 1972), where the staff granted a no-action letter to Chris-Craft, which argued that since it could act only through its officers, directors, and employees, so long as these individuals received no special compensation in connection with the exchange offer, Section 3(a)(9) permitted their communicating with security holders. The corporation also believed that Section 3(a)(9) "permits officers and directors affirmatively to recommend to bondholders that they accept the Exchange Offer." *Id.* at 82, 279. *See also* Shawnee Chiles Syndicate, 10 S.E.C. 109, 117 (1941); Free Traders, Inc., 7 S.E.C. 913, 922 (1940); 1 L. Loss, *supra* note 5, at 549.

[131] Thus, in *Chris-Craft*, the staff's no-action letter was effective "[p]rovided that the activities of the directors or officers are only incidental to their regular duties." [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. at 82,278. In its letter of request, Chris-Craft was careful to state that directors and officers who planned to assist the solicitation effort "will receive their regular salaries and will also attend to their regular duties." *Id. Accord*, UniCapital Corp., [1974] "NO ACTION" LETTERS, roll 11, frame 14957 (October 3, 1974).

Payments to third persons for services in connection with an exchange, however, raise special problems not present with regular employees. Certainly, persons hired temporarily to perform promotional services would destroy the exemption, even if compensated only by straight salary. Such persons can, however, be hired to render purely mechanical services or even to assist in those functions such as legal advice which, although not mechanical, "are in their nature ancillary to the effective mechanical operation of the transaction."[132] Hypothetically, if the services rendered are "mechanical"[133] and do not fall within the ambit of "soliciting," as that term is construed in Section 3(a)(9), the issuer can properly condition compensation upon the success of the exchange. But the practical risk facing the issuer is that a contingent fee arrangement for what it believes are merely mechanical services could reasonably result in an SEC determination that the services actually involved solicitation and promotion. Consequently, such remuneration plans are best avoided for even purely mechanical services.[134]

Investor relations firms which assist corporations in communicating with security holders present further substantial risks for the issuer seeking Section 3(a)(9) exemption. If such a firm facilitates publication of an issuer's exchange offer, it would be providing services that might be considered exemption-destroying solicitation activities. Certain services by an investor relations organization have been interpreted[135] as not vitiating the exchange exemption. An investor relations firm may, for instance, obtain a list of the issuer's security holders to confirm the accuracy of addresses and may contact the back office personnel of brokers, banks, and other nominees to ensure that sufficient exchange materials have been received and

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[132] Throop & Lane, *supra* note 7, at 102.

[133] *See* Infotronics Corp., *supra* note 56. The issuer proposed to offer its common stock in exchange for certain outstanding debt securities. The staff granted a no-action letter under Section 3(a)(9) and acknowledged that the issuer could pay all mechanical expenses incurred in connection with the exchange offer such as "postage, telephone and telegraph bills, any newspaper advertisements and travel expenses of employees considered necessary, as well as the charges of its Transfer Agent and Registrar in connection with the issuance of the Common Stock and the cancellation of the Debentures and of the Notes and Warrants." *Id.* at frame 05787.

[134] The one notable exception is the standby arrangement, where it is customary to compensate the investment banker on the basis of the number of securities tendered. *See* note 52 *supra*.

[135] *See, e.g.*, Daitch Crystal Dairies, Inc., *supra* note 33; El Paso Natural Gas Co., [1971] "No Action" Letters, roll 1, frame 00877 (February 9, 1971).

are being promptly forwarded to beneficial holders.[136] It may also communicate directly with each holder to ascertain whether he has received the issuer's mailings and understands the mechanics of the exchange plan.[137] It may further answer any questions on the mechanical procedures to be followed, even though a careful reading of the offering material would provide that information.[138]

There are, nevertheless, quite clearly certain limits. If a firm is questioned by a holder as to the investment-related attributes of the exchange, it must — unlike employees under *Chris-Craft* — inform the holder to seek advice from his own investment counsellor. Under no circumstances may the firm make any recommendation, "directly or indirectly," regarding acceptance or rejection of the exchange plan or offer.[139] The firm's compensation should, of course,

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[136] *See, e.g.*, The Carter Organization, Inc., [1975] "No Action" Letters, roll 4, frame 04086 (March 5, 1975).

[137] *Id.*

[138] *See, e.g.*, Alpex Computers Co., *supra* note 44.

There are several policy arguments against interpreting the words "commission or other remuneration" to include the compensation which investor relations organizations receive for their services: (1) such firms rely heavily upon this type of service for their business; (2) exchange transactions would become unduly burdensome for the issuing corporations if they did not have the professional assistance provided by these firms; and (3) the remuneration is paid not to solicit an exchange but merely to advertise the issuer's exchange plan to security holders to whom it is addressed and to make sure that they will not inadvertently lose the opportunity to participate. *See* Georgeson & Co., [1973] "No Action" Letters, roll 6, frame 10578 (May 10, 1973); Chris-Craft Indus., Inc., *supra* note 130.

[139] *Id. See also* Dean Witter & Co., Inc., CCH Fed. Sec. L. Rep. ¶ 80,078 (SEC November 21, 1974); Dean Witter & Co., Inc., [1975] "No Action" Letters, roll 2, frame 01204 (January 23, 1975). In the first inquiry, Dean Witter requested no-action treatment on a proposed involvement, as an investor relations organization, in an exchange transaction between two corporations where it planned to offer services that were acceptable under staff interpretations of Section 3(a)(9). It also planned to render an opinion concerning the "fairness" of the proposed exchange to the corporation's shareholders and to telephone shareholders to inquire whether they had received the exchange material and answer any questions raised by such shareholders concerning the information contained in the material. The staff responded that such services, "particularly the expression of an opinion by it concerning the fairness of the proposed exchange coupled with subsequent telephone discussions of the exchange with shareholders would raise serious doubts as to whether Dean Witter would be engag[ed] in soliciting activities. . ." *Id.* at 85,030.

In the second communication with the staff, Dean Witter sought an interpretation of this above-quoted portion of the staff's response. Counsel for Dean Witter suggested that the staff's rejection of the earlier request for no-action had been due to its concern over the coupling of Dean Witter's "fairness opinion" in an offering circular with those services requiring telephone discussions between Dean Witter personnel and shareholders. *Id.* at frame 01207. Consequently, counsel informed the staff that Dean Witter would uncouple those services so that in any one transaction the services would include either: (1) all the usual noncontroversial activities, plus the rendering of its formal "fairness opinion" to the steckholders

be on a fixed-fee-plus-necessary-expenses basis and not related in any way to the amount of the securities tendered in the exchange.[140] Otherwise, its financial interest in the success of the exchange will quite naturally lead the SEC staff to view the transaction as suffused with a promotive aspect.

E. Resale of Securities Acquired Under Section 3(a)(9)

There are, then, four prerequisites to a claim by an issuer of an exchange exemption under Section 3(a)(9). (1) The securities for exchange must be offered by the same entity that issued the outstanding ones. (2) The security holder must not be asked to part with anything of value besides the outstanding security. (3) The exchange must be offered exclusively to the issuer's existing security holders. (4) The issuer must not pay any compensation for the solicitation of the exchange. It should also be noted that Section 3(a)(9) may impose some problems upon the offeree. As a transactional exemption, Section 3(a)(9) provides an exemption only once; it does not exempt the subsequent sale of the new securities once received.[141] A security holder involved in such a sale must find another exemption or comply with the registration requirements of the Act. In most cases, of course, an exemption can be found under Section

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personally and in the offering circular, but no other communication between Dean Witter and the shareholders; or (2) all the usual activities, plus communication by Dean Witter with shareholders including its formal "fairness opinion," but without inserting the opinion in the offering circular. *Id.* at frame 01208. The staff rejected the proffered interpretation and adhered to its original position. "In our view, there is an inconsistency on the surface in the proposition that representatives of a firm which has expressed an opinion (whether publicly stated or not) on the fairness of a proposed exchange may initiate contacts with security holders voting on the exchange and express wholly impartial views on questions raised by those security holders." *Id.* at frame 01205. The staff also refused to authorize Dean Witter to be named in an offering circular as Dealer-Manager of an exchange.

[140] *Id.* at frames 09383-85.

[141] *See* SEC Securities Act Release No. 33-646, 1 CCH FED. SEC. L. REP. ¶ 2136 (1936). SEC Securities Act Release No. 4162, [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,677 (1959), states:

> It has been generally understood that a conversion is an exchange within the meaning of section 3(a)(9), with the result that the actual transaction of conversion is exempt if the other conditions of the section are satisfied. It is clear, however, that there is nothing in the intrinsic nature of securities issued in a transaction falling within section 3(a)(9) which justifies consideration of such securities as permanently exempt from registration without regard to any other factors.

Id. at 80,540. The classic case is Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825, [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,539 (1957).

4(1),[142] but not always.

The danger to the unwary is that the exchangee might be deemed a statutory underwriter and thereby lose an exemption under Section 4(1). The staff, as a matter of policy, refuses to express an opinion as to whether a person would be deemed an underwriter under this or that set of circumstances, on the grounds that it is simply a question of fact. It has indicated, nonetheless, factors which it considers important in making its determination. An investment banker who is a party to a standby agreement[143] in an exchange transaction, for example, will be concerned not only with the availability of the Section 3(a)(9) exemption but also with whether he will be considered an underwriter if he resells the securities acquired under the agreement. The resolution of these issues, according to the staff, depends on whether the investment banker purchases the securities from the issuer with a view to their distribution, sells them for an issuer in connection with a distribution, or participates in any such undertaking.[144] Whether intent to distribute exists, in turn, "depends on such factors, among others, as the amount of securities to be sold and the manner in which it is proposed to sell them."[145]

Another relevant factor in assessing underwriter status is whether the selling security holder himself, or the person from whom he has acquired his securities, is in a position to control the issuer.[146] If he

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[142] 15 U.S.C. § 77d(1) (1970):

> The provisions of section 77e of this title shall not apply to —
>
> (1) transactions by any person other than an issuer, underwriter, or dealer.

[143] *See* text accompanying note 49 *supra*.

[144] *See, e.g.*, Salomon Brothers, *supra* note 50.

[145] *Id.* at frame 14885. In preliminary note 2 to Rule 144, 17 C.F.R. § 230.144 (1974) [hereinafter cited as Rule 144], the SEC lists three factors to be considered in determining when a person is deemed not to be engaged in a distribution. First, the underlying policy of the Act requires that there be adequate current information concerning the issuer. Second, a holding period prior to resale is essential to ensure that security holders are not acting "as conduits for sale to the public of unregistered securities, directly or indirectly, on behalf of an issuer." A third factor is the impact of the particular transaction or transactions on the trading markets. A person reselling securities under Section 4(1) of the Act

> must sell the securities in such limited quantities and in such a manner as not to disrupt the trading markets. The larger the amount of securities involved, the more likely it is that such resales may involve methods of offering and amounts of compensation usually associated with a distribution rather than routine trading transactions.

[146] 15 U.S.C. § 77b(11) (1970). The "control" or "affiliate" concept is defined in Rule 405, which reads:

> The term "control" (including the terms "controlling," "controlled by" and "under common control with") means the possession, direct or indirect, of the power to direct

is himself a control person, his resales might constitute a nonexempt secondary distribution. Even if the selling security holder does not control the issuer, Section 2(11) of the Act may apply. That section designates a control person as an "issuer" for the limited purpose of defining statutory underwriter liability. The effect of the definition in Section 2(11) is that anyone who acquires securities from a controlling person with a view to their distribution or participates in that person's distribution of securities falls within the definition of "underwriter" and will not have an exemption under Section 4(1).

The adoption of Rule 144 and the staff's interpretations of it relative to Section 3(a)(9) transactions suggest a consideration of three separate issues before one can confidently conclude that a security holder may sell his new securities under the Section 4(1) exemption: (1) Is the security holder a control person, termed "affiliate" in Rule 144? (2) Did the security holder acquire his *old* securities directly or indirectly from the issuer, or from an affiliate of such issuer, in a transaction or chain of transactions not involving a public offering? (3) Was the exchange in which the security holder acquired his *new* securities a nonpublic transaction?

Rule 144 assists an affiliate, who would otherwise be unsure of an exemption, by permitting him to resell a limited amount of securities without fear of being deemed an underwriter. An affiliate who acquires securities in an exempt exchange can, therefore, turn to the rule for protected resales. But in certain exchanges, an affiliate may find the new securities subject to a holding period under Rule 144 even though the surrendered securities contained no such disability. Likewise, a nonaffiliated person who receives new securities in an exempt exchange, although normally in a position to transfer freely the new securities under Section 4(1), may in some cases be limited by the conditions of Rule 144. Specifically, the right of any security holder — be he affiliate or nonaffiliate — to sell, without registration, new securities received in an exchange is limited by the manner in which he acquired both his old securities and the new securities issued under Section 3(a)(9). The first limitation depends on whether the old securities were "restricted" within the meaning of

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or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract or otherwise.

17 C.F.R. § 230.405(f) (1974). *See generally* Sommer, *Who's "In Control"? — S.E.C.*, 21 Bus. Law. 559 (1966).

Rule 144. The second results from a staff interpretation of Section 3(a)(9) that distinguishes between "public" and "non-public" exchange transactions, and must be discussed in the context of the first.

1. Where Non-restricted Securities Are Surrendered in the Exchange

Rule 144 categorizes securities as either restricted or non-restricted. Restricted securities are those "acquired directly or indirectly from the issuer thereof, or from an affiliate of such issuer, in a transaction or chain of transactions not involving any public offering."[147] If the old securities are not restricted,[148] and the exchange transaction has a public character, new securities acquired by *nonaffiliates* may subsequently be freely traded. Assume, for example, that a corporation *L* completes an intrastate offering of its subordinated debentures to a sizeable number of residents in compliance with Section 3(a)(11). Later, *L* exchanges its common stock for the outstanding debentures, using a Section 3(a)(9) exemption. If *L*'s exchange offer were made to more than a few of the original[149] debenture holders, so that the exchange does not resemble a private placement, the common stock received in the exchange could be resold immediately by nonaffiliates without registration.[150] Any

[147] Rule 144(a)(3).

[148] Non-restricted securities include those securities offered to the public pursuant to a registration statement or in a transaction meeting the requirements of Section 3(a)(10), 3(a)(11), 3(b), or 3(c).

[149] Nonaffiliates who did not acquire the debentures directly or indirectly from the issuer may hold restricted securities if they acquired them from an affiliate. Rule 144(a)3. For a discussion of resales by nonaffiliates of securities acquired in a Section 3(a)(9) transaction where the securities surrendered are restricted, see text accompanying note 154 *infra*.

[150] *See, e.g.*, Wright Air Lines, Inc., *supra* note 30; American Electronic Laboratories, Inc., *supra* note 30.

The staff has received several inquiries concerning the availability of Section 4(1) to non-American holders of securities acquired in a Section 3(a)(9) exchange. *See, e.g.*, Sperry Rand Corp., [1974] "No Action" Letters, roll 3, frame 03435 (March 1, 1974). Sperry sold $60 million in debentures in London to an international underwriting syndicate, which purchased with a view to distributing the debentures through resale outside the United States to persons who were neither United States nor Canadian nationals, citizens, or residents. The debentures were not registered under the Act in reliance upon Securities Act Release Nos. 33-4708, 34-7366, 1 CCH Fed. Sec. L. Rep. ¶¶ 1361-63 (SEC 1964), in which the SEC announced that registration would not be required for securities of domestic issuers which were distributed abroad under circumstances reasonably designed to preclude their distribution within, or to nations of, the United States.

Sperry then proposed to issue shares of its common stock in a Section 3(a)(9) exchange for

such public non-registered resales of the common stock by an *affiliate* of *L*, on the other hand, would be subject to the conditions of Rule 144.

Suppose, however, that the old non-restricted securities were exchanged in a Section 3(a)(9) transaction that is basically *private* in character — say by only five of the debenture holders, all of whom are nonaffiliates. May those five investors resell immediately? Arguably, the shares of common stock acquired by the five investors are restricted securities as defined in Rule 144(a)(3), since they were "acquired directly . . . from the issuer thereof . . . in a transaction . . . not involving any public offering." The Commission took a similar position under old Rule 155 as to convertible securities issued in reliance on Section 3(a)(9).[151]

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the debentures held by the non-American holders. The staff agreed not to recommend any action so long as Sperry complied with all of the section's requirements. Sperry's counsel further argued that registration would not be necessary in connection with the ultimate resale of any common stock issued upon conversion as the debenture holder was not an issuer, underwriter, or dealer within the meaning of Section 4(1) of the Act. [1974] "No Action" Letters, roll 3, at frame 03448 (letter of corp. counsel). Here, however, the staff refused to decide, before the fact, "when and under what circumstances the Debentures or the common stock issuable upon conversion of the Debentures may be resold in the United States or to citizens, residents or nationals of the United States." *Id.* at frame 03439. *Accord*, Masco Corp., [1973] "No Action" Letters, roll 8, frame 14121A (July 23, 1973); International Tel. & Tel. Corp., [1973] "No Action" Letters, roll 6, frame 10572 (May 3, 1973). In one such request, however, the staff stated that it was unable to conclude that it would not recommend appropriate action to the Commission if the securities "were to be distributed" in the United States without registration, International Tel. & Tel. Corp., [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,462 (SEC 1973), leaving open the possibility of resales in the United States which would not constitute a "distribution." With respect to the applicability of Rule 144, the staff responded to a no-action inquiry that securities originally issued to European investors without registration under the Act are not restricted securities under the definition of Rule 144(a)(3). However, the staff hastened to point out that it did not therefore imply that those European shares had "come to rest abroad," as this was a factual determination which would be left, at least initially, to the company's judgment. The First Artists Prod. Co., [1972] "No Action" Letters, roll 9, frame 14997 (August, 1972).

[151] SEC Securities Act Release No. 4248, [1957-1961 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,710 (1960). Rule 155 provided that:

> (a) The phrase "transactions by an issuer not involving any public offering" in Section 4(2) of the Act shall not include: (1) any public offering of a convertible security (which at the time of such offering is immediately convertible into another security of the same issuer) by or on behalf of any person or persons who purchased the convertible security directly or indirectly from an issuer as part of a nonpublic offering of such security, or (2) any public offering by or on behalf of any such person or persons of the security acquired on conversion of a convertible security, unless the security so acquired was acquired under such circumstances that such person or persons are not underwriters within the meaning of Section 2(11) of the Act.

Rule 155 remains effective only for those securities acquired prior to, but not sold thereafter

Yet, there are at least two reasons why Rule 144(a)(3) restricted securities should not be interpreted to mean simply securities received in a non-public exchange. First, the Commission's position in the old Rule 155 area is inappropriate precedent here. Rule 155 was a corrective measure, narrowly drawn, to plug a hole in the private placement exemption that had allowed issuers, through the use of convertible securities, to distribute their securities in a two-step process.[152] Rule 144, on the other hand, represents a major reform in the Commission's disclosure system, embracing many different transactions and imposing burdensome restrictions on those subject to it.

Second, a public—non-public distinction in exchange transactions is essentially artificial. It is neither consistent with the purpose of Rule 144[153] nor protective of the public in those transactions where the public most needs protection. Such a distinction allows nonaffiliates to resell immediately where they obtain the new securities in a *public* exchange, even though adequate current information concerning the issuer is unavailable and the likelihood of active trading is enhanced because the securities are widely held. But where only a few security holders participate in the exchange transaction — the

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under, Rule 144. The Commission took the position that where a convertible security was issued in a non-public transaction, "whether or not the transaction might also be urged as one falling within the literal mold of one of the stated exemptions [§§ 3(a)(9), 3(a)(10), 3(a)(11), 3(b), 3(c), or Rule 133]," Rule 155 would apply. The Commission gave the following example:

> If, apart from Section 3(a)(9), an exchange offer of a convertible security is essentially private in character, any later public offering of the convertible security (if then immediately convertible) and any public offering of the underlying security received upon conversion would be subject to the proposed rule. On the other hand, if the exchange offer is essentially a public offering which, except for the provisions of Section 3(a)(9), would be subject to the registration and prospectus provisions of the Act, the proposed rule would not apply either to a later public offering of the convertible security, or of the underlying security, by the holders. If such an offering were made by or on behalf of a person in a control relationship with the issuer or by or on behalf of a person acting as an underwriter for such control person, registration would be necessary without reference to Section 3(a)(9) or the proposed Rule 155.

Id. at 80,655. Rule 155 was rescinded at the time Rule 144 was adopted.

[152] *See, e.g.*, Orrick, *Registration Problems Under the Federal Securities Act — Resales Following Rule 133 and Exchange Transactions*, 10 HASTINGS L.J. 1 (1958); Sargent, *supra* note 7.

[153] One of the purposes of Rule 144 was to effectuate the underlying policy of the Act, the protection of investors, by requiring "that there be current information concerning the issuer, whether the resales of securities by persons result in a distribution or are effected in trading transactions." SEC Securities Act Release No. 5223, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487, at 81,053 (1972).

so-called private exchange — the "public" is "protected" by Rule 144, even though the securities acquired in the exchange may be few, and the nonaffiliate security holders who formerly held nonrestricted securities now find themselves saddled with restricted ones.

2. *Where Restricted Securities Are Surrendered in the Exchange: The Problem of Tacking*

Since Section 3(a)(9) is a transactional exemption, security holders who part with restricted securities in an exempt recapitalization will find their new securities still carrying the "taint" of the predecessors and subject to the two-year holding period under Rule 144. Rule 144's continuing burdens on such security holders might actually be greater after the exchange than they were before it, depending on when the holding period is determined to have commenced. Whether the holding period of the old securities survives the exchange, to be counted toward the holding period of the new, or whether the period begins anew with the subsequent acquisition depends on the applicability of Rule 144's formal tacking provisions and the essentially public or private character of the exchange.[154]

Rule 144(d)(4) contains the tacking provisions that offer relief in some cases to holders of restricted securities who exchange them in a 3(a)(9) transaction. Securities received in a recapitalization, for example, are treated as having been acquired at the same time as the original securities surrendered.[155] While Rule 144 does not define the term "recapitalization," the staff interprets it to include certain Section 3(a)(9) exchanges that are public in character.[156] Likewise, securities acquired on conversion are deemed, by virtue of Rule

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[154] One writer has suggested that where the security holder is an affiliate, the staff will probably not allow tacking and will instead insist on a two-year holding period irrespective of the character of the offering. H. BLOOMENTHAL, *supra* note 5, at 4-142 (1972). *But see* Wright Air Lines, Inc., *supra* note 30, where the staff permitted an officer and a director of the issuer to utilize the tacking provision of Rule 144(d)(4)(ii) for securities acquired in a Section 3(a)(9) exchange. *See* note 162 *infra*, for a discussion of the no-action letter.

[155] Rule 144(d)(4)(i) provides:

> (i) *Stock Dividends, Splits and Recapitalizations.* Securities acquired from the issuer as a dividend or pursuant to a stock split, reverse split or recapitalization shall be deemed to have been acquired at the same time as the securities on which the dividend or, if more than one, the initial dividend was paid, the securities involved in the split or reverse split, or the securities surrendered in connection with the recapitalization.

[156] *See, e.g.*, Wright Air Lines, Inc., *supra* note 30; International Sys. & Controls Corp., [1972] "NO ACTION" LETTERS, roll 10, frame 16451 (September 14, 1972).

144(d)(4)(ii), to have been acquired at the same time.[157]

The value of Rule 144(d)(4) to a security holder here is, however, somewhat limited in view of the staff's broad reading of the definition of "restricted securities" in Rule 144(a)(3) and its narrow interpretation of "recapitalization" in Rule 144(d)(4)(i). Suppose that corporation *M* offers and sells 100,000 debentures to 20 investors under Regulation A and it later exchanges with each two shares of its common stock for each debenture outstanding in a transaction exempt under Section 3(a)(9). As noted earlier,[158] the staff might view the shares of common stock acquired by the 20 investors as restricted securities since the exchange resembles a private placement. Even though *M* as the issuer may claim an exemption under Section 3(b), a literal reading of Rule 144(a)(3) certainly implies that the 20 debenture holders own restricted securities, in which case the permissibility of tacking holding periods again arises.

The security holders would then argue, of course, that the exchange constituted a Rule 144(d)(4)(i) "recapitalization" and, therefore, that the two-year holding period for the common stock started when they acquired the old debentures. Such a literal reading is risky, however, since the staff has taken the position that not all 3(a)(9) recapitalizations qualify for tacking under Rule 144(d)(4)(i). If the exchange transaction is limited to the few security holders usually associated with a private placement, the staff may characterize it as a "negotiated exchange"[159] and not as a "recapitalization." Although it is far from clear,[160] the staff seems to

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[157] Rule 144 (d)(4)(ii) provides:

> *Conversions.* If the securities sold were acquired from the issuer for a consideration consisting solely of other securities of the same issuer surrendered for conversion, the securities so acquired shall be deemed to have been acquired at the same time as the securities surrendered for conversion.

See SEC Securities Act Release No. 5306 [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,000 (1972), the Division of Corporate Finance's interpretative release on Rule 144.

Although Rule 155 was rescinded with the adoption of Rule 144, Rule 155 still applies to sales outside Rule 144 of privately placed convertible securities, or their underlying securities, acquired before April 15, 1972. For an example where Rule 155 was available in conjunction with a Section 3(a)(9) exchange, see Computer Response Corp., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,228 (SEC 1972).

[158] *See* text accompanying note 151 *supra*.

[159] Computer Network Corp., [1973] "No ACTION" LETTERS, roll 1, frame 00840 (Dec. 27, 1972).

[160] The staff has issued four interpretations in this area. In International Sys. & Controls Corp., *supra* note 156, the staff took the view that in a voluntary exchange of shares of preferred stock for shares of a new class of preferred stock in a transaction exempt under

require here a recapitalization that has either been approved by a vote of security holders[161] or is tantamount to a recapitalization pursuant to such a vote.[162] As a result, the holding period for the 20 investors in *M*'s "negotiated" exchange transaction would not begin until the acquisition of the new common stock.

At first, the staff's narrow interpretation of a Rule 144(d)(4)(i) recapitalization is difficult to reconcile with its treatment of Rule 144(d)(4)(ii). In the hypothetical just discussed, the exchange of *M* common stock for *M* debentures produced restricted securities that require a full two-year holding period from the time the exchange occurred. If, instead, *M* had issued 100,000 debentures with a conversion feature that allowed the 20 holders later to convert one debenture into two shares of common stock, Rule 144(d)(4)(ii)

Section 3(a)(9), the new preferred would be deemed to have been acquired at the same time as the old preferred for purposes of computing the holding period.

But beginning with Computer Response Corp., *supra* note 157, the staff has taken a very narrow view of "recapitalization" in Rule 144(d)(4)(i). In this case, involving a voluntary exchange (structured to comply with Section 3(a)(9)) of subordinated notes and common stock for outstanding senior subordinated convertible debentures, the staff concluded that the securities received in exchange for the debentures should be deemed to have been acquired on the date of the exchange for the purposes of Rule 144. In Computer Network Corp., *supra* note 159, Computer exchanged senior convertible preferred stock and 8 percent notes for certain 8½ percent promissory notes as part of a series of arrangements with major shareholders and creditors undertaken to effect a certain corporate acquisition. The staff characterized the exchange as "negotiated" and as one which "did not constitute a recapitalization as that term is used in Rule 144." In Genway Corp., [1973] "No Action" Letters, roll 6, frame 10720 (May 11, 1973), the staff rejected counsel's claim of a "recapitalization" for an exchange of common stock for convertible preferred, despite the fact that (1) the entire capital structure of Genway was changed; (2) the recapitalization, which was exempt under Section 3(a)(9), could not have been accomplished merely by reaching agreement with certain security holders of Genway; (3) the transaction required an amendment to the issuer's certificate of incorporation and required approval of its stockholders at a special meeting; and (4) the transaction constituted a "recapitalization" for the purposes of Section 368(a)(1)(E) of the Internal Revenue Code. In denying the requested no-action, the staff placed special emphasis on the fact that "the convertible preferred stock was acquired in a private placement in reliance upon the Section 4(2) exemption . . . . Securities received in exchange for convertible securities acquired in a private placement should be deemed, for purposes of resale under Rule 144 to have been acquired on the date of the exchange." *Id.* frame 00840 (December 27, 1972).

[161] *See, e.g.*, Canrad Precision Indus., Inc., *supra* note 30. See *Release 5306*, *supra* note 157, for an interpretive response to the applicability of Rule 144(d)(4)(i).

[162] *See, e.g.*, Wright Air Lines, Inc., *supra* note 30, where the proposed recapitalization was conditioned upon participation by all of the security holders involved. The staff has permitted tacking under Rule 144(d)(4)(i) following other exempt exchanges, but the facts as reported in the correspondence made available to the public are not sufficient to use in attempting to construct a pattern of staff policy. *See, e.g.*, Decraform, Inc., *supra* note 25.

would regard the common stock as standing in the same place as the convertible debenture itself. In short, in the voluntary exchange, tacking is not allowed; in the voluntary conversion, it is.[163] Under either method of financing, of course, the transaction will qualify under Section 3(a)(9). And all the same factors are present—public information, holding period, and quantity limitations—that initially led the SEC to conclude that resales under Rule 144 are not "distributions" and thus exempt from the stringent reporting requirements of Section 5. Consequently, one might argue, it makes little sense to treat the two voluntary transactions differently for registration purposes.

Yet a significant difference does exist. Under Rule 144(d)(4)(ii) tacking is permitted only with true convertible securities.[164] Also, the security must be convertible into another security of the same issuer.[165] Both of these limitations restrict tacking to situations prior to purchase where the convertible security holder is in a knowledgeable position to decide whether to acquire *both* the convertible security and the underlying security for investment rather than for distribution. A single holding period of two years is sufficient objective proof that each of the two restricted securities had been acquired and held with the requisite investment intent. The same, however, cannot be said of all recapitalizations under Section 3(a)(9). Consider, for example, investors who have purchased non-convertible debentures in a private placement. Presumably, they are aware of the investment risks of the debentures and are not taking them with

[163] *See* Wright Air Lines, Inc., *supra* note 30, where two individual stockholders failed in their argument for tacking under Rule 144(d)(4)(i) but were successful under Rule 144(d)(4)(ii). The two stockholders were an officer and a director of the issuer who had acquired shares of convertible preferred stock in 1970 from Wright Air Lines, Inc. in a private placement. After holding the convertible preferred stock for over three years, the two stockholders converted it to common stock. When they asked the staff whether they could resell the shares of common stock immediately in reliance on Rule 144, the staff responded that the exchange, which was an exempt transaction for the issuer under Section 3(a)(9), did not constitute a recapitalization within the meaning of Rule 144(d)(4)(i). The staff apparently viewed the conversion of the convertible preferred as a "negotiated exchange," although it did note that the preferred stock could be considered a convertible security within the meaning of Rule 144(d)(4)(ii). As such, the common stock would be deemed to have been acquired on the same date as the preferred for purposes of computing the Rule's holding period.

[164] *See, e.g.*, Manufacturer's Sys., Inc., [1973] "No Action" Letters, roll 2, frame 02210 (January 18, 1973); Nationwide Nursing Centers, Inc., [1972] "No Action" Letters, roll 12, frame 19519 (November 13, 1972); SEC Securities Act Release No. 5306, *supra* note 157.

[165] *See, e.g.*, Walter E. Heller Int'l Corp., [1972] "No Action" Letters, roll 10, frame 16416 (September 12, 1972); Power Physics Corp., [1972] "No Action" Letters, roll 8, frame 13888 (July 25, 1972).

a view to their distribution. If one year after purchase they are asked to exchange their restricted debentures for the issuer's common stock, under Section 3(a)(9) they may or may not be provided information about the full investment value of the new securities. In any event, since the investors did not know at the time they originally purchased the debentures that subsequently they would be exchanging them for the issuer's common stock, it is impossible to ascertain whether their investment representations covered both the debentures and the common stock. As a result, tacking is inappropriate and a new two-year holding period begins from the time of the exchange. Rule 144(d)(4)(i), as the staff apparently interprets it, mitigates the severity of such a no-tacking policy for those exchanges that are not "voluntary" or "negotiated" but are, instead, the result of a complete restructuring of the capitalization of an entity, requiring the approval of security holders.[166]

III. Reconciling the 3(a)(9) Exchange Exemption with the Policy of Continuous Disclosure

According to the SEC, Congress created, through the federal securities statutes, a continuous disclosure system designed to protect investors and to assure the maintenance of fair and honest security markets.[167] The registration requirements of Section 5 of the

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[166] In a sense, the suggested interpretation is reminiscemt of the "no-sale" theory under old Rule 133: where a proposed corporate act is submitted to security holders as a class, in their capacity as members of the corporate body, an act of submission does not involve an offer to exchange with any stockholder as an individual. *See generally* Purcell, *A Consideration of the No-Sale Theory Under the Securities Act of 1933*, 24 Brooklyn L. Rev. 254 (1958).

An even narrower interpretation of Rule 144(d)(4)(i) is possible if one focuses on the theory behind the two other categories of that provision, stock dividends and stock splits. In both cases, the new security does not change the nature of the capital at risk. "The securities acquired merely change their form . . . The new securities arise out of the old ones." Comm'r Loomis, quoted in Smith, *Fungibility, Tacking, Registration Covenants*, in PLI, Third Annual Institute On Securities Regulation 55, 71 (R. Mundheim & A. Fleischer, Jr. eds. 1972). To be consistent, one might interpret "recapitalization" in Rule 144(d)(4)(i) as encompassing only those exchanges where the new security is not materially different from the one exchanged. Tacking would, therefore, be limited to recapitalizations where there is no new investment decision. It is then, perhaps, significant that the example of tacking under Rule 144(d)(4)(i) selected by the Division of Corporate Finance for its interpretative release on Rule 144 involved a limited recapitalization, changing the par value of the issuer's common stock. *Release 5306, supra* note 157, at 82,159. Such a narrow interpretation would have the operative effect of restricting tacking under Rule 144(d)(4)(i) to recapitalizations where an exemption is unnecessary since, arguably, any action taken would not amount to the sale of a new security. *See* note 21 *supra*.

[167] *See, e.g.*, SEC Securities Act Release No. 5450, [1973-1974 Transfer Binder] CCH Fed.

Securities Act of 1933 form an integral part of this disclosure system. Sections 3 and 4 of the 1933 Act provide specific exemptions from these registration requirements for certain securities or certain transactions.[168] Section 3(a)(2) through 3(a)(8) exemptions turn on the intrinsic nature of the securities or the impropriety of further governmental regulation.[169] The other exemptions in Sections 3 and 4 are limited to specific transactions which for a variety of reasons do not justify full and detailed compliance with Section 5. Some of these transaction exemptions require certain disclosure to investors as a condition for exemption,[170] but other sections, including Section 3(a)(9), do not. In view of this fact, it is important to ask to what extent the Section 3(a)(9) exemption squares with the disclosure objectives of the Act as administered and implemented by the SEC through Rules 146 and 147.[171]

Section 3(a)(9), and Sections 3(a)(10) and 3(a)(11), are, in fact, glaring exceptions to the "continuous disclosure system." By their terms, these exemptive provisions relieve issuers of the necessity of providing investors or outstanding security holders with the information they might need to make informed investment decisions. Section 3(a)(10) offers a substitute for disclosure requirements, being conditioned upon judicial or administrative review of a proposed securities exchange. The principal justification — no matter how ill-founded — of Section 3(a)(11) is that investors, who must be residents of the same state as the issuer, will be adequately protected by state securities statutes. Section 3(a)(9) is narrow in terms of scope, exempting only exchanges of securities and not the issuance of new securities for cash. Furthermore, it is unavailable to non-issuers, limited to an issuer's present security holders, and proscriptive of the use of paid solicitors. While it thus falls short of

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SEC. L. REP. ¶ 79,617 at 83,649 (1974); SEC Securities Act Release No. 5316, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,015 at 82,197 (1972); SEC Securities Act Release No. 5223, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487 at 81,051 (1972). *Cf.* the discussion of similar statutory purpose behind the Exchange Act in SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 847-48 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

[168] *See* note 22 *supra*.

[169] *See generally* Throop & Lane, *supra* note 7, at 92.

[170] *See, e.g.*, Section 4(2) and Rule 146.

[171] With the adoption of these rules, the Commission sought "to coordinate and integrate this disclosure system with the exemptive provisions" of the 1933 and 1934 Acts. SEC Securities Act Release No. 33-5487, 1 CCH FED. SEC. L. REP. ¶ 2710 at 2907-2 (1974); *see* Securities Act Release No. 5450, *supra* note 167.

the independent supervision of Section 3(a)(10), which in certain respects resembles the per se exemptions of the Act, it is less inconsistent with the objectives of the Act than is Section 3(a)(11).

Given these restrictions, perhaps Section 3(a)(9) is an appropriate exemptive provision that should be integrated into a continuous disclosure system. After all, the issuer that claims the exemption is not relieved "from the responsibility for disclosure necessary to avoid infractions of the anti-fraud provisions of the securities laws."[172] In many exchange transactions an issuer will either voluntarily furnish its security holders with critical information about the transaction or be compelled to do so by other state or federal regulations.[173] And, at any rate, if the outstanding securities were offered pursuant to an agreement that obligated the issuer to exchange subsequently other securities for those originally issued, the security holders may have already received sufficient information about the proposed transaction. In some exchanges, too, no actual investment decision is required by security holders since the outstanding securities are valueless or clearly inferior to the securities offered by the issuer. Finally, in most exchange transactions the benefits of registration or prescribed disclosure are outweighed within the restricted confines of Section 3(a)(9) by the fact that security holders are not investing additional money or other value but are simply substituting the form of their investment in an issuer with which they presumably are already acquainted.

There is, however, a case for SEC-controlled disclosure under Section 3(a)(9), at least for some transactions. To begin, it appears that many of the present uses of Section 3(a)(9) are inconsistent with its original purpose, as revealed by its legislative history, to balance disclosure against the facts that recapitalization itself puts present security holders on notice that the corporation is in some degree of financial disadvantage and that the financial remedy should be as quick and as easy as feasible.[174] Even in situations where an exemption from full registration would be advisable, minimal disclosure standards may be necessary. The SEC has in fact

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[172] Consolidated Oil & Gas, Inc., *supra* note 56, at frame 13489.

[173] *See, e.g.*, Securities Exchange Act of 1934 § 14a, 15 U.S.C. § 77n(a) (1970); 17 C.F.R. §§ 240.14a(1) *et seq.* (1973) (rules for the solicitation of proxies under Section 14a). Thus, security holders who are asked to amend the issuer's certificate of incorporation as a preliminary step in a recapitalization program are likely to receive some information about the exchange in the issuer's proxy statement.

[174] *See* text accompanying note 19 *supra*.

broadened its focus beyond an issuer's periodic or ad hoc disclosure of material information to include its participation in a "continuous" disclosure system.[175]

Indeed, a recapitalization under the exchange exemption can present, as we have seen, complex investment alternatives upon which security holders must decide. Even where an exchange offer represents an immediate financial advantage for them, the ultimate consequences of the transaction may have greater significance for all, or some, holders than the financial data might otherwise suggest. Neither the presence of conscientious management nor the application of other disclosure-oriented legislation can guarantee that information such as the following will be highlighted and explained adequately to exchange offerees:

(1) the market price history of the securities involved in the exchange;

(2) the differences between the value of the security offered and the net book value, net quick asset value, and earnings per share of the outstanding security;

(3) the underlying reasons for the exchange;

(4) the intended group of participants — whether, for instance, all security holders are to be included in the exchange and whether insiders will be tendering their securities;

(5) the history of recent securities transactions by the issuer and insiders; and

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[175] It should be noted that, unlike the more general Section 3(a)(11), whose use can be justified in states where blue sky laws require disclosure in intrastate offerings, *see, e.g.*, New York Intra-State Financing Act, N.Y. GEN. BUS. LAW § 359-ff (McKinney Supp. 1974), Section 3(a)(9) has been followed in similar exemptions from disclosure requirements under most state securities statutes. As of July 1974 the Uniform Securities Act had been adopted or substantially adopted with modifications in 32 states and the District of Columbia. 1 CCH BLUE SKY L. REP. ¶ 4901 at 701-02. The Act requires an issuer to file a registration statement and all sales and advertising literature to be used in a securities offering. N.Y. GEN. BUS. LAW § 403 (McKinney Supp. 1974). Section 402(b)(11) exempts the following transaction from those requirements:

> (11) any transaction pursuant to an offer to existing security holders of the issuer, including persons who at the time of the transaction are holders of convertible securities, non-transferable warrants, or transferable warrants exercisable within not more than ninety days of their issuance, if (A) no commission or other remuneration (other than a standby commission) is paid or given directly or indirectly for soliciting any security holder in this state, or (B) the issuer first files a notice specifying the terms of the offer and the [Administrator] does not by order disallow the exemption within the next five full business days . . . .

(6) the projected consequences of a successful or unsuccessful exchange, such as the impact on the issuer's present indebtedness and borrowing capacity, the probability that dilution will occur, the effect on the working capital position, or the likelihood of a change in corporate control.[176]

Section 3(a)(9) is most vulnerable to criticism in its exemption of exchange offers, which can present special risks to security holders, as the recent attempts at "going private"[177] have demonstrated. In *Broder v. Dane*,[178] a 1934 Act case, a federal district court, after reviewing some of the problems faced by stockholders who received an exchange offer from their own corporation, concluded that

> it is wholly consonant with congressional intent [reflected in the Williams Act of 1968] to place a heavier burden of disclosure and fair dealing upon a corporation and its insiders who are acting in their own behalf than would be justified were this a case involving a contested tender offer.[179]

This conclusion was bolstered by three interrelated considerations, all of which could be present in a Section 3(a)(9) transaction. First, unlike the tender offer battle between entrenched management and outside interlopers, an exchange offer by the issuer contains "no opposing factions possessing both the incentive and resources needed to challenge and elaborate upon the assertions contained in the initial offer."[180] Second, since no opposing group is

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[176] See generally the checklist for disclosure in Beck, *Corporate Repurchases and Going Private — Disclosure Requirements*, in PLI, SIXTH ANNUAL INSTITUTE ON SECURITIES REGULATION 365, 376 (1974).

[177] The exchange offer, usually debt for equity, is one technique for "going private." For a critical commentary on this concept, see Address by SEC Commissioner A. Sommer, Jr., at Notre Dame Law School, November, 1974, in CCH FED. SEC. L. REP. ¶ 80,010 at 84,692.

[178] 384 F.Supp. 1312 (S.D.N.Y. 1974). In this case, Inland Credit Corporation, listed on the American Stock Exchange, attempted to "go private" through an exchange offer to its common stockholders. Seventy percent of the outstanding common stock was held by Inland's management and their families; the remaining 30 percent, by 1,500 public shareholders. *Id.* at 1315. Inland's exchange offer invited all owners of common stock to tender their stock back to the corporation, on a one-for-one basis, in exchange for 10 percent non-convertible subordinated debentures due in 1984. *Id.* at 1316. In response, two shareholders moved for, and the district court granted, a preliminary injunction restraining Inland from consummating its exchange offer, alleging violations of Sections 10(b), 13(d), 14(d), and 14(e) of the 1934 Act as well as New York common and statutory law. *Id.* at 1314.

[179] *Id.* at 1318.

[180] *Id.*

> presenting the shareholders with an arguably distorted view of the facts, there is no justification for anything but the most straightforward and fullest disclosure. As such, a higher level of disclosure is attainable without placing any unjustifiable burden upon the purchasing company.[181]

Third, the issuer attempting to repurchase its own shares "is the insider par excellence,"[182] and, consequently, more rather than less disclosure should reasonably be expected. The district court in *Broder v. Dane*, advancing this proposition, quoted from a memorandum submitted by the SEC during congressional hearings on the Williams Act:

> [I]t must be recognized that the disclosures which should be made by an issuer making a tender offer for its own shares are entirely different than those which should be made by a third party. For example, an issuer making such a tender offer probably should disclose substantially more information with respect to its own business and prospects than can reasonably be expected of a third party.[183]

In view of the special needs of security holders in certain exchange transactions and the variety of uses that the exchange exemption affords, it is difficult to understand why Congress and the SEC permit Section 3(a)(9) to continue in its present form.

State blue sky laws occasionally depart from the liberal federal scheme, limiting the exchange exemption. California, for instance, has a limited exchange exemption which requires that certain stock splits and reverse stock splits be qualified under its securities act[184] and, also, denies exemption in numerous instances where a change in the character of the outstanding shares or debt securities would substantially and adversely affect any class of security holders.[185] Wisconsin, too, limits its exchange exemption,[186] but here the emphasis is more on enhancing disclosure than on restricting the exemption's applicability. The Wisconsin provision requires the issuer

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[181] *Id.* at 1319.

[182] *Id.*

[183] *Id.*, *citing* Supplemental Memorandum of the SEC, in *Hearings on S. 510 Before the Subcomm. on Securities of the Senate Comm. on Banking and Currency*, 90th Cong., 1st Sess. at 202 (1967).

[184] CAL. CORP. CODE §25103 (West Supp. 1975).

[185] *Id.*

[186] WIS. STAT. ANN. §551.23(12)-(14) (1974).

to file notice specifying the terms of the offer and such other information as the securities commissioner by rule may require.[187] The offer is then reviewed by the commissioner who may disallow the exemption within ten days.[188] In states where limited exchange exemptions similar to these exist,[189] the blue sky provisions may extend protection of the public investor beyond that afforded by Section 3(a)(9). Nevertheless, state securities provisions of the California and Wisconsin type still suffer problems arising from their own peculiar approaches. The case-by-case application of California's "substantially adverse" standard, for instance, might be so unpredictable that the specter of potential litigation costs will dissuade the would-be security holder-litigant from contesting the exchange transaction. Likewise, no ready means exists for translating the disclosure of relevant information to the securities commissioner, as required by Wisconsin, into investment-related information readily available to and easily comprehended by the offeree.

The proposed Federal Securities Code, in preparation under the auspices of the American Law Institute,[190] also contains a counterpart to Section 3(a)(9) which would make an exchange exemption available only to issuers which have been continuously registered with the SEC for a period of one year or more.[191] The proposed code's "one-year registrant" concept[192] entails a shift in emphasis from "the static disclosure concept of the 1933 Act to the continual disclosure concept of the 1934 Act . . . ."[193] This shift in emphasis, in which reasonably current information is made available to an issuer's security holders, results in the proposed successor provisions

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[187] *Id* §551.23(12).

[188] *Id.*

[189] In addition to California, the following states limit the scope of an exemption for recapitalizations: Arizona, 1 CCH BLUE SKY L. REP. ¶ 6134; Maine, 2 *id.* ¶ 22,124; Minnesota, 2 *id.* ¶ 26,175; Mississippi, 2 *id.* ¶27,125-1; Oregon, 3 *id.* ¶40,204; South Dakota, 3 *id.* ¶¶44,185, 44,193; and Vermont, 3 *id.* ¶48,104.

In addition to Wisconsin, the following states require the issuer in a recapitalization to notify the appropriate state administrator as a condition of an exempt transaction: Alaska, 1 *id.* ¶6014; Arizona, 1 *id.* ¶ 6651 (administrative agency order); Arkansas, 1 *id.* ¶ 7114 (Rule 8 of the Exemption Policies in Arkansas requires that the notice include a description of the method by which full disclosure of material facts will he made to each offeree, *id.* ¶ 7608, at 3534); Indiana, 1 *id.* ¶ 17,102; and Oklahoma, 2 *id.* ¶ 39,151 (as interpreted by Oklahoma Securities Commission, *id.* ¶ 39,704, at 35,531-32).

[190] *See* ALI, FEDERAL SECURITIES CODE (Tent. Draft No. 1, 1972, and Rev. Draft, 1974).

[191] *Id.* §511(f)-(g). *See id.*, comments at 110-14 (Tent. Draft No. 1).

[192] *See id.* §270.

[193] *Id.* § 270, comment (Rev. Draft, 1974).

to Section 3(a)(9)'s being generally less restrictive as disclosure is enhanced. The exclusively-in-exchange condition of Section 3(a)(9) is dropped under the ALI proposal so that its exemptive provisions would no longer distinguish, for instance, between rights which require cash payments and rights which require surrender of outstanding securities.[194] Such an exemptive scheme, in the overall context of the proposed code, makes considerable sense not only from the standpoint of management flexibility, but also from the predominant perspective of effective investor protection.

Until such time, however, as Congress or the SEC modifies the current federal exchange exemption, Section 3(a)(9) will remain an exception to the Commission's avowed commitment "to coordinate and integrate the [continuous] disclosure system with the exemptive provisions provided by [the Act]."[195]

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[194] *See id.* §511 (f)-(g), comment (5) at 112 (Tent. Draft No. 1).

[195] SEC Securities Act Release No. 5450, CCH FED. SEC. L. REP. ¶ 79,617, at 83,649 (1974).