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# Problems in General Practice Under the Federal Securities Act

By JAMES E. NEWTON\*

Problems under the Federal Securities Act, the Securities Act of 1933,<sup>1</sup> are not restricted to attorneys who specialize in corporate finance or other obvious far-flung public money-raising campaigns. No matter what specialty an attorney may have, he is sure to have rather frequently posed to him problems under the Act, whether recognized as such or not. No matter how small a client's business may be or what form it may take, when financing is involved consideration should usually be given to the Act—and more than merely holding up a wetted finger.

This does not necessarily mean that the Act will be applicable in all cases, but the Commission's files are rife with inadvertent violations, and the civil liability which results from these violations,<sup>2</sup> even though inadvertent, can be extremely serious. Willingness to assume the blame for such violations is not of much assistance to a client, for example, when the financial statement reflecting such civil liability is reviewed by the critical eye of his banker.

Such violations are primarily due to the failure to recognize in time the applicability of the Securities Act; and even when its application is recognized there is frequently misunderstanding as to whether or not there is an available exemption from compliance with its requirements.

The Securities Act of 1933 is administered by the Securities and Exchange Commission, represented in the Northwest by the Seattle Regional Office, which has as its territory Idaho, Montana, Washington, Oregon and Alaska. Although personnel limitations do not permit branch offices, there is a representative of the Commission in these states most of the time.

## *DISCLOSURE TYPE STATUTE*

The Securities Act of 1933, often described as the "Truth in Securities Act," is what is known as a disclosure type statute, and is more readily understood when compared to the qualification type Blue Sky law such as the Montana Investment Law.<sup>3</sup> Whereas the Montana law vests the authority and responsibility in the Investment Commissioner to determine whether a particular plan for transaction of business is "fair, just, and equitable," and to issue a permit accordingly, the Securities and Exchange Commission does not pass on the merits of any offering. Its function under the Act instead is to assure prospective purchasers' being furnished with all information pertinent and material to their exercise of informed judgment in making a purchase.

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<sup>1</sup>48 STAT. 74 (1933), 15 U.S.C. §§ 77a-77aa (1952), as amended 15 U.S.C. §§ 77b-77v (Supp. III, 1956).

<sup>2</sup>Section 12, in clause (1), imposes civil liabilities for failure to comply. 48 STAT. 84 (1933), 15 U.S.C. § 77i (Supp. III, 1956).

<sup>3</sup>REVISED CODES OF MONTANA, 1947, Title 66, Chapter 20.

In short, whereas the Montana law is in effect a qualification type statute, the Federal Act is strictly and realistically a disclosure statute, under which any securities can be sold to anyone at any price, provided there is furnished all the material information necessary regarding the offering.

Such disclosure and the providing of information to prospective purchasers is effected through filing with the Commission certain information in what is known as a registration statement, and furnishing information in connection with all sales by the use of a prospectus.<sup>4</sup>

### USEFUL CRITERIA

Failure to recognize in time the applicability of the Act is one of the primary causes of inadvertent violations. There are no hornbook rules which automatically determine such problems. There are, however, certain criteria which should properly be considered in connection with any proposed financing in determining whether the Act is applicable.

#### *Whether a Security Is Involved*

The first criterion is whether a "security" is involved, within the meaning of the Act. The term "security," as defined by the Act,<sup>5</sup> is extremely broad and includes much more than the orthodox types such as stocks and bonds. In fact, it is so broad that it is necessary to be consciously on the lookout to avoid missing in the not infrequent difficult borderline cases. The trouble comes in connection with those flexible, all-inclusive categories such as "certificate of interest or participation in any profit-sharing agreement" and "investment contracts." Under these headings come not only interests in partnerships, syndicates, or any joint ventures, but also the sale of what would otherwise be a commodity except for the arrangement under which it is sold. For example, the definition of a security can cover a variety of transactions from the sale of chinchillas under an arrangement for a division of progeny to the sale of crab pots to be fished on a share-the-profit basis.

A good illustration is a promotion which took place in Montana under which oil, allegedly collected from service stations and rerefined, was sold to the public much as fuel oil would be sold, except that as an integral part of the deal the purchaser (or victim) would authorize the seller (or promoter) to make the oil so purchased part of a pool composed of similar oil purchased by others, on the assurance that all of the oil so pooled would be sold periodi-

<sup>4</sup>Sections 6, 7, and 8 describe the procedure of preparing and filing a registration statement, and Regulation C of the General Rules and Regulations under the Act gives further explanation of these requirements. 48 STAT. 78 (1933), 15 U.S.C. §§ 77f-77h (1952). Various forms of registration statements are provided to accommodate different types of issuers and issues of securities.

<sup>5</sup>Section 2(1) defines a "security" as "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." 48 STAT. 74 (1933), 15 U.S.C. § 77b(1) (1952).

cally for their respective pro rata benefit. In this particular case the promoter not only failed to comply with requirements of the Securities Act, but he also failed to have any oil to cover the purchases. He was convicted of violation of the Securities Act. The indictment described the security involved in the following language: "contracts for the purchase of re-refined oil together with the right to participate in a pooling arrangement and profit-sharing agreement in connection therewith."<sup>6</sup>

The Supreme Court in the case of *SEC v. W. J. Howey Co.*<sup>7</sup> laid down the following very usable formula: "An investment contract for the purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party. . . ." They applied and interpreted this formula realistically and practically, cutting through all form to substance. The *Howey* case involved the sale of citrus fruit lots under arrangements whereby they would be managed by a service corporation operated by the promoters on a community basis. The fact that purchasers were given warranty deeds was answered by the court: ". . . it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."

It should also be remembered that, being a remedial statute, the definition of a "security" is subject to liberal construction by the courts, and the courts have been very prone to point this out in connection with their decisions interpreting the definition.<sup>8</sup>

#### *Whether a "Sale" Is Involved*

If a security is involved, the next criterion to be applied is whether the security is being "sold." Here again, it is necessary in effect to forget the usual understanding of "sale" since within the meaning of the Act "sale" involves an extension of the common law concept.

Too frequently determination whether a sale is involved is delayed too long. This seems to be particularly the case with preorganization subscriptions, which are just another security and governed as such. Often preorganization subscriptions are sold to large groups without compliance, and with the bona fide intent to comply "later on." Delayed compliance not only does not suffice and results in violative sales, but it often renders compliance more difficult.

Judge Black's ruling in the case of *SEC v. Starmount*<sup>9</sup> is an excellent example of how far the courts go in realistically construing what is or is not a sale within the meaning of the Act. In this case the defendant Starmount, through his publication *Mining Truth*, advised his subscribers relative to a corporation *to be formed* and to be known as Assessable Exploration

<sup>6</sup>For other illustrative cases see *SEC v. W. J. Howey Co.*, 328 U.S. 293 (1946); *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); *SEC v. Universal Service Ass'n.*, 106 F.2d 232 (7th Cir. 1939); *SEC v. Crude Oil Corp. of America*, 93 F.2d 844 (7th Cir. 1937).

<sup>7</sup>328 U.S. 293 (1946).

<sup>8</sup>See *SEC v. Crude Oil Corp. of America*, 93 F.2d 844 (7th Cir. 1937); *Kerst v. Nelson*, 171 Minn. 191, 213 N.W. 904, 905 (1927).

<sup>9</sup>31 F. Supp. 264 (E. D. Wash. 1939).

Co., and solicited what was called an "Indication of Possible Acceptance (This is not a subscription to anything)." The court said:

I appreciate that the argument of the defendants is that the Commission is becoming alarmed before anything is being sold; that no money is to be collected until the prospectus is issued, as provided by law, and until the corporation is organized and registered according to law. But this Act itself appreciates the importance of preliminary negotiations being free from falsity, and so the purpose of this remedial legislation is that the remedy shall be applied while it can be effective. There is no use to apply a remedy to protect the public after the public has been infected by the virus, and so long after it has been affected by the virus that the remedy will be of no avail.

### *Situations Frequently Misunderstood*

There are certain situations which quite commonly seem to give trouble in connection with fully understanding when a sale is involved. For example, when the sale may have resulted from efforts or initiation on the part of the customer only, no matter how active the purchaser may be, or how passive the seller may be, it is "sold" within the meaning of the Act.

Too often a sale seems to be associated only with money as consideration. A security traded for any type of consideration is a sale.

Although it is permissible to make a gift of securities, if it is in effect a bonus given with something for which consideration has been paid, the Act expressly provides that a sale is involved, and it is deemed to be "sold."<sup>10</sup>

If the sale of a security is involved, compliance with the provisions of the Federal Securities Act is required, unless an exemption from such compliance exists.

### *EXEMPTIONS FROM COMPLIANCE*

There are provided in the Act<sup>11</sup> and the rules and regulations thereunder certain exemptions from the registration requirements of the Act; that is to say, the requirements of filing a registration statement with the Commission's office in Washington and delivering a prospectus to purchasers are expressly dispensed with in connection with certain types of securities and certain types of transactions. Such exemptions are designed to cover situations in which purchasers do not require the protection of such disclosure requirements.

#### *Private Offering Exemption*

The Act expressly provides an exemption where no public offering is involved—commonly referred to as the "private offering exemption"<sup>12</sup>—which is, as would be expected, the most commonly claimed exemption, but it also, unfortunately, is the most commonly misunderstood exemption.

<sup>10</sup>Section 2(3). 48 STAT. 74 (1933), 15 U.S.C. § 77b(3) (1952), as amended, 15 U.S.C. § 77b(3) (Supp. III, 1956).

<sup>11</sup>Sections 3 and 4. 48 STAT. 75 (1933), 15 U.S.C. §§ 77c-77d (1952), as amended, 15 U.S.C. §§ 77c-77d (Supp. III, 1956).

<sup>12</sup>Section 4(1), second clause. 48 STAT. 77 (1933), 15 U.S.C. § 77d(1) (1952), as amended, 15 U.S.C. § 77d(1) (Supp. III, 1956).

The Act does not define what constitutes a public or private offering. However, judicial decisions have pretty well staked out the boundaries.

The most important step in determining whether the private offering exemption is available is recognition that the offering need not be open to the whole world to be "public"; that is, merely distinguishing the populace at large from individual members because of some interest or characteristic has been held to be inappropriate for the purpose of this exemption.<sup>13</sup>

Since the private offering exemption is designed to cover transactions where purchasers do not need the protection provided by the Securities Act, this of course means it is designed to cover transactions where the purchasers do not need the information required by the Act to be disclosed. This acid test is well spelled out by the Supreme Court in the case of *SEC v. Ralston Purina Co.*<sup>14</sup> In essence, the court held that the exemption is available if all offerees are for one reason or another in a position to "fend for themselves."

There is no question that the private offering exemption is available in many situations; but it is well to be warned that the test, which may at first blush seem easy to apply, is without question the most common source of inadvertent violation.

There are a few circumstances which may frequently give trouble in determining whether or not the private offering exemption is available.

#### *Small Number of Offerees*

Probably the most difficult situation to appraise is where only a small number of offerees is involved. Needless to say, if only a small number is involved, the chances are better that they all may have the necessary information and be in a position to "fend for themselves." However, this is not always the case, and there is no magic number or any thumb rule which can be applied to determine whether the private offering exemption is available in the case of small numbers any more than in the case of large numbers of offerees. It is a factual question which has to be resolved in the light of the fact that it turns strictly on the information possessed by the offerees. In other words, the mere fact that only a small number is involved does not enable one to say that, therefore, it is a private offering. There are situations where a hundred offerees could be involved, and they would be clearly

<sup>13</sup>In the case of *SEC v. Sunbeam Gold Mines Co.*, 95 F.2d 699 (9th Cir. 1938), Judge Denman said: "In its broadest meaning the term 'public' distinguishes the populace at large from groups of individual members of the public segregated because of some common interest or characteristic. Yet such a distinction is inadequate for practical purposes; manifestly, an offering of securities to all red-headed men, to all residents of Chicago or San Francisco, to all existing stockholders of the General Motors Corporation or the American Telephone & Telegraph Company, is no less 'public,' in every realistic sense of the word, than an unrestricted offering to the world at large. Such an offering, though not open to everyone who may choose to apply is none the less 'public' in character, for the means used to select the particular individuals to whom the offering is to be made bear no sensible relation to the purposes for which the selection is made. For the purposes of an offering of securities, red-headed men, residents of San Francisco, and stockholders of General Motors are as much members of the public as their antithetical counterparts. To determine the distinction between 'public' and 'private' in any particular context, it is essential to examine the circumstances under which the distinction is sought to be established and to consider the purposes sought to be achieved by such distinction."

<sup>14</sup>346 U.S. 119 (1953).

private offerings. On the other hand, there are situations involving a very few, even one offeree, which could not pass the acid test.

In this connection, it is important to consider that it is the knowledge of *all* persons to whom the securities are offered, the offerees, rather than just those who buy, the actual purchasers, which governs. In other words, it is necessary to consider the information possessed by each and every person to whom the offer is made in determining the availability of the exemption, not just those who actually buy.

#### *Relation of Seller and Purchaser*

Probably the next most difficult situation is where the relationship or character of the offerees is such that an offering to them "just does not seem to be a public offering." For example, suppose a client intends to sell the stock of a small corporation, which has been set up for him, to his relatives—and just to his relatives. Such relationship, close as it may be, does not in itself suffice for the information required to be possessed by all offerees.

A very similar situation is presented where the offering is to be made to friends and associates. Here also, friendship, close as it may be, does not suffice. If a stranger is entitled to have certain information, certainly a friend is not to be prejudiced by not being a stranger.

#### *Relation of Issuer and Purchaser*

*Stockholders*—Frequently offerings are restricted to stockholders of the issuing company, by virtue of preemptive rights or otherwise. Such an offering is not deemed private because of the mere fact that it is so restricted. The judicial interpretation of this facet of the private offering question was the result of an early decision by the Court of Appeals, Ninth Circuit, in the case of *SEC v. Sunbeam Gold Mines Co.*<sup>15</sup> The *Sunbeam* case involved an offering of stock restricted to the stockholders of the issuer, and the claim was made, and sustained by the lower court, that the mere fact that the offering was so restricted rendered it exempt as a private offering—that is, no public offering was involved irrespective of the number of stockholders. The case as presented to the Court of Appeals was pinpointed to just that question and at that time it was a case of first impression for an appellate court.

The decision of the *Sunbeam* case is regarded as controlling on the question. This ruling is, namely, that offerings restricted to stockholders of the issuer are public within the meaning of the Act, unless the stockholders have adequate information thereby not requiring the protection afforded by the registration requirements of the Act.

*Employees*—Another troublesome situation frequently presented is the offering restricted to employees of the issuing company. The Supreme Court has effectively taken care of this problem in the recent case of *SEC v. Ralston Purina Co.*<sup>16</sup> In that case the company, staffed by several thousand employees, had the policy of encouraging stock ownership among its employees, and each year made an offering to its employees described as

<sup>15</sup>95 F.2d 699 (9th Cir. 1938).

<sup>16</sup>349 U.S. 119 (1953).

eligible for promotion. The employees were not solicited. Those who bought included more than key employees and covered a wide range, including electricians and stenographers. The company relied on the private offering exemption, and although the trial court and the court of appeals took the position that the exemption was available, the Supreme Court not only reversed the lower courts but laid down the rule now in effect, governing the private offering exemption, namely, that the offerees must be in a position "to fend for themselves."

*Customers*—Not infrequently offerings are restricted to customers. Particularly is this the case with wholesale distributors, which desire to have their dealer-customers also their stockholders. Frequently customers are not in a position to fend for themselves.

Reliance on the private offering exemption is dangerous unless the facts will without any semblance of doubt meet the test laid down by the Supreme Court in the *Ralston Purina* case. On the other hand, the private offering exemption should not be overlooked or ignored. It should be considered and used, but not "stretched."

#### *Intrastate, or Local Exemption*

The Federal Securities Act expressly provides an exemption for local or strictly intrastate offerings, where sales of an entire issue are restricted to residents of the state of incorporation, provided the company is doing business there.<sup>17</sup> This is also an exemption which can be easily misunderstood, and unfortunately a mistaken use of this exemption has a particularly vicious result.

The requirement that all sales be to residents of the state of incorporation is strictly construed. A single sale to a single non-resident is fatal and destroys the exemption.<sup>18</sup> This exclusionary feature is rendered even more difficult since it applies not only to the particular offering involved but to the entire issue of which the offering is a part. An "issue of securities," as that term is used, may consist of more than one offering if the securities in each offering are of the same class and for the same financing purpose.

It is for this reason that in taking advantage of the intrastate exemption you make your bed and have to lie in it. That is, you can not later change your mind and decide to sell to non-residents, even though you may want to, through the means of making a new offering. It requires more than another offering; it requires a new issue, which is often difficult and sometimes impossible. And it should always be remembered that too often the fields across the state lines look much greener.

#### *Typical Example*

A typical example illustrates the pitfalls of this exemption. Assume a corporate client organized under the laws of Montana desires to raise some

<sup>17</sup>Section 3(a)(11) provides: "Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities: . . . (11) Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory." 48 STAT. 75 (1933), 15 U.S.C. § 77c(a)(11) (1952), as amended, 15 U.S.C. § 77c(a)(11) (Supp. III, 1956).

<sup>18</sup>*Hunt v. SEC*, 158 F.2d 981 (9th Cir. 1947).



\$250,000 through the sale of its common stock. It is a company with a simple capital structure consisting of only common stock. The officers are most sanguine of being able to sell the entire offering to residents of Montana. Their optimistic view is accepted at its face value, and the intrastate exemption is relied on. As is often the case, these fond dreams are not fully realized and difficulty is encountered in disposing of the offering to residents of Montana, and the point of saturation in Montana is soon reached. Now suppose an Idaho or North Dakota or Wyoming resident wants to make a substantial, and much desired, purchase. Having started to sell under the intrastate exemption, your client has made his bed, and has to lie in it. He must continue to restrict his sales to residents of Montana under the intrastate exemption, unless and until there is a different issue, which of course would require a new class of stock—the only means of changing the issue, since it naturally would not be desirable to change the financing program in midstream. This would of course require the time, expense, and possible difficulty of revamping the capital structure. This illustrates the inflexible result of utilizing this exemption.

Assume that without setting up a new issue (and without advice of counsel) the client succumbs to the temptation and sells to one or more non-residents or makes a sale to a non-resident inadvertently. This will show an other peculiarly dangerous aspect to this particular exemption. Since the exemption is available only if the *entire* issue is sold to residents, if any part of the issue is sold to non-residents, however few, it would preclude compliance with the conditions of the exemption and would render the exemption unavailable even for that portion of the issue previously sold to residents. This means, in effect, that in a case where the intrastate exemption is claimed a sale to a non-resident can have the retroactive effect of making violative sales previously made in reliance on the intrastate exemption, which in turn means that a single non-resident sale could subject the company to a statutory contingent civil liability<sup>19</sup> for all securities sold through the mails during the preceding year.<sup>20</sup>

Under this exemption it is essential that the securities involved come to rest in the hands of the resident purchaser. Because of this requirement, inadvertent violations of the Act can result if a resident purchaser does not take for investment, but instead with a view to reselling. Such a purchaser would be an underwriter within the meaning of the Act,<sup>21</sup> and a resale by such original resident purchaser to a non-resident purchaser would be chargeable to the issuer, the securities involved not having come to rest in the hands of a resident before getting into the hands of a non-resident.

Such situations are not uncommon. A very substantial new enterprise in Washington started its financing under the intrastate exemption. It was an enterprise which required considerable capital, and along the line a few shares were sold to a very few non-residents. Although the amount of this "foreign" money was negligible as compared to the local money, when the

<sup>19</sup>Section 12(1). 48 STAT. 84 (1933), 15 U.S.C. § 771(1) (Supp. III, 1956).

<sup>20</sup>Section 13 provides a statute of limitations of one year after violation for actions brought to enforce liability created under section 12(1). 48 STAT. 84 (1933), 15 U.S.C. § 77m (1952).

<sup>21</sup>Section 2(11). 48 STAT. 75 (1933), 15 U.S.C. § 77b(11) (Supp. III, 1956).

exemption was destroyed by the few non-resident sales, the previous sales under the exemption became violative and subjected the company to a contingent civil liability in the amount of approximately \$900,000 (based on sales made during the preceding year). This had the serious effect of precluding the company from being able to obtain much needed financial assistance. The resulting situation was basically attributable to the mistake in adopting the intrastate exemption in a situation where it was not adaptable.

### *Small Offering Exemption*

The so-called "private offering" and "intrastate" exemptions are automatically effective or available if and when the certain required facts exist, no filing of any kind being required. If available, there is no limit on the amount which can be sold.

Pursuant to the authority vested in it under the Act<sup>22</sup> the Securities and Exchange Commission has provided by regulation a so-called small offering exemption. This exemption, however, is not automatic but is available only upon filing certain summary information and using, under some circumstances, a limited prospectus in connection with sales.

The small offering exemption, commonly referred to as Regulation A,<sup>23</sup> permits the sale of not to exceed \$300,000 in each 12-month period without compliance with the registration requirements of the Act. The requirements of the Regulation have been simplified and streamlined, consistent with the purpose of the exemption, namely, to accommodate small offerings by inexpensive and expeditious compliance.

Filing under Regulation A, for which no fee is required, is made in the Regional Office for the region in which the principal business operations are conducted. It consists of two parts. One part is the so-called "Notification," which includes certain background information for the use of the Commission in determining whether the exemption is available and the manner in which the offering is to be sold. The other part is the so-called "Offering Circular," in effect a summary prospectus which must be delivered to purchasers in connection with all sales except in connection with offerings not exceeding \$50,000 of seasoned companies.<sup>24</sup> This material must be filed ten days, Saturdays, Sundays, and holidays excluded, prior to the commencement of the offering, unless, upon request, the offering date is accelerated by the Commission.

Subsequent to the commencement of the offering a report is required to be filed every six months until the offering has been completed.

In many of those situations where the availability of the private offering and intrastate exemptions may be questionable, but still very much of a temptation, the Regulation A exemption is usable.

<sup>22</sup>Section 3(b). 48 STAT. 76 (1933), 15 U.S.C. § 77c(b) (1952).

<sup>23</sup>Rules 251 to 262, inclusive. 21 FED. REG. 5739 (1956), amending 17 C.F.R. §§ 230.215-230.224 (Supp. 1956).

<sup>24</sup>The Regulation defines an unseasoned company as "any issuer which (1) was incorporated or organized within one year prior to the date of filing the notification required by Rule 255 and has not had a net income from operations; or (2) was incorporated or organized more than one year prior to such date and has not had a net income from operations, of the character in which the issuer intends to engage, for at least one of the last two fiscal years."

### CONCLUSION

There are in addition to the private offering, intrastate offering, and small offering exemptions, other exemptions which are provided by the Act designed to handle types of issuers, transactions, and securities less frequently encountered in general practice. But a clear understanding of what constitutes a "security," a realistic approach to what constitutes a "sale," together with a repertoire composed of a working knowledge of the private, intrastate, and small offering exemptions, will not only resolve most problems under the Securities Act of 1933, but will alert in a timely manner attorneys in general practice to the fact that such problems exist.