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Exempted Transactions Under the Securities Act of 1933

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and the Democratic Process: A Study of the Railroad Problem. The address will appear in the June issue of the Quarterly.

The 1939 Summer Session of the Washington University School of Law will begin on June 19 and end July 28. Courses will be offered in Criminal Law, Personal Property, Constitutional Law, Damages, Federal Jurisdiction and Procedure, and Insurance.

NOTES

EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933*

A recognition that the wide distribution of securities in the United States gives rise to an appropriate public interest in securities¹ and security markets² and that the prevention of fraud in the sale of securities is a proper governmental function³ were strong factors leading to the enactment of the Securities Act of 1933.⁴ The Act undertook to correct existing faults by requiring a full and complete disclosure of information concerning the security to be issued and the issuing company⁵ and by imposing

* The Act also exempts from the provisions of Section 5 certain classes of securities as set forth in Section 3. These exemptions will not be dealt with except incidentally where context requires it.

1. In 1929 the volume of shares bought and sold on the New York Stock Exchange amounted to 1,125,000,000. Twentieth Century Fund, Inc., *Stock Market Control* (1934) 3. One-third to one-half the annual savings of Americans, individual and corporate, went into various securities. *Id.* at 1. For a complete discussion on the effect of security prices on the public, *i. e.*, persons, business, banks, insurance companies, endowed institutions, charities, etc., see Chapter I of the study of the Twentieth Century Fund, Inc., *op. cit. supra.*

2. The New York Stock Exchange does two-thirds of the security business in the United States. Of the remaining one-third the New York Curb Exchange does one-half, and the rest is scattered over the other exchanges in the country. Twentieth Century Fund, Inc., *op. cit. supra*, note 1, at 28.

3. Smith, *The Relation of the Federal and State Securities Laws* (1937) 4 *Law & Contemp. Prob.* 241, 253.

4. (1933) 48 Stat. 74, (1938 Supp.) 15 U. S. C. A. sec. 77a-77aa. The United States Code cites the subdivisions of the Act by letters; they will be cited hereinafter, however, by numbers in conformance with the more popular and convenient mode of the Statutes-at-Large. The Act was held constitutional in *Securities and Exchange Commission v. Crude Oil Corp. of America* (D. C. W. D. Wis. 1936) 17 F. Supp. 164.

5. Note the statement of purpose in the title to the Act: "To provide full and fair disclosure of the character of securities sold * * * and to prevent fraud in the sale thereof * * *." Disclosure is to be accomplished by a detailed registration statement provided for in sec. 7 and a slightly less detailed prospectus provided for in sec. 10.

heavy civil⁶ and criminal⁷ liabilities on those connected with the issue.⁸ It is thus provided under Section 5 of the Act that unless a registration statement is in effect as to a security, it shall be unlawful for any person to use the mails or any means of interstate commerce to sell or offer to buy such security, or to transport such security for sale or delivery after sale. It is also made unlawful to transmit any prospectus relating to any security registered under this title unless the prospectus meets the requirements of Section 10, or to carry any such security for the purpose of sale or for delivery after sale, unless accompanied by or preceded by a prospectus.⁹

Under Section 4 of the Act, however, certain exemptions are provided for; the provisions of Section 5 are not to apply to any of the following transactions:

(1) Transactions by any person other than an issuer, underwriter, or dealer; transactions by a dealer (including an underwriter no longer acting as an underwriter in respect to the security involved in such transaction), except transactions within one year after the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter (including in the computation of such year any time during which a stop order * * * is in effect as to the security), and except transactions as to securities constituting the whole or part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such security by the issuer or by or through an underwriter.

(2) Brokers' transactions, executed upon any customers' orders on any exchange or in the open market, but not the solicitation of such orders. * * *

This note will undertake an analysis and discussion of these exempt transactions.¹⁰ These being exemptions from a general rule, the burden of proof lies on him who claims to be within the exemption.¹¹

6. Sec. 12.

7. Secs. 17 and 24.

8. Sec. 11.

9. The American Bar Association recommends that sec. 5 be amended to make clear that it does not apply to persons who have no direct financial interest in the sale referred to. Report of Special Committee on Amendments to Securities Act of 1933 (1935) 60 A. B. A. Rep. 543.

10. Interpretation of the statutory provisions relative to exempted transactions has been confined largely to advisory opinions of the General Counsel of the Securities and Exchange Commission and to the rules and regulations adopted by that body.

11. Securities and Exchange Commission v. Sunbeam Gold Mines Co. (C. C. A. 9, 1938) 95 F. (2d) 699; Schlemmer v. Buffalo, Rochester and Pittsburgh Ry. (1906) 205 U. S. 1.

I

Transactions by an issuer¹² not involving any public offering are expressly exempted by the Act.¹³ This is to permit the issuer to make a special or isolated sale¹⁴ of his securities¹⁵ to a particular person without the need of registration.¹⁶ When, however, such a sale amounts to a public offering of the security, the exemption is lost.¹⁷ It then becomes pertinent to inquire what is a public offering. Nowhere in the Act is the phrase defined.¹⁸ In an early letter¹⁹ from the Securities Division of the Federal Trade Commission²⁰ it was stated that an offering to a small number of persons, perhaps below twenty-five, would not be a public offering. This opinion, however, was later rescinded by an opinion which went into the problem in more detail.²¹ In that opinion the following factors were specified as of prime importance in determining whether an offer was public²² or not: (1) the number of offerees and their relationship to each other and to the issuer;²³ (2) the number of units offered;²⁴ (3) the

12. Defined in sec. 2(4).

13. Sec. 4(1).

14. Defined in sec. 2(3).

15. Defined in sec. 2(1).

16. The theory is that in such transactions the securities are not likely to get into the hands of the general public. Securities Act Release No. 285, Jan. 24, 1935, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2203.021.

17. If no registration statement is in effect, the Commission can proceed by injunction to enjoin the further distribution of the securities under sec. 20, and those connected with the issue incur liability under sec. 11.

18. The American Bar Association committee recommended that "public offering" be defined in the Act. Report of Special Committee on Amendments to Securities Act of 1933 (1935) 60 A. B. A. Rep. 542.

19. Letter to Corporation Trust Company of April 27, 1934, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2203.03.

20. Originally the administration of the Act was under the Federal Trade Commission. By the Securities Exchange Act of 1934 it was transferred to the Securities and Exchange Commission. (1934) 48 Stat. 908, (1938 Supp.) 15 U. S. C. A. sec. 78 ii.

21. Securities Act Release No. 285, Jan. 24, 1935, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2203.021.

22. *Nash v. Lynd* [1929] A. C. 158, 45 T. L. R. 42, decided under the English Companies Act, holds that "the public is * * * a general word. Anything from two to infinity may serve."

23. This factor refers to the number to whom the sale is offered and not the number who actually buy. The term "offer" is to be construed as any attempt to dispose of a security whether by formal or informal means. Thus if a company first investigates to determine a small number of persons who will buy and then offers the securities to them, this will, nevertheless, be construed as a public offering. Securities Act Release No. 285, Jan. 24, 1935, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2203.021.

24. An issue in large denominations is more indicative of a private offering than one in small denominations or convertible into small denominations. The latter indicates a contemplation of ultimate public distribution. 133 C. C. H. at 570.

size of the offering;²⁵ (4) the manner of the offering.²⁶ These factors certainly constitute no set rule but may serve as guides. The dividing line between public and non-public offerings is obviously not clear,²⁷ the determination being essentially a question of fact to be decided in each case on the peculiar facts and circumstances²⁸ and with a view to the purpose of the Act. An offering, however, to members of a class with special knowledge of the issuer would appear to be less indicative of a public offering than a like offer to another group of the same size but without this special knowledge.²⁹

Many situations might arise involving the availability of this exemption. In a release of the Securities and Exchange Commission,³⁰ the General Counsel has advised that where an issuer offers securities at a bona fide private offering but later determines to make a public offering, the original exemption is not thereby lost if a registration statement is later filed. This advisory opinion was subsequently crystallized into Rule 152 of the Commission.³¹ In an earlier release³² it was advised that mere restriction of the issue to the issuer's employees would not thereby render the issue non-public,³³ and that limitation of the

25. This indicates the likelihood of a later public offering, a small offering being less apt later to be redistributed. For the same reason it is also of some importance whether the present issue is a part of an issue already being dealt in by the public or is likely to be so dealt in within reasonable contemplation of the issuer. 133 C. C. H. at 570-571.

26. Transactions effected by direct negotiations are less likely to be public offerings than are those effected through the machinery of public distribution. 133 C. C. H. at 571.

27. *Ex parte Leach* (1932) 215 Cal. 536, 12 P. (2d) 3 (decided under state blue sky law).

28. *Securities and Exchange Commission v. Federal Compress and Warehouse Co.* (D. C. W. D. Tenn. 1936) 133 C. C. H. *Stocks & Bonds Law Serv.* par. 8584, appeal denied (C. C. A. 6, 1937) 88 F. (2d) 1018.

29. "The crux of the problem would seem to be whether the prospective buyers are in some especially privileged position which renders it unnecessary that they be protected by the registration requirements of the Act." *Krupshaw, Opinions of the Securities and Exchange Commission* (1937) 10 *Miss. L. J.* 8, 48.

30. *Securities Act Release No. 305*, Mar. 2, 1935, (1937) 133 C. C. H. *Stocks & Bonds Law Serv.* par. 5152.02. See also *Buwiller, Exemptions of Securities and Transactions Under the Federal Securities Act of 1933* (1936) 10 *U. of Cin. L. Rev.* 125, 162.

31. Rule 152, adopted March 15, 1936, states: "The term 'transactions by an issuer not involving any public offering' in Section 4(1) shall be deemed to apply to transactions not involving any public offering at the time of said transaction although subsequently thereto the issuer decides to make a public offering and/or files a registration statement." (1937) 133 C. C. H. *Stocks & Bonds Law Serv.* par. 5152.

32. *F. T. C. Release No. 98*, Pt. 6, Dec. 28, 1933, (1936) 133 C. C. H. *Stocks & Bonds Law Serv.* par. 2203.05.

33. When the Securities and Exchange Act was passed in 1934, it was proposed to amend sec. 4(1) of the Securities Act of 1933 to include such

issue to existing shareholders would not necessarily make the issue non-public.³⁴ This latter ruling was first set out in a release by the Federal Trade Commission³⁵ advising a corporation which had defaulted on its bonds and proposed to exchange them for bonds of a lower interest rate through the use of brokers.

In *Securities and Exchange Commission v. Federal Compress and Warehouse Co.*³⁶ a preliminary injunction to restrain further distribution of securities to existing security holders was denied. In that case the defendant had outstanding over two million dollars' worth of preferred stock callable on any interest day. The defendant also had some ninety thousand shares of unregistered common stock in its treasury. Many of the preferred shareholders were also common shareholders. In order to retire the preferred stock, defendant offered to issue, to common shareholders only, one share of treasury stock for every five shares of common stock owned, at twenty-five dollars per share.³⁷ The proceeds were to be paid to a trustee for the sole use of retiring the preferred stock. The court found as facts that defendant had its principal office and place of business in Memphis, Tennessee, and had had a long and successful history; that most of its shareholders lived in Memphis or its vicinity and knew at least by reputation the officers and directors of the company; that all had full opportunity to become familiar with the affairs and condition of the business through their contacts with the officers and directors and through statements sent out to them and otherwise; that the resolution passed by the defendant to effect the proposed change expressly provided against the public offering of these treasury shares and against the use of brokers and underwriters or payment of any commissions to effect the change; that before the exchange the defendant sent its shareholders a

an issue within the exemptions. The proposal was rejected, however, on the ground that employees might be in as much need for information as to the issuer as anyone else. (1934) H. R. Rep. No. 1838, 73rd Cong., 2nd Sess., 41, (1938) 133 C. C. H. Securities Act Serv. par. 2203.10. Although the American Bar Association Committee agreed with the theory set forth in note 29, *supra*, it nevertheless recommended that an issue to the employees of the issuer should be exempt from registration. Report of Special Committee on Amending the Securities Act of 1933 (1935) 60 A. B. A. Rep. 542. See criticism of these proposals by Dodd, Amending the Securities Act (1935) 45 Yale L. J. 199, 205-8.

34. The English Companies Act of 1929 makes this an express exemption. 19 & 20 Geo. V. c. 23 pt. II, sec. 35 (5).

35. F. T. C. Release No. 97, Pt. 5, Dec. 28, 1933, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2203.04.

36. (D. C. W. D. Tenn. 1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 8584.

37. Common stock sold on market for thirty-five dollars per share.

letter explaining the contemplated change, with financial statements as of date; that the whole transaction was accomplished directly by defendant with its shareholders; and that there was no intent to get any money from the public but only to benefit the shareholders. On these findings, the court held that this transaction did not involve a public offering within Section 4(1) and was therefore exempt from the registration requirement of Section 5. The court relied strongly on the opinion of the Securities and Exchange Commission setting out the four factors involved in determining whether an offering is public.³⁸ The court stated further:

The plan offered was a bona fide, straightforward, legitimate transaction, * * * with no remuneration or other commission paid to accomplish a legitimate purpose in the fairest and most equitable manner, and the public interest was in no wise prejudicially affected, and the transaction is also probably exempt from registration under Section 3(a) (9) of the Securities Act.³⁹

In *Securities and Exchange Commission v. Mining Truth Publishing Co.*⁴⁰ the court enjoined the further distribution of securities in violation of Section 5. The president of defendant company conducted an investment advisory service in connection with which he published a service sheet for his subscribers called "Mining Truth." The defendant sent through the mail to his 600 subscribers a solicitation to purchase interests in the "Mining Truth Blind Pool of 1937." The court held that even though thus

38. *Supra*, pp. 385-6.

39. 133 C. C. H. Stocks & Bonds Law Serv. at 2964. Sec. 3(a) (9) provides an exemption for "Any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange." (1934) 48 Stat. 906, (1938 Supp.) 15 U. S. C. A. sec. 77c(a)(9). This section in addition to part of sec. 3(a)(10) was originally sec. 4(3) of the Act which read: "The provisions of section 5 shall not apply to any of the following transactions: (3) 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; or the issuance of securities to the existing security holders or other creditors of a corporation in the process of a bona fide reorganization of such corporation under the supervision of any court, either in exchange for the securities of such holders or claims of such creditors or partly for cash and partly in exchange for the securities or claims of such security holders or creditors." By an amendment in 1934 sec. 4(3) was repealed. (1934) 48 Stat. 906. Thus the character of the exemption, so far as formal classification is concerned, was changed from an exempt transaction to an exempt security.

40. (D. C. E. D. Wash. 1937) 133 C. C. H. Securities Act Serv. par. 30,015.

restricted to subscribers, the offering was, nevertheless, public within the meaning of Section 4(1) and, consequently, not exempt from registration.⁴¹

In *Securities and Exchange Commission v. Sunbeam Gold Mines Co.*⁴² an injunction was issued against an intended issue of securities without registration. Defendant contracted with another company to purchase its assets. Letters were then sent to the combined 530 shareholders of both corporations soliciting pledge-loan agreements for the purpose of completing the purchase and of raising money to register a contemplated new issue of stock with the Securities and Exchange Commission. On signing the agreement the shareholders got a "shareholder's receipt," promising to repay the sum lent with interest. The court held this a public offering and, therefore, necessary to be registered, saying:

* * * an offering of securities under the Securities Act of 1933 may be a public offering though confined to shareholders of an offering corporation, *a fortiori* where the offerees include the shareholders of another corporation, though seeking to become stockholders of the offeror.⁴³

We are not required to determine whether such an offer becomes private rather than public if each of the 530 shareholders were shown to know everything about the mining properties, their operation, and the financial condition of the company which would be disclosed if the management had complied with the Securities Act and furnished the information to the Commission.⁴⁴

It would seem, however, that if that showing had been made, the case of *Securities and Exchange Commission v. Federal Compress and Warehouse Co.*⁴⁵ might be authority for such a holding.

Stock dividends have been ruled by the Commission to be

41. The American Bar Association Committee has recommended that offers confined solely to holders of issuer's securities be exempted from registration. Report of Special Committee on Amending the Securities Act of 1933 (1935) 60 A. B. A. Rep. 542.

42. (C. C. A. 9, 1938) 95 F. (2d) 699.

43. The American Bar Association Committee has recommended that sec. 3(a)(9) of the Act be broadened so as to exempt securities issued to existing security holders in connection with a statutory merger or consolidation. Report of Special Committee on Amending the Securities Act of 1933 (1935) 60 A. B. A. Rep. 542. Under the blue sky laws of twenty-two states such exemption already exists. See compilation in (1938) 132 C. C. H. Stocks & Bonds Law Serv. 6531, Chart IV.

44. (C. C. A. 9, 1938) 95 F. (2d) 699, 702.

45. (D. C. W. D. Tenn. 1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 8584, cited *supra*, note 36.

exempt from registration⁴⁶ or not depending on the manner in which they are declared.⁴⁷ The crucial question is whether they are "sold" within the definition of "sell" in Section 2(3). If a corporation declares a dividend payable in cash or stock at the election of the shareholder, then neither declaration of the dividend nor subsequent distribution constitutes a sale by the corporation or a giving of value by the shareholder, and no registration is required. But, since declaration of a dividend by a corporation out of surplus instantly creates the relationship of debtor and creditor as between the corporation and the shareholder, if the corporation then first declares a cash dividend and gives the shareholder an opportunity to waive his existing rights to the cash and take stock instead, this constitutes a giving of value and a sale, within Section 2(3) of the Act, and registration is required.⁴⁸

The issuance of securities in compliance with conversion or subscription privileges attached to the original securities, if exercisable at any time, is considered "an offer to sell" within Section 2(3).⁴⁹ Registration is therefore required at the time the original securities are issued. But, if the privileges are not exercisable until a future date, the original issuance is not considered "an offer to sell." The security need not be registered, therefore, until the time the security to which the privilege attaches is offered to the public.⁵⁰ In either case, however, the conversion

46. The blue sky laws of thirty states expressly exempt stock dividends. See compilation in (1938) 132 C. C. H. Stocks & Bonds Law Serv. 6536, Chart IV.

47. S. E. C. Release No. 929, July 29, 1936, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 8556. The original draft of the Act specifically exempted stock dividends. This was later excluded from the specific exemptions on the ground that stock dividends, not being given for value, would be exempt anyhow. (1933) H. R. Rep. No. 152, 73rd Cong., 1st Sess., 25.

48. It is still exempt of course if not constituting a public offering within sec. 4(1).

49. Sec. 2(3) defining "sell" states: " * * * the issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be a sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such security." See also F. T. C. Release No. 97, Dec. 28, 1933; Comment (1937) 46 Yale L. J. 1071; (1938) 132 C. C. H. Stocks & Bonds Law Serv. 6527, Chart IV.

50. (1933) H. R. Rep. No. 85, 73rd Cong., 1st Sess., (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 1640.01. It would seem that there is just as much reason to hold a conversion privilege exercisable in the future as an "offer to sell" as there is to hold preliminary negotiations between the

or subscription rights must be registered when issued.⁵¹ In *In Matter of Gold Producers, Inc.*,⁵² the court held that the issuance of "gift stock" which was assessable not more than nine times at two cents an assessment constituted a "sale" of the stock. Registration would thus be required unless exempt for some other reason. Bonus stock would seem to be covered by Section 2(3)⁵³ and require registration.

Under Section 3(a) (11) an additional exemption is afforded to "Any security which is a part of an issue 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."⁵⁴ However, an issuer cannot escape registration by selling the entire issue to a resident who resells out of the state. "In order that the exemption of Section 3(a) (11) might be available it is clearly required that the securities at the time of the completion of ultimate distribution shall be found only in the hands of investors resident within the state."⁵⁵ As to the apparent potential danger of evasion through this section, the Commission itself has this to say:

From a practical point of view the provisions of that section can exempt only issues which in reality represent local financing by local industries, carried out purely through local purchasing. In distributions not of this type the requirements of Section 3(a) (11) will be extremely difficult, if not impossible, to fulfill.⁵⁶

II

Under the Securities Act the transactions of underwriters are in no case exempt, except where the underwriter has ceased to

originating house and dealers prior to the underwriting to constitute an "offer to sell." See discussion *infra*, p. 394.

51. (1933) H. R. Rep. No. 85, 73rd Cong., 1st Sess., (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 1640.01.

52. (1933) 1 S. E. C. 1.

53. " * * * Any security given or delivered with or as a bonus on account of any purchase of securities or any other thing shall be conclusively presumed to constitute a part of the subject of the purchase and to have been sold for value."

54. This section in practically the identical words was originally sec. 5(c) of the Act. By an amendment in 1934 it was repealed and made sec. 3(a) (11). (1934) 48 Stat. 906, (1938 Supp.) 15 U. S. C. A. sec. 77e.

55. F. T. C. Release No. 201, July 30, 1934, 133 C. C. H. Stocks & Bonds Law Serv. par. 2163.04; *Securities and Exchange Commission v. Brooklyn Manhattan Transit Co.* (1935) 1 S. E. C. 147, 157.

56. *Securities Act Release No. 1459*, May 29, 1937, (1937) 133 C. C. H. Stocks & Bonds Law Serv. par. 8595.

act as such in respect to the security involved in the transaction.⁵⁷ In such a case he is subject only to the restrictions imposed upon him as a dealer.⁵⁸ It is therefore of importance to inquire who is an underwriter.

The Act defines an underwriter as:

* * * any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such terms shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.⁵⁹

This definition includes all who in common parlance are taken to be underwriters; and regardless of their commitments, they would become liable for the whole issue. It does not, however, include a strict underwriter.⁶⁰ Strict underwriting is "an agreement by one party to compensate another to the extent of the latter's failure to obtain purchasers for an issue, or to take from the latter such unsold portions of the issue at a price."⁶¹ In such case one does not necessarily take securities with a view to their further distribution; but may take for purposes of investment or management. It is thus possible to have underwriters who may be immune from any liability under the Act.⁶² Practically, however, such a situation can seldom result, because few under-

57. Sec. 4(1).

58. (1933) H. R. Rep. No. 85, 73rd Cong., 1st Sess., (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2202.02.

59. Sec. 2(11). The American Bar Association Committee recommended that the phrase "direct or indirect" be eliminated so as to exclude the possibility of making people underwriters who were never intended to be so made, *e. g.*, finders, transfer agents, attorneys, etc.; also, that the definition clearly state that those who merely receive a commission from an underwriter are not to be construed as underwriters. Report of Special Committee on Amending the Securities Act of 1933, (1935) 60 A. B. A. Rep. 541.

60. The American Bar Association Committee seems to be of the opinion that it does, recommending that sec. 2(11) be amended to exclude the "true" underwriter and to prohibit sales by him for six months after his acquiring the securities. (1935) 60 A. B. A. Rep. 541. See also Dodd, Amending the Securities Act (1935) 45 Yale L. J. 203-4.

61. Douglas and Bates, Some Effects of the Securities Act upon Investment Banking (1933) 1 U. of Chi. L. Rev. 283, 286.

62. *Id.* at 294.

writers have sufficient money to carry on such a business without selling some of the securities. If a sale were made under such circumstances, the underwriter's original purchase might be construed to be "with a view to distribution." Moreover, "a view to distribution" is purely a matter of motive. If there were several underwriters, one could never be certain to whom such a motive might be imputed. If anyone were later found to have had such a motive when he purchased, all would be held to be underwriters under Section 2(11) by virtue of their participation.⁶³

The above definition of "underwriter" also specifically excludes "a person whose interest is limited to a commission⁶⁴ from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission."⁶⁵ A dealer, however, who does not do strict underwriting but merely subscribes in advance of orders from customers may nevertheless be deemed to be an underwriter if a strict construction of this Section is adopted.⁶⁶ By virtue of the last sentence in the above definition an underwriter might also be an "issuer." But the fact that the underwriter from whom the commission is received is such an issuer does not make the dealer receiving the commission an underwriter.⁶⁷

No distinction is made between the originating house and other underwriters. Before an issue is finally floated,⁶⁸ the originating house performs active duties of investigation and of consultation with the issuer. As to these preliminary negotiations, the originator incurs no risk of liability, by reason of the fact that "preliminary negotiations" between the issuer and underwriter are expressly excluded from the definition of "sell."⁶⁹ The originator

63. *Ibid.*

64. See Rule 141 (a), interpreting "commission." (1937) 133 C. C. H. Stocks & Bonds Law Serv. par. 5141.

65. See Rule 141 (c), interpreting "usual and customary * * * commission." (1937) 133 C. C. H. Stocks & Bonds Law Serv. par. 5141.

66. Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 Yale L. J. 171, 202.

67. Throop and Lane, *Some Problems of Exemption under the Securities Act of 1933* (1937) 4 Law & Contemp. Prob. 89, 116. Rule 141(b) also provides: "The term 'commission from an underwriter or dealer' in Section 2(11) shall include commissions paid by an underwriter or dealer directly or indirectly controlling or controlled by, or under direct or indirect common control with the issuer." (1937) 133 C. C. H. Stocks & Bonds Law Serv. par. 5141.

68. For an excellent explanation of the flotation of a new issue from origination to retail selling, see Douglas and Bates, *Some Effects of the Securities Act upon Investment Banking* (1933) 1 U. of Chi. L. Rev. 283.

69. Sec. 2(3) in defining the term "sell" reads: "* * * except that such term shall not include preliminary negotiations or agreements between an issuer or an underwriter * * *."

has not yet become an underwriter because, under Section 2(11), he has not yet purchased from or sold for an issuer. But the activities of the originating house with others whom it intends to invite to share in the underwriting are not excluded, for invitations to participate constitute "offers to sell" and "attempts to dispose of securities or an interest in securities."⁷⁰ On this ground, even before any commitment has been made, the originating house incurs liability on the registration by reason of its participation; certainly it does so as soon as it buys.⁷¹

III

A dealer is defined by Section 2(12) of the Act as "any person who engages either for all or a part of his time, indirectly⁷² or directly, as agent, broker, or principal in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person." A dealer may engage in the trading in and/or the distribution of securities. Generally as to trading his transactions are exempt from the provisions of Section 5, but as to distribution they are not. Under Section 4(1) none of his transactions involving a security within one year of its public offering are exempt.⁷³ This in effect raises a presumption that all sales by a dealer within that period are a part of the distribution.⁷⁴ In *Securities and Exchange Commission v. Brooklyn Manhattan Transit Co.* it is said that this presumption is subject to refutation on a showing of facts that distribution was completed within less than one year.⁷⁵ This concession, however, would seem questionable in view of the explicit language of Section 4(1).⁷⁶ Distribution is not defined in the Act proper, but

70. Douglas and Bates, *supra*, note 68, at 289; see also note 50, *supra*.

71. Douglas and Bates in the article cited *supra*, note 68, discuss at pages 289 to 297 what possibilities for reducing underwriting risks seem unavailable. It seems likely that under the act as is, little can be done practically to lessen the hazard.

72. The American Bar Association Committee recommended that this phrase be eliminated for the same reason as in sec. 2(11), see note 59, *supra*, Report of Special Committee on Amending the Securities Act of 1933 (1935) 60 A. B. A. Rep. 541.

73. The period of a year is taken as being the length of time needed for the average public offering. (1933) H. R. Rep. No. 85, 73rd Cong., 1st Sess., 16, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2202.011. Any time during which a stop order is in effect as to a security is not to be included in the computation of this period. Sec. 4(1).

74. *Securities and Exchange Commission v. Brooklyn Manhattan Transit Co.* (1935) 1 S. E. C. 147, 162. Were this not so, a dealer might attempt evasion on the ground that the security he sold was acquired after the process of distribution had ended.

75. 1 S. E. C. at 163.

76. " * * * except transactions within one year after the first date upon which the security was bona fide offered to the public * * *." Douglas and

in Rule 140 the Commission has stated that

A person, the chief part of the business of which consists in the purchase of the securities of any one issuer, its subsidiary and/or affiliate, and in the sale of its own securities to furnish the proceeds with which to acquire the securities of such issuer, subsidiary and/or affiliate, is to be regarded as engaged in the distribution of the securities of such issuer, subsidiary and/or affiliate * * * .⁷⁷

In the original distribution of an issue, the dealer acquires his share of the securities either from the originating house or from members of the buying syndicate, depending on whether he is himself a member of such buying syndicate.⁷⁸ Sales by the dealer in such circumstances are obviously part of the distribution of the securities. But, suppose an initial purchaser acquires the securities in connection with a "private offering"; if a dealer subsequently acquires these securities from the initial purchaser, can he resell them to the public without a registration statement being in effect? The Commission has rendered an advisory opinion to the effect that the answer depends upon the intent with which the initial purchaser acquired the securities; if with intent to distribution, then he would be an underwriter.⁷⁹ This intent was said to be a question of fact, and the mere fact that the purchaser expressed his intent in the purchase of the securities to be for investment is not conclusive. Other factors to be considered are:

(1) the relation between the issuer and the initial purchaser; (2) the business of the latter, as for example, whether such purchaser is an underwriter or dealer in securities, and if not, whether the purchase of such a block of securities is consistent with its general operation, and (3) the length of time elapsing between the acquisition of the securities by the initial purchaser and the date of their proposed resale.⁸⁰

If the initial purchase really was for investment and not for re-

Bates in their article, *The Federal Securities Act of 1933* (1933) 43 *Yale L. J.* 171, 208, say that, even though the dealer had nothing to do with the distribution of the security, his transactions within that period are subject to sec. 5.

77. *Securities Act Release No. 47*, Sept. 22, 1933, (1937) 133 *C. C. H. Stocks & Bonds Law Serv.* par. 5140.01.

78. Douglas and Bates, *Secondary Distribution of Securities* (1932) 41 *Yale L. J.* 949, 951.

79. *Securities Act Release No. 603*, Dec. 16, 1935, (1936) 133 *C. C. H. Stocks & Bonds Law Serv.* par. 2202.021.

80. *Ibid.*

sale, registration would not be required.⁸¹ Since, however, the motive for a purchase is a difficult matter to ascertain, the dealer in such a transaction takes a substantial risk.⁸²

Again, one may suppose a case where the securities presently being publicly offered are an addition to a class already outstanding. Under Section 3(a) (11) any security sold or bona fide offered to the public before or within sixty days after the enactment of the Act need not be registered.⁸³ This would exempt from registration the outstanding securities, and, therefore, a prospectus need not be used in the sale thereof. But this would not affect those presently being offered. If the dealer intends to take advantage of this exemption, he must see to it that some differentiation is made between the two issues. It will be seen that for practical reasons, this would be impossible, and the dealer under such circumstances sells at his own risk unless he gives a prospectus first.⁸⁴ A registration statement, moreover, must be filed for the whole issue (including those outstanding before the passage of the Act) in the event of a redistribution of the securities. Although it would seem that an exemption, once acquired, should continue even though a secondary distribution follows, "this conclusion * * * is necessary to relieve the dealer from the burden of tracing the history of securities dealt in to ascertain whether they come from a block accumulated in the hands of a controlling person."⁸⁵

It may be noted that, as to securities constituting the whole or a part of an unsold allotment to or subscription by a dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter, transactions by a dealer are not exempt.⁸⁶

81. *Securities and Exchange Commission v. Brooklyn Manhattan Transit Co.* (1935) 1 S. E. C. 147, 153, where it is said that the "bonds could not be considered 'sold' until they had reached the hands of purchasers buying for investment and not with a view to further distribution or for purposes of resale." See also (1937) 133 C. C. H. *Stocks & Bonds Law Serv.* par. 8595.

82. See discussion of motive in reference to "with a view to distribution," *supra*, p. 393.

83. For a summary of the results implicit in secs. 3(a) (1) and 4(1) see Throop and Lane, *Some Problems in Exemptions under the Securities Act of 1933* (1937) 4 *Law & Contemp. Prob.* 89, 121. Is a pledge of a block of securities made before the effective date of the Act considered as "sold" or "disposed of by issuer" so as to be exempt under sec. 3(a) (1)? See Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 *Yale L. J.* 171, n. 58.

84. Throop and Lane, *supra*, note 83 at 122. Under Rule 153, however, if the security is dealt with on a registered exchange, the commission allows the deposit of prospectuses there so as to be available to public.

85. Throop and Lane, *supra*, note 83, at 121, n. 90.

86. Sec. 4(1).

From these various situations one obvious hardship to the dealer appears, that is, that nowhere in the Act is provision made whereby he can force a registration statement to be filed.⁸⁷ Without this protection the hands of the dealer are virtually tied. Under Section 10(b) (1) a prospectus must be revised and brought up to date every twelve months. Here again, however, the Act gives the dealer no power to obtain a freshly dated prospectus.⁸⁸ A dealer who at the end of a twelve-month period has on hand some unsold securities must therefore either be in a position to secure and furnish a revised prospectus or be precluded from dealing in that security publicly until such can be furnished.

IV

The Act also exempts from the provisions of Section 5, "brokers' transactions executed upon customers' orders on any exchange or in the open or counter market"; but where they are the result of solicitation by the broker, the exemption is lost.⁸⁹ It contains no separate definition of "broker," but defines a dealer as one who engages in the trading in securities as "agent, broker, or principal."⁹⁰ Indeed it is common for a broker to act as a dealer in some transactions, depending upon whether the market is such that it is more advantageous for him so to act.⁹¹ While as to a dealer the entrance of a stop order tolls the running of the period during which the dealer's transactions are non-exempt, as to brokers' transactions the stop order has no effect. In the event one is entered as to a security, one may nevertheless dispose of his holdings of the security in question through his broker and thereby cut any losses that may have resulted. A free market is thereby maintained. On the other hand the entering of a stop order prevents further distribution of the security.⁹² If a broker solicits⁹³ orders or buys and sells for his

87. Douglas and Bates, *Some Effects of the Securities Act upon Investment Banking* (1933) 1 U. of Chi. L. Rev. 283, 303.

88. *Ibid.*

89. Sec. 4(2).

90. See Throop and Lane, *Some Problems in Exemptions under Securities Act of 1933* (1937) 4 Law & Contemp. Prob. 89, 113, n. 56. Ordinarily the relationship between broker and customer in the execution of an order is that of agent and principal. Meyer, *Stock Brokers and Stock Exchanges* (1931) 39. Is then the broker liable under sec. 12 to his customer? If he is an agent of the customer, has he "sold" to him? See Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 Yale L. J. 171, 207.

91. Douglas and Bates, *Secondary Distribution of Securities* (1932) 41 Yale L. J. 949.

92. (1933) H. R. Rep. No. 85, 73rd Cong., 1st Sess., 16, (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2201.01.

93. "Solicitation" is not defined in the Act.

own account, he is placed under the same restrictions as is a dealer.⁹⁴ In *Securities and Exchange Commission v. Brooklyn Manhattan Transit Co.*⁹⁵ it was urged that the phrase "but not the solicitation of such orders" applies only to the act of solicitation, and that therefore a broker can solicit the order without the use of the mails or means of interstate commerce and thus be exempt from Section 5, even though the mails and/or means of interstate commerce be used to complete the order. The court held, however, that this was not a proper interpretation of the phrase,⁹⁶ stating that:

A transaction by a broker filling an unsolicited order is perhaps properly exempted from these requirements. He has not induced the sale; his conduct has in no way prejudiced the position of the buyer; he has not assumed the responsibility of using his experience and superior knowledge of the investment to induce the buyer to buy; he has not induced the buyer to rely on his judgment. In the case of solicited transactions, however, the broker's position and interest in, and his responsibility for, the transaction cannot in substance be distinguished from the case of a dealer who is selling for his own account.⁹⁷

A further interpretation of the term "solicitation" is found in a release of the Securities and Exchange Commission advising in a case in which a corporation called in its bonds for redemption and contemplated the flotation of a new issue of debentures. A registration statement had been filed but was not yet in effect.⁹⁸ Certain financial houses circularized the holders of the bonds, informing them of the call for redemption and suggesting that they present their bonds. The letters also advised of the pendency of a registration statement for the new issue, and that the new bonds would soon be offered. The houses offered their services as "buying agents" for the old bond-holders in reference to purchases of the new issue. The letter further stated that the services were offered only for execution of orders for accounts of customers, and that no recommendation was being made as to the new debentures. The Commission felt that "a circular let-

94. Douglas and Bates, *The Federal Securities Act of 1933* (1933) 43 Yale L. J. 171, 206.

95. (1935) 1 S. E. C. 147.

96. See to same effect Securities Act Release No. 1256, Feb. 9, 1937, (1937) 133 C. C. H. Stocks & Bonds Law Serv. par. 8583.

97. *Securities and Exchange Commission v. Brooklyn Manhattan Transit Co.* (1935) 1 S. E. C. 147, 172.

98. Under sec. 8(a) 20 days must elapse after registration statement is filed before it becomes effective.

ter of this type would obviously be a 'solicitation of an offer to buy' the new debentures, and would therefore involve a 'sale' of such debentures within the meaning of the term 'sell' as defined in Section 2(3) of the Securities Act.⁹⁹

V

That the real purpose of the Securities Act is to control the distribution of securities as distinguished from the trading in them¹⁰⁰ is well indicated by the above exemptions and the remaining exemption of all transactions by persons other than issuers, underwriters, and dealers.¹⁰¹ This exemption plus the previous one concerning brokers are the real stalwarts insuring a free and open market for trading in so far as the Securities Act is concerned. An instance where an individual buys fifty shares of stock in a corporation through the medium of his broker is easily categorized as being within this exemption; conversely as to an outright underwriting. The position of a mere pledgee, however, might present some difficulty. The definition of "underwriter" in the Act is sufficiently broad to include a pledgee.¹⁰² Neither the courts nor the Commission have been presented with his problem as yet, but it would seem that an interpretation of the definition from a functional point of view would lead to the conclusion that a bona fide pledgee is not to be construed as an underwriter.¹⁰³ In all other cases that may arise, it is obvious that the exemption is available or not depending upon whether one's activities are such as not to place him in the character of an issuer, underwriter or dealer according to the interpretations in the foregoing sections.

VI

The Securities Act in addition to providing exemptions for certain transactions in Section 4, provides for additional exemptions of certain securities in Section 3. These stand in a separate category except in so far as every transaction involving an exempt security is *a fortiori* an exempt transaction. Under Section 3(b) any issue of securities where the aggregate amount is not in excess of \$100,000 is exempt. In so far as it applies to all

99. Securities Act Release No. 1256, Feb. 9, 1937, (1937) 133 C. C. H. Stocks & Bonds Law Serv. par. 8583.

100. (1933) H. R. Rep. No. 85, 73rd Cong., 1st Sess., 15-16 (1936) 133 C. C. H. Stocks & Bonds Law Serv. par. 2204.01.

101. Sec. 4(1).

102. See discussion *supra* p. 392 for definition of underwriter. A pledgee who sells a pledge under a power of sale is really selling for the account of the pledgor.

103. Throop and Lane, Some Problems in Exemptions under Securities Act of 1933 (1937) 4 Law & Contemp. Prob. 89, 124.

securities, regardless of other facts and circumstances, this provision also constitutes an exempt transaction. However, let it be remembered that all the exemptions heretofore referred to are exemptions from the registration and/or prospectus requirements of Section 5. By reason of the Securities Act, it is now the law that even if a registration statement is in effect as to a security, or even if the security is exempt under Section 3 of the Act and the transaction in which it figures is also exempt under Section 4 of the Act, one may still be liable for fraud in the sale of the security under Sections 12 and 17 and this for the first time under Federal Statute. From Sections 12 and 17 there are no exemptions.

BERNARD SUSMAN.

STATUTORY DAMAGES FOR COPYRIGHT INFRINGEMENT

Legislatures and courts have long been baffled by the problem of proper redress for infringement of copyright.¹ The Constitution grants exclusive power in the copyright field to Congress.² Pursuant to this provision statutes have been enacted which govern the various phases of copyright regulation and practice,³ *inter alia*, the matter of remedies in cases of infringement.⁴ Equity, with⁵ or without⁶ statutory authorization, however, will enjoin infringement of a copyright. Recovery may be had of a money judgment, measured by profits which have accrued to the offender,⁷ damage sustained by the copyright owner,⁸ and lost

1. See generally Caplan, *The Measure of Recovery in Actions for Infringement of Copyright* (1939) 37 Mich. L. Rev. 564; Lerner, *Copyright Law and Its Sanctions* (1938) 7 Brooklyn L. Rev. 523; Solberg, *Copyright Law Reform* (1925) 35 Yale L. J. 48; Solberg, *The Present Copyright Situation* (1931) 40 Yale L. J. 184.

2. U. S. Const. Art. I, Sec. 8: "The Congress shall have power * * * To promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."

3. (1927) 17 U. S. C. A. secs. 1-62.

4. (1909) 35 Stat. 1031, (1912) 37 Stat. 489, (1927) 17 U. S. C. A. sec. 25, hereinafter cited as 17 U. S. C. A. sec. 25.

5. 17 U. S. C. A. sec. 25 (a); Admur, *Copyright Law and Practice* (1936) 1170; Copinger, *Law of Copyright* (6th ed. 1927) 167 et seq.

6. *Wilkens v. Aiken* (Ch. 1810) 17 Ves. 422, 34 Eng. Rep. 163; *Lawrence v. Smith* (Ch. 1827) Jacob 473, 37 Eng. Rep. 928; *Spottiswoode v. Clark* (Ch. 1846) Coop. T. Cott. 254, 47 Eng. Rep. 844; *Pierpont v. Fowler* (C. C. D. Mass. 1846) 19 Fed. Cas. No. 11,152; *West Publishing Co. v. Thompson* (C. C. E. D. N. Y. 1909) 169 Fed. 883.

7. Statutory provision is found in 17 U. S. C. A. sec. 25 (b). See also Admur, *Copyright Law and Practice* (1936) 1112; Caplan, *The Measure*