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## INTRASTATE OFFERINGS UNDER RULE 147

J. William Hicks\*

SECTION 3(a)(11)<sup>1</sup> of the Securities Act of 1933 exempts from the registration requirements<sup>2</sup> of that Act the offer and sale of securities that are part of an issue offered and sold only to persons resident within a single state or territory where the issuer is a person resident and doing business within that state or territory.<sup>3</sup> The intrastate exemption, as section 3(a)(11) is sometimes called, is intended to apply when local industries seek financing from local investors.<sup>4</sup> Persons claiming the exemption have the burden of proving that (1) the issuer is a resident of the state in which the offering is to occur and, if it is a corporation, that it is incorporated in that state; (2) the issuer is doing a substantial amount of its business in that state; (3) the proceeds of the offering are to be used within that state; (4) all offerees and purchasers are residents of that state; (5) the securities offered pursuant to the exemption have come to rest<sup>5</sup> in the hands of persons residing in that state; and (6) the entire issue of securities was offered and sold pursuant to section 3(a)(11).<sup>6</sup> An issuer that fails to meet all

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1. 15 U.S.C. § 77c(a)(11) (1970). The section exempts "[a]ny security which is 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." See generally SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2270 (1973) [hereinafter Release 4434]; SEC Securities Act Release No. 1459 (May 29, 1937), 1 CCH FED. SEC. L. REP. ¶ 2260 (1973) [hereinafter Release 1459]; McCauley, *Intrastate Securities Transactions Under The Federal Securities Act*, 107 U. PA. L. REV. 937 (1959).

2. See Securities Act of 1933, §§ 5-8, 15 U.S.C. §§ 77e-77h (1970).

3. The exemption provided by section 3(a)(11) applies only to the registration requirements of section 5 of the Act. The antifraud and civil liability provisions of the Act are applicable if the issuer utilizes the requisite jurisdictional means, *i.e.*, the mails or any means or instrumentalities of transportation or communication in interstate commerce. The antifraud provisions of the Act are contained in section 17. 15 U.S.C. § 77q (1970). Section 12(2) of the Act sets forth the conditions precedent to the imposition of civil liability. 15 U.S.C. § 77l(2) (1970).

4. Release 4434, *supra* note 1, at 1, ¶ 2270 at 2607-08.

5. The SEC uses the phrase "come to rest" to describe its requirement that the securities sold under the intrastate exemption be held by the original purchasers (or by subsequent purchasers who also reside in the state) for more than a brief period of time. Without such a requirement the intent of section 3(a)(11) could be easily evaded by using the initial purchasers as conduits to place the securities in the hands of out-of-state residents.

6. See generally Release 4434, *supra* note 1. The availability of the exemption does

of these conditions<sup>7</sup> exposes itself to civil liability and administrative sanctions.<sup>8</sup>

It is often difficult to determine whether the exemption provided by section 3(a)(11) is available, for the language of the statute is not precise. A careful reading of the section will not reveal the intended meanings of such terms as "part of an issue," "person resident," or "doing business within," and a common sense approach to the language can be dangerous. The courts and the Securities and Exchange Commission (SEC) have consistently interpreted the exemption strictly in order to ensure that it is used only for the purpose that Congress intended.<sup>9</sup> However, the judicial and administrative interpretations of section 3(a)(11) have not eliminated the ambiguities in the statute's language. As a result, use of the intrastate exemption has been characterized by a chairman of the SEC as being "loaded with dynamite."<sup>10</sup>

In an effort to publicize administrative and judicial interpretations of the exemption, to protect investors, and to provide more certainty in determining the parameters of section 3(a)(11), the SEC has adopted rule 147.<sup>11</sup> This Article, in three parts, will examine

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not depend upon the avoidance of means or instrumentalities of interstate commerce or of the mails. If these jurisdictional means are never used throughout the intrastate offering, the Act would not apply, and an exemption would be unnecessary. *See Securities Act of 1933, § 5, 15 U.S.C. § 77e (1970).*

7. Strict compliance with the exemption requirements is demanded. *See, e.g., Professional Investors, Inc., 37 S.E.C. 173 (1956)*, where the issuer sold all of its 30,000 shares of stock to residents of Indiana with the limited exception of 20 shares that were sold to one nonresident. The issuer had satisfied all the other requirements for the intrastate exemption. It was held that section 3(a)(11) did not apply. For other examples where one sale to a nonresident has defeated the exemption, see *Shaw v. United States, 131 F.2d 476 (9th Cir. 1942)*; *Edsco Mfg. Co., 40 S.E.C. 865 (1961)*; *Universal Serv. Corp., 37 S.E.C. 559 (1957)*; *Peterson Engine Co., 2 S.E.C. 893 (1937)*.

8. The SEC can invoke one or more of several sanctions against an issuer that misuses the exemption: (1) threaten an injunction to prohibit further distribution of securities until a registration statement is filed, *see Securities Act of 1933, § 20(b), 15 U.S.C. § 77t(b) (1970)*; (2) require disclosure of the issuer's contingent liability under section 12(1), 15 U.S.C. § 77l(1) (1970), with respect to those securities already sold in violation of section 5; (3) insist on an offer of rescission and redemption for all securities transactions consummated prior to the violation, including those involving residents of the state; and (4) recommend criminal prosecution under section 24, 15 U.S.C. § 77x (1970). *See Comment, The Intrastate Exemption: Current Law, Local Practice and the Wheat Report, 31 OHIO ST. L.J. 521, 532 (1970).*

9. *See Release 4434, supra note 1, at 4, ¶ 2270 at 2611; cases cited in note 7 supra.*

10. Gadsby, *The Securities and Exchange Commission and the Financing of Small Business*, 14 BUS. LAW. 144, 148 (1958).

11. SEC Securities Act Release No. 5450 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶ 79,617 [hereinafter Release 5450]. The rule is effective for issues of securities commenced on or after March 1, 1974, and will be codified at 17 C.F.R. § 230.147. The rule was proposed in 1973. SEC Securities Act Release No. 5349 (Jan. 8, 1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,168 [hereinafter Release 5349]. It was first mentioned pub-

that rule. Part I is devoted to an explanation of the rule; it will indicate how the rule differs from earlier interpretations of section 3(a)(11) and discuss the problems that the rule leaves unanswered. Part II will consider the interrelationships among the various sections of the rule, as well as interpretative issues that have not yet arisen under section 3(a)(11). Part III will assess the rule in terms of the original purposes of the intrastate exemption.

#### I. RULE 147—AN OVERVIEW

Paragraph (a) of rule 147 identifies the transactions covered by the rule. Paragraphs (b), (c), and (d) clarify what is meant in section 3(a)(11) by the phrases "part of an issue," "person resident within," and "doing business within." Paragraph (e) provides objective standards for determining when an issue comes to rest; paragraph (f) requires issuers to take certain specified steps that are designed to protect against interstate distribution of the securities. Securities Act Release No. 5450, which accompanied the SEC's promulgation of the rule, and the preliminary notes<sup>12</sup> to the rule emphasize that the rule is not intended to be exclusive.<sup>13</sup> Persons may claim a section 3(a)(11) exemption without complying with the rule if they meet the conditions set forth in administrative and judicial interpretations in effect at the time of the transaction.

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lily by William J. Casey, then Chairman of the SEC, in an address to the American Bar Association Convention on August 15, 1972, reprinted in 28 BUS. LAW. 537, 538-39 (1973). The rule is the fourth in a series of efforts by the SEC to establish more objective standards for interpreting and applying the federal securities laws. Other SEC efforts in this regard are (1) the adoption of rule 144, SEC Securities Act Release No. 5223 (Jan. 11, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487 (codified at 17 C.F.R. § 230.144 (1973) (specifies what persons are not deemed to be engaged in a distribution of securities and therefore are not underwriters as defined in section 2(11) of the Act)); (2) the adoption of rule 145, SEC Securities Act Release No. 5316 (Oct. 6, 1972), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,015 (codified at 17 C.F.R. § 230.145 (1973) (defines the terms "offer" and "sale" in Section 2(3) of the Act to include reclassification of securities, statutory mergers or consolidations, and transfers of assets for securities)); and (3) the announcement of proposed rule 146, SEC Securities Act No. 5336 (Nov. 28, 1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,108 [hereinafter Release 5336] (explains when the nonpublic offering exemption (section 4(2)) is available), and the announcement of revised proposed rule 146, SEC Securities Act Release No. 5430 (Oct. 10, 1973), [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,529 [hereinafter Release 5430]. Proposed rule 146 in its revised form can be found in 1 CCH FED. SEC. L. REP. ¶ 2709 (1973) [hereinafter Proposed Rule 146].

12. Rule 147 contains four preliminary notes. The first preliminary note states that noncompliance with the terms and conditions of the rule raises no presumption that section 3(a)(11) is not otherwise available. In the second note the SEC reminds issuers that the rule does not affect compliance with state law. The third preliminary note summarizes the rule and explains its purpose. The fourth states that the rule is available for primary distributions only.

13. Release No. 5450, *supra* note 11, at 83,650; Rule 147, preliminary note 1.

### A. Transactions Covered by Rule 147

Rule 147(a) provides:

(a) *Transactions Covered.*

Offers, offers to sell, offers for sale and sales by an issuer of its securities made in accordance with all of the terms and conditions of this rule shall be deemed to be part of an issue offered and sold only to persons resident within a single state or territory where the issuer is a person resident and doing business within such state or territory, within the meaning of Section 3(a)(11) of the Act.

This section reaffirms the position that the intrastate exemption covers only specific transactions and not the securities themselves, even though the exemption is subsumed under section 3 of the Act, which is concerned with exempt securities.<sup>14</sup> In this respect the rule is hardly surprising.<sup>15</sup> On the other hand, the scope of rule 147 is narrower than the traditional coverage of section 3(a)(11). The SEC has uniformly interpreted the intrastate exemption as applicable to both primary and secondary distributions,<sup>16</sup> but by limiting the rule to offers and sales "by an issuer of its securities,"<sup>17</sup> the SEC has chosen to provide more certainty only in the use of the exemption by issuers.

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14. See Release 4434, *supra* note 1, at 1, ¶ 2270 at 2608; Throop & Lane, *Some Problems of Exemption Under the Securities Act of 1933*, 4 LAW & CONTEMP. PROB. 89 (1937). Sections 3 and 4 of the Act provide certain specific exemptions from the registration requirements of section 5. The heading for section 3, "[e]xempted securities," suggests that all the securities included under it are exempted, but only securities covered by sections 3(a)(2) through 3(a)(8) are treated as exempt securities. Sections 3(a)(1), 3(a)(9), 3(a)(10), 3(a)(11), and 3(b) are, in reality, transactional exemptions and are viewed as though they were included under section 4. Section 5 of the Act as drafted in 1933 generally prohibited any use of the mails or instrumentalities of interstate commerce in the sale of securities. Securities Act of 1933, ch. 38, tit. I, § 5, 48 Stat. 77. Congress narrowed the sweep of these prohibitions in section 5(c) by exempting securities sold by issuers within a single state by use of the mails. Securities Act of 1933, ch. 38, tit. I, § 5(c), 48 Stat. 77. In 1934, Congress repealed section 5(c) and repositioned the intrastate exemption in section 3(a)(11). Securities Exchange Act of 1934, ch. 404, § 202, 48 Stat. 906. The amendment adding section 3(a)(11) was aimed at accomplishing two purposes. First, by placing the exemption under section 3, Congress intended to support an interpretation of section 5(c) rendered by the Federal Trade Commission that securities entitled to exemption on original issuance because of section 5(c) would retain that exemption in the hands of dealers. Second, the amendment made it clear that, in addition to use of the mails, one could use the instrumentalities of interstate commerce and not forfeit protection. H.R. REP. NO. 1838, 73d Cong., 2d Sess. 40-41 (1933). See also Throop & Lane, *supra*, at 107.

15. Rule 147(a) is substantially the same as proposed rule 147(a). See Proposed Rule 147(a) in Release 5349, *supra* note 11, at 9.

16. Release 4434, *supra* note 1, at 3, ¶ 2270 at 2609.

17. In its explanation of the rule, release 5450 is not completely clear on this point. The SEC states at the conclusion of release 5450 that "Rule 147 . . . is not available for secondary offerings." Release 5450, *supra* note 11, at 83,654. However, in that portion of the release devoted to an explanation of rule 147(e) it states that "[p]ersons who acquire securities from issuers or affiliates in transactions complying with the rule would acquire

The SEC has stated in the past that a secondary offering by a person in control of the issuer may be made in reliance on section 3(a)(11) "provided the exemption would be available to the issuer for a primary offering in that state."<sup>18</sup> Unfortunately, this pronouncement does not sufficiently aid a person who contemplates a secondary distribution under section 3(a)(11) because it requires the person to guess which conditions of a valid primary intrastate offering will also apply to him. One might reasonably conclude that the exemption provided by section 3(a)(11) is available in a secondary distribution if the controlling person can demonstrate that the issuer is incorporated in and doing business within the state where the secondary offering will occur. However, this conclusion ignores several problems: Must the controlling person also be doing business in the issuer's state? Is it necessary to determine the circumstances under which the controlling person acquired the securities to be offered? Securities Act Release No. 4434, the principal SEC interpretative release dealing with section 3(a)(11), would indicate that these questions should be answered in the negative, for it suggests that, in the case of secondary distributions, the focus should be on the issuer and not on the controlling person.<sup>19</sup> But two recent SEC staff responses to requests for no-action letters<sup>20</sup> cast doubt on the position taken by the SEC in release 4434.

In one situation,<sup>21</sup> both the issuer and the controlling person were corporations. National Investment Corporation (National), a Kansas corporation, was a controlling stockholder of Continental Investors

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unregistered securities that could only be reoffered and resold pursuant to an exemption from the registration provisions of the Act." Release 5450, *supra*, at 83,653 (emphasis added). In view of the explicit language in rule 147(a), it is hard to understand how one could acquire securities from an affiliate in a transaction "complying with the rule."

18. Release 4434, *supra* note 1, at 3, ¶ 2270 at 2609.

19. *Id.*

20. A "no-action letter" is an informal opinion of certain SEC officials and is not binding on the Commission itself. The staff of the SEC is usually presented with a specific factual situation and counsel's opinion that a certain legal position is correct under the circumstances. The staff is then asked to assure the writer that no action will be taken by the Commission if the contemplated activity occurs. Responses to requests for no-action letters involving section 3(a)(11) come from the Division of Corporate Finance. Since December 1, 1970, the SEC has published requests for no-action letters, together with the responses by the Commission staff. SEC Securities Act Release No. 5098 (Oct. 29, 1970), [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,921. In its announcement of this policy, the SEC issued the following caveat: "It should be recognized that no-action and interpretative responses by the staff are subject to reconsideration and should not be regarded as precedents binding on the Commission." *Id.* at 2, ¶ 77,921 at 80,052. Nonetheless, the no-action letter "remains a highly useful and popular tool." 6 L. LOSS, SECURITIES REGULATION 4024 (2d ed. supp. 1969).

21. Continental Investors Life Ins. Co., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,084 (March 4, 1971).

Life Insurance Company, Inc. (Continental), a Colorado corporation authorized to do business only in Colorado. National proposed a plan through which Continental agents, district supervisors, regional supervisors, and lower-echelon employees could purchase Continental stock from National. All of the intended offerees and purchasers were residents of Colorado. National planned to designate a Kansas bank as the trustee to receive and hold the proceeds of each sale for the benefit of National. The SEC staff concluded that section 3(a)(11) did not apply. It stated that "[t]he diversity of citizenship of the parties and the payment of proceeds to a non-Colorado corporation in our opinion destroys the local nature of the offering. We refer you to Securities Release 4434 discussing Section 3(a)(11)."<sup>22</sup> Release 4434 would suggest that there is only one problem with the offering, because it explicitly eliminates the need for identical residency between the issuer and the offeror.<sup>23</sup> Therefore, according to that release, the "diversity of citizenship of the parties" would not destroy the local nature of the offering. The only impediment to an exemption would be that the proceeds were not to be used "locally." Perhaps the SEC staff position would have been different had National selected a Colorado trustee and earmarked the proceeds for use in Colorado.

In another request for a no-action letter, the SEC staff was asked whether a controlling individual stockholder could sell his securities pursuant to section 3(a)(11).<sup>24</sup> The staff decided that the intrastate exemption did not apply because

[t]he securities proposed to be sold do not appear from the facts presented to be of an issue offered and sold only to persons resident within a single state. It is clear from a reading of Securities Act Release No. 4434 that the exemption contained in section 3(a)(11) is available only to persons proposing to finance an enterprise meeting the requirements established in said section. The burden is on the claimant to prove that the securities are part of an issue by the issuer thereof which when made, was in compliance with the provisions of section 3(a)(11).<sup>25</sup>

No other authority can be found for the proposition that section 3(a)(11) exempts secondary distributions only where the offeror can demonstrate that he acquired his shares in an earlier intrastate offer-

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22. *Id.* at 80,350.

23. "It is not essential that the controlling person be a resident of the issuer's state of incorporation." Release 4434, *supra* note 1, at 3; ¶ 2270 at 2609.

24. Consolidated Bankshares of Fla., Inc., [1972] CCH FED. SEC. MICROFILM, roll 11, frame 17560 (Oct. 24, 1972).

25. *Id.*

ing.<sup>26</sup> In fact, the SEC staff response is inconsistent with other administrative interpretations of section 3(a)(11).<sup>27</sup>

The risks are high in any offering under section 3(a)(11), even when the law can be understood.<sup>28</sup> They are higher in secondary distributions, where the applicable legal standards are neither clearly delineated nor consistently interpreted.<sup>29</sup> If the SEC chooses to restrict section 3(a)(11) to primary distributions, as Congress probably intended,<sup>30</sup> it should do so explicitly, but if the SEC and the courts intend to permit secondary distributions under section 3(a)(11), the public should be provided with clear standards.

### B. *The "Part of an Issue" Concept*

The intrastate exemption applies to "any security which is part of an issue" offered and sold exclusively to residents of the same state; an offeror who seeks a section 3(a)(11) exemption must offer and sell the *entire* issue of securities intrastate. The danger to the unwary lies in determining what constitutes an issue. Two or more apparently unrelated securities offerings by an issuer could be viewed by the SEC or the courts as integral parts of a single issue for purposes of section 3(a)(11).<sup>31</sup> Such an integration of offerings means that a prior or sub-

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26. Throop and Lane have suggested an interpretation that may have formed the basis for the staff position in Consolidated Bankshares: "Furthermore, it seems questionable whether the exemption would be available [to a controlling stockholder] unless the entire issue of which the redistributed block, upon its original distribution by the actual issuer, formed a part, was upon such original distribution similarly confined to residents of the state of such issuer's incorporation." Throop & Lane, *supra* note 14, at 111 n.54. This position has never been adopted by the courts or the Commission.

27. See, e.g., Subaru of America, Inc., [1973] CCH FED. SEC. MICROFILM, roll 1, frame 00255 (SEC staff, Dec. 19, 1972).

28. One errant offer or sale to a nonresident can cost the issuer its exemption under section 3(a)(11). See note 7 *supra*.

29. For a critical analysis of the Commission's informal method of altering 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).

30. The SEC interprets the sparse legislative history of section 3(a)(11) to suggest that the exemption was intended to apply only to issues that represent "local financing by local industries." It feels that the focus was clearly on issues sold by "local businesses seeking finances from local sources." Release 5450, *supra* note 11, at 83,649. See H.R. REP. NO. 85, 73d Cong., 1st Sess. 6-7 (1933); H.R. REP. NO. 1838, 73d Cong., 1st Sess. 40-41 (1934). While it is possible that local industries can raise capital through the sale of securities issued by other local industries, this is not common. Local industries are more likely to achieve local financing through the sale of their own securities. In view of the arguments traditionally raised in support of section 3(a)(11), see text accompanying notes 127-32 *infra*, it seems probable that Congress envisioned the exemption as applicable only to primary distributions. But see 1 L. LOSS, SECURITIES REGULATION 594 (2d ed. 1961).

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



sequent interstate offering, even if made pursuant to a registration statement<sup>32</sup> or to an offering circular under Regulation A,<sup>33</sup> may destroy the exemption for an intrastate offering because together they form a single securities issue that has not been limited to residents. In release 4434, the SEC has identified five factors that relate to the question of integration:

- (1) Are the offerings part of a single plan of financing;
- (2) Do the offerings involve issuance of the same class of security;
- (3) Are the offerings made at or about the same time;
- (4) Is the same type of consideration to be received;
- (5) Are the offerings made for the same general purpose.<sup>34</sup>

Issuers faced with a potential integration problem may rely upon these factors<sup>35</sup> and upon the SEC's informal position that a period of at least one year between the date of an intrastate offering and any other offering of an issue of the same security "will create a presumption in favor of recognizing both offerings as two different and unintegrated issues."<sup>36</sup>

Rule 147(b) is designed to ease, in certain situations, the often

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32. See, e.g., *Texas Glass Mfg. Corp.*, 38 S.E.C. 630 (1958), where the issuer, a Texas corporation, sold 83,708 shares of its common stock and 15,425 shares of its optioned stock from January 1956 to June 1957 in reliance on section 3(a)(11). The offerings were registered under the state's blue-sky law. In May 1957, the issuer filed a registration statement with the SEC for a proposed public offering of common stock of the same class as that previously offered in the intrastate offering. The issuer's prospectus noted the earlier sales but stated that they had been exempted by section 3(a)(11). With respect to the 83,708 shares, the Commission concluded that the exemption was not available since "they were part of the same issue as the shares covered by the registration statement which are to be offered to non-residents of Texas; they are securities of the same class, and there are no substantial differences in the circumstances under which they are proposed to be offered or in the purposes of the financing." 38 S.E.C. at 634. The case involved the situation where an original intrastate offering is unsuccessful and the issuer then attempts to offer the rest of the issue by registering under the Act.

33. See, e.g., *Lexton-Ancira, Inc.*, [1971] CCH FED. SEC. MICROFILM, roll 5, frame 10295 (SEC staff, July 23, 1971). Regulation A is the SEC regulation dealing with the exemption of small issues (less than 500,000 dollars) from the registration requirements of the Act. See Securities Act of 1933, § 3(b), 15 U.S.C. § 77c(b) (1970); 17 C.F.R. §§ 230.251-263 (1973).

34. Release 4434, *supra* note 1, at 2, ¶ 2270 at 2068. The same factors are set out in preliminary note 3 to rule 147.

35. It has been suggested that the last four items are, in reality, detailed statements of the first and that it is difficult to conceive of a situation where an issuer could claim that no single plan of financing was involved when the answers to the remaining four questions are affirmative. Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 W. RES. L. REV. 110, 124-26 (1964).

36. Goldman, *The Intrastate Offering*, in *NEW TRENDS AND SPECIAL PROBLEMS UNDER THE SECURITIES LAWS* 173, 182 (A. Sommer ed. 1970). Mr. Goldman was at the time an Associate Regional Administrator for the SEC.

difficult factual determination of which offerings should be integrated. The rule provides:

(b) *Part of an Issue.*

(1) For purposes of this rule, all securities of the issuer which are part of an issue shall be offered for sale or sold in accordance with all of the terms and conditions of this rule.

(2) For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, *provided that*, there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.<sup>37</sup>

Rule 147(b) does not define "part of an issue."<sup>38</sup> Instead, it provides certainty "to the extent feasible"<sup>39</sup> by identifying certain types of offers and sales of securities that will be deemed not to be part of an issue. Where it is applicable, rule 147(b) provides an issuer with two benefits not formerly available. It obviates the need to examine the five traditional integration factors in determining whether offers and sales should be regarded as part of the same issue. It also reduces by six months the one-year waiting period between offerings that the SEC has regularly suggested.<sup>40</sup>

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37. Appended to this paragraph is the following note:

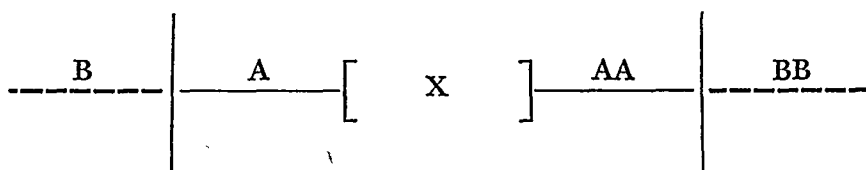
In the event that securities of the same or similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six months prior to or subsequent to any offer, offer for sale or sale pursuant to this rule, see Preliminary Note 3, hereof as to which offers, offers to sell, offers for sale, or sales are part of an issue.

38. Proposed rule 147 contained a definition of "part of an issue" that was designed "to create greater certainty and to obviate the need for a case-by-case determination of when intrastate offerings should be integrated with other offerings." Release 5349, *supra* note 11, at 5, ¶ 79,168 at 82,547. It provided, in general, for automatic integration of all securities sold by the issuer, its affiliates, and its predecessors within any consecutive six-month period. It also provided that securities offered or sold by an entity that was in a business separate and distinct from the issuer and that was affiliated with the issuer solely by reason of the existence of a common general partner would be deemed not to be part of the same issue. See Proposed Rule 147(b) in Release 5349, *supra*, at 9. On reconsideration, the Commission decided that proposed rule 147(b) "would be too restrictive." Release 5450, *supra* note 11, at 83,651. The decision by the SEC to omit a definition of "part of an issue" in rule 147 is consistent with the position taken in revised proposed rule 146, where the Commission determined that its existing guidelines relating to the integration of offerings should continue to apply to offerings made pursuant to rule 146. Release 5430, *supra* note 11, at 83,454.

39. Rule 147, preliminary note 3.

40. See Goldman, *supra* note 36, at 182.

Close analysis of paragraph (b), however, reveals that its value is limited. The following diagram depicts the time frame contemplated by Rule 147(b)(2):



X—represents the period of time during which offers or sales are made pursuant to Rule 147.

A—represents the six-month period immediately preceding X.

AA—represents the six-month period immediately after X.

B—represents the period of time immediately preceding A.<sup>41</sup>

BB—represents the period of time immediately after AA.

The usefulness of rule 147(b) can be tested by examining it in the context of the six basic transactions possible during this time frame.<sup>42</sup>

*Transaction 1.* Issuer makes no offers or sales of its securities during A, AA, B, and BB. Since there are no other offers or sales, the integration question does not arise, and the issuer has no need for rule 147(b).

*Transaction 2.* Issuer has offers or sales during B and/or BB but not during A and AA; the offers or sales are pursuant to valid exemptions provided by section 3 or section 4(2)<sup>43</sup> of the Act or pursuant to a registration statement filed under the Act. Rule 147(b) applies and the offers and sales during B and/or BB are not deemed part of the rule 147 offering, even though a contrary determination might be reached with the traditional integration factors. The point can be seen by illustration.

Corporation Z plans to offer 10,000 shares of its common stock at ten dollars per share for the purpose of expanding its principal plant. On June 1, it makes an intrastate offering under section 3(a)(11), and it completes that offering by June 15. On December 16 of the same year, Z makes another offering of its common stock at ten dollars per share for the same purpose. The December offering, however, is

41. As a practical matter, the time periods described as B and BB in the diagram can be limited to six months since it is unlikely that the SEC would integrate two offerings occurring more than one year apart. See text accompanying note 36 *supra*.

42. In each case it is assumed that the issuer satisfies the other requirements of the rule.

43. Section 4(2) of the Act provides an exemption from the registration requirements of section 5 for "transactions by an issuer not involving any public offering." 15 U.S.C. § 77d(2) (1970).

made pursuant to section 4(2) and includes some nonresident purchasers. In the absence of rule 147, the SEC would probably integrate Z's two offerings.<sup>44</sup> The SEC could point to the proximity of the financings and the similarities between them—same class of security, same type of consideration to be received, and same purpose. Under rule 147(b)(2) the December private placement would not be integrated with the June intrastate offering, which occurred more than six months earlier. A question then arises as to whether the earlier, intrastate offering, which may have involved unsophisticated purchasers, would be integrated with the subsequent private placement, thereby jeopardizing the issuer's section 4(2) exemption?<sup>45</sup> An argument in favor of integration is found in the language of rule 147(b)(2), which states that the interpretation of the phrase "part of an issue" is "[f]or purposes of this rule only."<sup>46</sup> This result would, however, defeat the whole purpose of the rule. If such an integration were effected, the 4(2) exemption would be lost. Without the valid 4(2) exemption, the conditions of subparagraph (b)(2) would not be met, and the rule 147 exemption would be lost. If the intrastate offering were not also exempt under section 4(2), it would likewise be illegal. Such an interpretation would seem perverse, and it seems very unlikely that the SEC would intend such a result. A more reasonable interpretation is that the objective test contained in the rule covers those nonintrastate offerings of securities that take place immediately prior to or immediately subsequent to an intrastate offering made in reliance upon the rule. Other nonintrastate offerings would, of course, be tested against the traditional doctrine of integration and not the objective standard in rule 147(b).

*Transaction 3.* Issuer has offers or sales during B and/or BB, but not during A and AA; the offers or sales are *not* pursuant to valid exemptions provided by section 3 or section 4(2), nor are they pursuant to an effective registration statement. Rule 147(b) does not solve the issuer's possible integration problem, and uncertainty returns in the form of the five traditional factors. If the improper offers or sales occurred during B, the issuer may have to delay its intrastate offering until one year after the last sale during B.<sup>47</sup> If the issuer completes an

44. For a discussion of integration as it relates to successive offerings made pursuant to different exemptions, see McCauley, *supra* note 1, at 944-45.

45. A section 4(2) exemption is not available if offers are made to persons not capable of making an informed investment decision. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953); Proposed Rule 146(3)(b), *supra* note 11, at 2901.

46. Further support is found in the preliminary notes, where it is stated that "[s]ubparagraph (b)(2) . . . is designed to provide certainty to the extent feasible . . . for the purposes of the rule *only*." Rule 147, preliminary note 3 (emphasis original).

47. See text accompanying note 36 *supra*.

offering pursuant to rule 147, waits six months during AA, and then makes what it erroneously believes is an exempt offering during BB, integration may occur. A finding of integration means that the sales made during BB are deemed to be part of the earlier intrastate offering. Since the issuer has not complied with rule 147(b)(1), which requires that all securities of the issuer that are part of an issue be offered or sold only in accordance with all the terms of the rule, the intrastate offering is not exempt under rule 147. The issuer now faces the consequences that arise from two securities offerings made in violation of section 5.<sup>48</sup>

*Transaction 4.* During B and/or BB issuer has offers or sales that are exempt under sections 3 or 4(2) or are registered under the Act; issuer has offers or sales during A and/or AA. Since the offers or sales during B and/or BB qualify under the first part of rule 147(b)(2), the availability of the rule depends on the nature of the securities offered or sold during A and/or AA. The protection of the rule is not available if the securities offered or sold during A and/or AA are "of the same or similar class as those offered, offered for sale or sold pursuant to the rule."<sup>49</sup> Unfortunately, neither the rule nor the accompanying release provides guidelines for making that determination.<sup>50</sup>

If the securities are found to be "of the same or similar class," the issuer must apply the five integration factors to determine whether the offers or sales during A and/or AA are part of the same issue as the intrastate offering.<sup>51</sup> To be safe, the issuer may have to postpone the intrastate offering until one year after the last offer or sale during A. If the rule 147 offering has already occurred and the offers or sales "of the same or similar class" of securities are made during AA on the erroneous belief that they will not be integrated, the issuer faces the same risks as those discussed in connection with transaction 3, where both offerings could be in violation of section 5.

The issue raised by transaction 4 can be seen by illustration. Corporation *T* plans to offer 5,000 shares of its preferred stock at five dollars per share for the purpose of acquiring new machinery for its plant. The preferred stock has dividend and liquidation preferences over *T* common stock and has no voting rights. On January 1, during

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48. For possible SEC actions, see note 8 *supra*.

49. Rule 147(b)(2).

50. *Cf.* SEC v. Hillsborough Inv. Corp., 176 F. Supp. 789 (D.N.H. 1959), *affd.*, 276 F.2d 665 (1st Cir. 1960).

51. Although the test applied by rule 147(b)(2) basically consists of one of the traditional five integration factors, *see* text accompanying note 34 *supra*, the other four factors might indicate that the issues should not be integrated.

period A, *T* makes an *interstate* offering of its preferred stock pursuant to what it in good faith believes is a valid exemption under section 4(2), and it completes the offering by January 15. Within six months of January 15, it commences an *intrastate* offering of its common stock at five dollars per share for the same purpose as the earlier offering. If *T* can establish that *T* preferred stock is not "of the same or similar class" as *T* common stock, the two offerings will not be integrated despite the proximity of the financings and the similarities between them. Furthermore, the benefits of rule 147(b)(2) are not conditioned on a finding that the offers or sales during the six months immediately before or immediately after the offering under the rule are made pursuant to sections 3 or 4(2) or to a registration statement. Under subparagraph (b)(2) *T*'s two offerings will not be deemed to be part of the same issue even if it should be decided that the offering of preferred stock was illegal and should have been registered. Such a result is surprising, and, if it was actually intended by the SEC, it raises at least two further problems for certain issuers.

The first involves disclosure. In the above illustration, integration is avoided because of rule 147(b) even though the private placement is not exempt. But suppose *T* discovers, or should have discovered, the illegality of the offering prior to its intrastate offering. The anti-fraud provisions of the federal securities laws appear to require full disclosure of that illegality to all subsequent offerees and purchasers.<sup>52</sup>

A second complication could arise where an issuer makes three or more securities offerings within one year. Assume that during period B, Corporation *R* effects an exchange of its preferred stock with *R* common stockholders pursuant to section 3(a)(9) of the Act.<sup>53</sup>

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52. For a discussion of the disclosure regulations of the Act and of the Securities Exchange Act of 1934, see 1 L. Loss, *supra* note 30, at 184-86; 3 *id.*, at 1421-519; McCauley, *supra* note 1, at 955-58. Professor Loss has questioned the advisability of transforming every violation of the registration or prospectus provisions of section 5 (when the seller did not disclose the violation) into a section 12(2) action, 3 L. Loss, *supra*, at 1701-02 n.51, but he states that "the possibility cannot be ignored, if only because the statute of limitations under §12(2) may occasionally be longer than that under §12(1)." 6 L. Loss, *supra* note 20, at 3831-32. It would seem, however, that a material misrepresentation of fact would occur when an issuer fails to inform a purchaser that the securities to be sold are not registered and are not exempt under sections 3 and 4 of the Act, or, as in the illustration in the text involving corporation *T*, when an issuer fails to inform offerees and purchasers that a previous securities offering by the issuer is illegal and may be integrated with the offering to them. In both cases, an issuer faces civil liability under section 12(1) for all sales made in violation of section 5 of the Act, a fact that, if disclosed, might have "deterred or tended to deter the average prudent investor from purchasing the securities in question." *Escott v. BarChris Constr. Corp.*, 283 F. Supp. 643, 681 (S.D.N.Y. 1968), quoting Charles A. Howard, 1 S.E.C. 6, 8 (1934). See also *Brown v. Gilligan, Will & Co.*, 287 F. Supp. 766 (S.D.N.Y. 1968); *Korber v. Lehman*, 41 Misc. 2d 568, 245 N.Y.S.2d 830 (Sup. Ct. 1963).

53. Section 3(a)(9) exempts from the registration requirements of the Act "[a]ny

It makes no further offers or sales for the next six months, period A, but then offers and sells its *R* common stock under rule 147. Within six months after the intrastate offering, in period AA, *R* completes a private placement of *R* preferred stock and erroneously claims a section 4(2) exemption. When the illegality of the private placement is discovered, what are the consequences to *R*'s reliance on rule 147? If the *R* preferred stock is not of the same or similar class as *R* common stock, subparagraph (b)(2) would appear to protect the intrastate offering from integration with the subsequent illegal private placement. But that protection may be illusory. An application of traditional integration factors might disclose that the period B offering, which, prior to the rule 147 offering, *R* could legitimately claim as exempt under section 3(a)(9), is integrated with the limited offering during period AA, thereby eliminating the existence of a valid exemption for the first offering of *R* preferred stock.<sup>54</sup> A finding of integration means that the sales of *R* preferred stock made during period B are deemed to be part of the later intrastate offering. Thus, *R* would not have complied with rule 147(b)(1) and, therefore, would not be able to rely on rule 147. As a result, it could incur civil liability to the investors in all three offerings.

In one type of transaction 4 situation subparagraph (b)(2) is more restrictive than the approach taken by the SEC prior to rule 147. Formerly, an issuer that planned to offer and sell its securities pursuant to a qualified pension plan within the limitations of section 3(a)(2) could make a contemporaneous intrastate offering under section 3(a)(11).<sup>55</sup> An integration question did not arise where one of the offerings involved exempt securities, even if the securities were of the same or similar class as those offered in the intrastate issue. Rule 147(b)(2) does not recognize a distinction between exempt securities

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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." 15 U.S.C. § 77c(a)(9) (1970).

54. The integration problem under section 3(a)(9) is achieved by reading the word "exclusively" as modifying both "exchanged" and "security holders." Thus, an exchange of securities with existing security holders cannot be combined with a private offering of the same class of securities to persons who were not formerly "security holders." See SEC Securities Act Release No. 2029 (Aug. 8, 1939), 1 CCH FED. SEC. L. REP. ¶ 2140.

55. An offering of securities exempt under sections 3(a)(2)-(8) is not subject to extinguishment by operation of the integration rule. "Because the availability of such an exemption is not dependent upon the character of the transaction in which the securities are offered for sale and sold, but rather upon the nature of the security itself, its status is unaffected by offering activities of the company . . ." Shapiro & Sachs, *supra* note 31, at 5. See also note 14 *supra*. No case or SEC release can be found suggesting that exempt securities could be part of an issue under section 3(a)(11).

and exempt transactions. Integration is avoided under the rule only if the issuer establishes that the exempt securities are not of the same or similar class as those offered under the rule.<sup>56</sup>

*Transaction 5.* During B and/or BB issuer has offers or sales that are not exempt pursuant to sections 3 or 4(2) and are not registered under the Act; issuer also has offers or sales during A and/or AA. Rule 147(b)(2) does not apply. Issuer is confronted with the problems discussed in connection with transactions 3 and 4.

*Transaction 6.* Issuer has no offers or sales during B and BB, but does have offers or sales during A and/or AA. Rule 147(b)(2) applies only if the securities offered or sold during A and/or AA are not "of the same or similar class" as those offered or sold under the rule. The difficulties of that determination and its consequences are discussed in connection with transaction 4.

Rule 147(b)(2) was designed to provide certainty only "to the extent feasible."<sup>57</sup> An analysis of integration under the rule in the context of these six basic transactions indicates that the SEC believes that very little certainty is feasible. With the exception of transaction 1, where no threat of integration exists, subparagraph (b)(2) provides certainty in only one situation, transaction 2.<sup>58</sup> In every other situation—issuer, offerees, and purchasers—be residents of the state in should be integrated.<sup>59</sup> In transactions 4 and 6, the subparagraph applies only after the issuer makes a preliminary judgment based on one of the traditional integration factors.

### C. Nature of the Issuer

Section 3(a)(11) requires that all parties to an intrastate transaction—issuer, offerees, and purchasers—be residents of the state in which the offering is to occur. Corporate issuers must be incorporated in that state. Furthermore, the issuer must establish that it is doing business within the state of the proposed offering. These requirements with regard to the issuer have engendered numerous practical and interpretative problems that rule 147 seeks to remedy.

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56. It is unclear whether this represents a change in SEC policy or whether such transactions would be allowed without reference to rule 147. The latter interpretation is possible, since rule 147 does not represent the exclusive route to a section 3(a)(11) exemption. Rule 147, preliminary note 1.

57. Rule 147, preliminary note 3.

58. Even in transaction 2, there is not complete certainty. If the offerings in B and/or BB are determined not to be exempt under sections 3 or 4(2) or not properly registered under the Act, the situation in transaction 3 arises.

59. It was precisely this type of case-by-case determination that proposed rule 147 attempted to eliminate. See Release 5349, *supra* note 11, at 5, ¶ 79,168 at 82,548.



### 1. Person Resident

Rule 147 continues the SEC policy of narrowly interpreting the residence requirement.<sup>60</sup> The rule restricts the definition of residence and separates the question of the issuer's residence from the more troublesome problem of the residence of offerees and purchasers. Rule 147(c)(1) defines residence for the issuer:

(c) *Nature of the Issuer.*

The issuer of the securities shall at the time of any offers and the sales be a person resident and doing business within the state or territory in which all of the offers, offers to sell, offers for sale and sales are made.

(1) The issuer shall be deemed to be a resident of the state or territory in which:

(i) it is incorporated or organized, if a corporation, limited partnership, trust or other form of business organization that is organized under state or territorial law;

(ii) its principal office is located, if a general partnership or other form of business organization that is not organized under any state or territorial law;

(iii) his principal residence is located, if an individual.

With one exception, subparagraph (c)(1) represents no change in earlier interpretations of residence for the issuer.<sup>61</sup> It does contribute

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60. See Release 4434, *supra* note 1, at 2, ¶ 2270 at 2609.

61. The subparagraph does, however, fail to clarify what is referred to as the "single business enterprise" problem. Consider Corporation *A*, which is incorporated in State *X* and does a substantial amount of its business there. Corporation *B*, a wholly owned subsidiary of *A*, is incorporated in State *Y*, where it does a substantial amount of its business. Both *A* and *B* are in the same type of business. *B* proposes to sell securities in State *Y* and to use the proceeds in State *Y*. Since *B*, the issuer, is incorporated in and doing business within State *Y* and its parent is incorporated in and doing business within State *X*, and since both corporations are in the same business, the SEC may take the position that *A* and *B* are a "single business enterprise"; if that position is taken, *B* cannot rely on the intrastate exemption. According to Release 4434, the intrastate exemption "should not be relied upon for each of a series of corporations organized in different states where there is in fact and purpose a single business enterprise or financial venture whether or not it is planned to merge or consolidate the various corporations at a later date." Release 4434, *supra* note 1, at 2-3, ¶ 2270 at 2609. See SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830 (S.D. Cal. 1960), *aff'd.*, 285 F.2d 162 (9th Cir. 1960). No objective criteria exist for determining when the relationship between or among corporations or other business entities constitutes "a single business enterprise or financial venture." For examples of situations where the SEC has found a single business enterprise, see International Funeral Serv. of Calif., Inc., [1971] CCH FED. SEC. MICROFILM, roll 1, frame 00986 (April 7, 1971); Commercial Credit Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,544 (Nov. 5, 1971). See generally Modesitt, *Exemptions from Registration Under the Securities Act of 1933*, 27 NEB. L. REV. 43, 45 (1947).

Release 5450 simply states: "In addition, any plan or scheme that involves a series of offerings by affiliated organizations in various states, even if in technical compliance with the rule, may be outside the parameters of the rule and of Section 3(a)(11) if what is being financed is a single business enterprise." Release 5450, *supra* note 11, at 83,654.

to clarification, however, by indicating what standard of residence applies when an individual, such as a promoter issuing preincorporation certificates or investment contracts, or a trustee issuing voting-trust certificates, is deemed to be an issuer. The major change is reflected in subsection (c)(1)(ii). Prior to the adoption of the rule, the SEC staff had been asked on several occasions to concur in counsel's opinion that a partnership can be a resident in a state where most, but not all, of the partners are residents. The staff had consistently taken the position that if one general partner is not a resident, section 3(a)(11) is not available for an offering by the general partnership.<sup>62</sup> Rule 147(c)(1)(ii) rejects that policy in favor of treating "all business entities in a similar manner."<sup>63</sup> It is not clear whether this change in administrative policy is restricted to offerings under the rule or whether it represents a new administrative interpretation of section 3(a)(11).

## 2. The "Doing Business Within" Requirement

One of the most difficult problems for an attorney trying to advise a client on the availability of section 3(a)(11) is to ascertain whether the issuer-client is "doing business within" the state where it is a resident or, if a corporation, the state where it is incorporated. The phrase "doing business within" can be interpreted in at least two ways. It could require the offeror to do *all* of its business in the state of the proposed offering. Such an interpretation, it has been argued, would unduly restrict the availability of section 3(a)(11).<sup>64</sup> On the other hand, "doing business" could be viewed as requiring only the "minimum contacts" sufficient to subject an individual or a business entity to the jurisdiction of the state's courts.<sup>65</sup> While it is agreed that, for purposes of section 3(a)(11), more business activity is required than would suffice for subjecting a nonresident to suit,<sup>66</sup> a problem

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62. See, e.g., *Western Mall Shopping Center*, [1971] CCH FED. SEC. MICROFILM, roll 5, frame 10308 (July 22, 1971).

63. Proposed rule 147(c) provided that, in a partnership, all the general partners must be resident within such state or territory. Proposed Rule 147(c)(1)(B) in Release 5349, *supra* note 11, at 10. "The Commission has reconsidered this provision in light of the provisions applicable to corporations and determined to treat all business entities in a similar manner." Release 5450, *supra* note 11, at 83,651.

64. "The fact that the word 'only' does not modify the 'doing business' clause indicates quite clearly that the issuer's business need not be *confined* to the state in which it is resident or incorporated." I L. Loss, *supra* note 30, at 601 (emphasis original).

65. See, e.g., *McGee v. International Life Ins. Co.*, 355 U.S. 220 (1957); *International Shoe Co. v. Washington*, 326 U.S. 310 (1945); *McCauley*, *supra* note 1, at 950.

66. In *Chapman v. Dunn*, 414 F.2d 153 (6th Cir. 1969), the issuer operated and staffed a Michigan office from which he offered and sold securities pursuant to a claimed section 3(a)(11) exemption. The court stated that: "While this can be viewed as 'doing

remains in defining the precise quantum of business operations that meets the Act's requirement. An early SEC release equated "doing business" with the performance of "substantial operational activities."<sup>67</sup> In a study of the securities markets, the SEC referred to the intrastate exemption and the need for "principal" activities within the state.<sup>68</sup> Judicial and administrative decisions have taken the same tack. In the leading case of *Chapman v. Dunn*,<sup>69</sup> the Court of Appeals for the Sixth Circuit discussed the "doing business" element of section 3(a)(11) at length. The court decided that an issuer that wishes to rely upon the intrastate exemption must conduct a "predominant" amount of its business within its state of residence. It found the quantum of income-producing activity to be significant in evaluating the predominance of an issuer's business operations.<sup>70</sup> A review of SEC staff responses to requests for no-action letters, especially those responses made during the period immediately before the adoption of rule 147, reveals that the SEC staff has regularly insisted that at least eighty per cent of the issuer's business exist in and continue within the state.<sup>71</sup>

Rule 147(c)(2) defines "doing business within" and establishes

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business' in Michigan for some purposes, such as State taxation and judicial process, we conclude that it is not 'doing business' within the meaning contemplated by Congress in § 3(a)(11) of the Act. We are convinced that Congress meant the 'doing business' requirement of § 3(a)(11) to be something substantially more than has been held sufficient to subject one to service of process in civil suits." 414 F.2d at 157.

67. Release 4434, *supra* note 1, at 2, ¶ 2270 at 2609:

The doing business requirement is not met by functions in the particular state such as bookkeeping, stock record and similar activities or by offering securities in the state. Thus, the exemption would be unavailable to an offering by a company made in the state of its incorporation of undivided fractional oil and gas interests located in other states even though the company conducted other business in the state of incorporation. While the person creating the fractional interests is technically the "issuer" as defined in Section 2(4) of the Act, the purchaser of such security obtains no interest in the issuer's separate business within the state.

68. 1 SECURITIES & EXCHANGE COMM., REPORT OF SPECIAL STUDY OF SECURITIES MARKETS 572 (1963) [hereinafter *SPECIAL STUDY*].

69. 414 F.2d 153 (6th Cir. 1969).

70. 414 F.2d at 158. *See also* SEC v. McDonald Inv. Co., 343 F. Supp. 343 (D.C. Minn. 1972).

71. *See, e.g.*, Potomac Valley Homes Inc., [1972] CCH FED. SEC. MICROFILM, roll 7, frame 11474 (June 5, 1972); James Gayner, [1972] CCH FED. SEC. MICROFILM, roll 6, frame 90637 (May 30, 1972); General Motor Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,332 (June 24, 1971). *But see* Pan Agra Cattle Fund, [1972] CCH FED. SEC. MICROFILM, roll 2, frame 01621 (Jan. 19, 1972), where a California corporation, with its principal office located within that state, proposed forming a limited partnership, with the corporation acting as the general partner. Limited partnership interests were to be sold to California residents; approximately 80 per cent of the partnership's operations were to be conducted in California, with the remainder in Arizona. The SEC staff stated that section 3(a)(11) was not available because a "significant portion of the issuer's operations will be conducted outside of California."

objective criteria that, if satisfied, will permit an issuer to meet the requirement under section 3(a)(11):

(2) The issuer shall be deemed to be doing business within a state or territory if:

(i) the issuer derived at least 80% of its gross revenues and those of its subsidiaries on a consolidated basis

(A) for its most recent fiscal year, if the first offer of any part of the issue is made during the first six months of the issuer's current fiscal year; or

(B) for the first six months of its current fiscal year or during the twelve month fiscal period ending with such six month period, if the first offer of any part of the issue is made during the last six months of the issuer's current fiscal year

from the operation of a business or of real property located in or from the rendering of services within such state or territory; provided, however, that this provision does not apply to any issuer which has not had gross revenues in excess of \$5,000 from the sale of products or services or other conduct of its business for its most recent twelve month fiscal period;

(ii) the issuer had at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80 percent of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;

(iii) the issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to this rule in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; and

(iv) the principal office of the issuer is located within such state or territory.

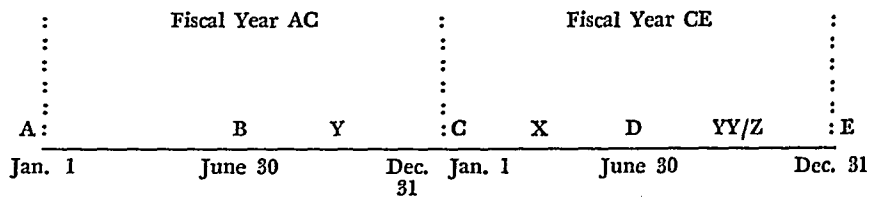
The objective criteria in subsections (c)(2)(i), (ii), and (iii) are not a departure from the strict interpretations made earlier by the courts and the SEC staff. An eighty per cent standard is certainly consistent with the judicially imposed standards of "substantiality" and "pre-dominance." Since the rule's criteria are fixed, attorneys should find its definition of "doing business" helpful.<sup>72</sup> In particular, subparagraph (c)(2) represents an ambitious effort by the SEC to formulate a revenue test applicable to large and small businesses alike.<sup>73</sup>

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72. The SEC received many requests for more elaboration of the objective standards in proposed rule 147(c). Release 5450 sets forth five examples that raise questions about the "doing business within" standards in rule 147(c) and presents the Commission's interpretive responses. See Release 5450, *supra* note 11, at 83,652-53.

73. Not all issuers must meet the gross revenues condition as a prerequisite to reliance on rule 147. Subparagraph (c)(2) provides that an issuer that has not, during its most recent twelve-month fiscal period, had gross revenues in excess of 5,000 dollars from the operation of its business need not satisfy the revenues test of subsection (c)(2)(i).

There are three possible periods over which the eighty per cent test can be applied. Which period is appropriate depends largely on when the first offer of any part of the issue is made. The following diagram depicts the alternatives for an issuer whose fiscal year ends on December 31:



If the issuer makes its first offer under rule 147 at point X, then, according to subsection (c)(2)(i)(A), the revenue test is measured against its gross revenues and those of its subsidiaries<sup>74</sup> for the preceding fiscal year (period AC).<sup>75</sup> The calculation period changes if the issuer's first offer under rule 147 is made during the last six months of its current fiscal year. In that event, subsection (c)(2)(i)(B) may provide the issuer with alternative measuring periods. If the first offer under rule 147 occurs at point Y or at point YY, then the eighty per cent test applies to gross revenues for the first six months of the current fiscal year (period AB or CD respectively). An alternative under rule 147(c)(2)(i)(B) is available to issuers that have completed one fiscal year. For such issuers that make their first offer under rule 147 during the last half of their current fiscal year (point Z), the rule allows the use of "a moving twelve month calculation." The significance of this provision can be seen in the following example. Corporation *M* has a local seasonal business that produces ninety per cent of its total gross revenues from July to December each year; its remaining gross revenues come from services rendered out of state. If *M* planned an intrastate offering for the second half of its fiscal year (point Z), it could not satisfy the test imposed by the first half of subsection (c)(2)(i)(B), because its gross revenues "for the first six months of its current fiscal year" (period CD) are not attributable to local, intrastate business. But the second half of subsection (c)(2)(i)(B) permits *M*

74. Subparagraph (c)(2) clarifies the Commission's previous intention to include gross revenues of subsidiaries consolidated with those of the issuer. See Proposed Rule 147(c)(2)(A) in Release 5349, *supra* note 11, at 10.

75. Under the proposed rule the issuer would have been required to satisfy the gross revenues condition at the end of the most recent fiscal year and its most recent fiscal quarter and to satisfy the assets test at the end of its most recent fiscal quarter. Proposed Rule 147(c)(2)(A) in Release 5349, *supra* note 11, at 10. The Commission, deciding that such a provision "might have been difficult for many small businesses to satisfy," revised it. Release 5450, *supra* note 11, at 83,652.

to demonstrate that it satisfies the eighty per cent test over the twelve-month period consisting of the last six months of its preceding fiscal year and the first six months of its current fiscal year (period BD).

Two additional effects of the subparagraph (c)(2) should be noted. First, the reference to "net proceeds" in subsection (c)(2)(iii) makes it clear that an issuer may use more than twenty per cent of its gross proceeds to compensate an out-of-state underwriter<sup>76</sup> or attorney before having to meet the eighty per cent test.<sup>77</sup> Second, subparagraph (c)(2) appears to preclude the use of rule 147 by newly formed issuers that have not completed at least one half of a fiscal year. The revenues test in subsection (c)(2)(i) requires a minimum of six months, and the assets requirements in subsection (c)(2)(ii) refer to an issuer's most recent "semi-annual fiscal period." If the SEC intends to so limit rule 147, it should clarify its policy on start-up issuers, for, under traditional interpretations, an issuer with little or no business experience has been allowed to utilize the section 3(a)(11) exemption.<sup>78</sup>

#### D. Residence of Offerees and Purchasers

As mentioned earlier,<sup>79</sup> the intrastate exemption requires that *all* parties to the transaction be residents of the same state or territory. Rule 147(d) is concerned with the required residence of offerees and purchasers:

##### (d) Offerees and Purchasers: Person Resident

Offers, offers to sell, offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is a resident. For purposes of determining the residence of offerees and purchasers:

(1) A corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state or territory if,

76. If all the requirements for an intrastate offering are met, an offeror may utilize the services of underwriters or dealers who are nonresidents. Release 4434, *supra* note 1, at 4, ¶ 2270 at 2610. If a nonresident underwriter (or dealer) is not acting as an agent but is buying for its own account, as in a firm-commitment underwriting, it appears that he becomes a nonresident purchaser. I L. LOSS, *supra* note 30, at 600 n.152; Goldman, *supra* note 36, at 183, 192. *But see* H. BLOOMENTHAL, *SECURITIES AND FEDERAL CORPORATE LAW* § 4.04[9], at 4-21 (1972).

77. The rule as initially proposed would have required that the issuer intend to use 90 per cent of the proceeds of the offering for intrastate purposes. Proposed Rule 147(c)(2)(B) in Release 5349, *supra* note 11, at 10. The percentage was reduced to 80 per cent in subsection (c)(2)(iii), "since [90 per cent] appeared to be unduly restrictive. Further, this is consistent with the nature of the business reflected in the other percentage tests." Release 5450, *supra* note 11, at 83,652.

78. *See, e.g.*, Holsen, Kaye Pretner Prods., [1972] CCH FED. SEC. MICROFILM, roll 10, frame 16108 (Sept. 18, 1972); Cook Properties, Inc., [1972] CCH FED. SEC. MICROFILM, roll 9, frame 14915 (Aug. 20, 1972). Absent a statement by the SEC to the contrary, issuers with little or no business history should be free to continue using section 3(a)(11).

79. *See* text accompanying note 6 *supra*.

at the time of the offer and sale to it, it has its principal office within such state or territory.

(2) An individual shall be deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale to him, his principal residence in the state or territory.

(3) A corporation, partnership, trust or other form of business organization which is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule shall be deemed not to be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory.

Subparagraph (d)(1) is significant in two respects. Prior to the rule, a business organization that wished to act as an offeree or purchaser in an intrastate offering had to be incorporated or organized in the issuer's state. The Commission now believes that "the location of a company's principal office is more of an indication of its local character for purposes of the offeree residence provision of the rule than is its state of incorporation."<sup>80</sup> The subparagraph also reflects the Commission's new policy to treat all business entities, including partnerships,<sup>81</sup> in a similar manner. Whether it is an issuer, under subsection (c)(1)(ii), or an offeree or purchaser, under subparagraph (d)(1), a partnership's residence is the location of its principal office.<sup>82</sup> Unfortunately, neither the rule nor the release indicates whether these new interpretations are applicable to intrastate offerings outside the rule.

If an individual offeree or purchaser is to be included in an intrastate offering, subparagraph (d)(2) requires that he have his principal "residence" in the state. The definition of residence includes the very term being defined. To understand the drafters' intent one must look at the SEC's releases, which emphasize that the exemption's object—

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80. Release 5450, *supra* note 11, at 83,653. The corporate issuer must still be incorporated in the state where the issue is offered. Rule 147(c)(1)(i).

81. For an example of the SEC's traditional policy on the residence of a partnership, see Pacific Income Plan Co. of Calif., [1971] CCH FED. SEC. MICROFILM, roll 6, frame 12667 (Aug. 6, 1971), where a California issuer proposed making an intrastate sale of a security to a limited partnership that had been in business prior to the offer. All three general partners, as well as nine of the ten limited partners, were residents of California. The SEC staff's response stated that "because of the non-residency of one of the limited partners we are unable to conclude that interests . . . may be sold to the limited partnership without prior registration under the Act, or Regulation A, if available." See also Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779, 785-86 (1971).

82. In defining the residency of an issuer, rule 147(c)(1) distinguishes between general and limited partnerships. If a limited partnership is the issuer, subsection (c)(1)(i) provides that its residency depends on its state of organization. If a general partnership is the issuer, subsection (c)(1)(ii) makes the location of its principal office determinative of residency. Paragraph (d), however, makes no such distinction where a partnership is an offeree or purchaser. According to rule 147(d)(1), the residence of a "partnership" is determined by the location of its principal office at the time of the offer and sale to it.

restricting the offering to local investors—is best served by interpreting the residence requirement narrowly.<sup>83</sup> But it is Securities Act Release No. 5349, which accompanied the rule in its proposed form, that discusses how the rule seeks to achieve this goal.

Residence of individuals, it notes, has usually been considered to refer to their domicile rather than to a temporary residence, and domicile must be determined in each instance in accordance with the relevant state law.<sup>84</sup> One might conclude from this that the SEC would insist on a domiciliary intent on the part of individual offerees and purchasers, but the release does not take this approach. It states that the proposed rule does not “substantially change” the traditional approach in determining residency under section 3(a)(11), but then adds that “it does abandon the domicile test and attempts to provide more objective standards for determining when a person is considered a resident.”<sup>85</sup> What at first appears as an inconsistency in the release is actually quite consistent. Subparagraph (d)(2) refers to an individual’s “principal residence.” Residence, in its technical sense, is merely a factual place of abode.<sup>86</sup> But a domicile is an abode at a particular place “accompanied with positive or presumptive proof of an intention to remain there for an unlimited time.”<sup>87</sup> The distinction, then, between a residence and a domicile turns on intention. Subparagraph (d)(2) provides a “more objective standard” by shifting the emphasis from the intention of an offeree or purchaser to the situs of his principal place of abode.<sup>88</sup> For one who resides in more than one state, as, for example, an individual who owns a winter home in Florida and a summer home in New England, the inquiry becomes: Where does

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83. See Release 5450, *supra* note 11, at 83,649, 83,653; Release 5349, *supra* note 11, at 2, ¶ 79,168 at 82,547.

84. Release 5349, *supra* note 11, at 4, ¶ 79,168 at 82,546.

85. Release 5349, *supra* note 11, at 4, ¶ 79,168 at 82,548.

86. 1 J. BEALE, *CONFLICT OF LAWS* § 10.3, at 109 (1934). See generally Hertz, *Federal Securities Act of 1933—The Intrastate Exemption of Section 3(a)(11)—Fact or Fiction*, 34 *DIGTA* 289, 295-303 (1957); McCauley, *supra* note 1, at 945-49.

87. *Mitchell v. United States*, 88 U.S. (21 Wall.) 350, 352 (1874). According to the *Restatement*, the most important factor in identifying domicile is the “intention or attitude of mind.” *RESTATEMENT (SECOND) OF CONFLICT OF LAWS* § 18, comment *a* at 70 (1971).

88. As proposed, subparagraph (d)(2) provided that an individual, in order to be deemed a resident, have his principal residence in the state and have “no present intention of moving his principal residence to a different state or territory.” Proposed Rule 147(d)(2) in Release 5349, *supra* note 11, at 11. On reconsideration, “[t]he Commission believes that it would be difficult to determine a person’s intentions, and accordingly, has deleted the latter requirement.” Release 5450, *supra* note 11, at 83,653. Subparagraph (d)(2) reflects a construction of the term “resident” in section 3(a)(11) that Professor Loss advanced in 1 L. Loss, *supra* note 30, at 598-99.



he spend most of his time? Residency becomes a factual determination measured by time spent in one place.<sup>89</sup>

Subparagraph (d)(3) of rule 147 is designed to thwart attempts at circumventing the strict residency requirements of section 3(a)(11). An illustration may best explain the drafters' fear. Under subparagraph (d)(1), a corporation that has its principal office located in the same state as the issuer may qualify as a purchaser in an intrastate offering even if all of its stockholders are nonresidents. The corporate entity is deemed to be the purchaser, and neither the courts nor the SEC would normally look behind the corporate form.<sup>90</sup> In such a situation, the intent of section 3(a)(11) could be easily thwarted. Prospective nonresident investors could simply be instructed to form a corporation, locate its principal office in the issuer's state, contribute their investment capital to the corporate entity, and invest in the subsequent intrastate offering through the resident corporate purchaser. In order to foreclose this misuse of rule 147, subparagraph (d)(3) provides that any entity organized for the specific purpose of acquiring securities in a rule 147 offering shall be deemed not to be a resident unless all of the beneficial owners of the entity are residents of the state. In this provision, rule 147 has retained the more troublesome subjective approach, for in each case where a newly organized entity with one or more nonresident beneficial owners is a purchaser or offeree, it must be determined whether it was "organized for the specific purpose" of acquiring part of an issue offered pursuant to rule 147. The SEC should consider a more objective approach, such as the disqualification of corporate purchasers incorporated within a certain period, e.g., six months or one year, prior to the intrastate offering unless the officers of the corporation are able to demonstrate its bona fide existence.

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89. The SEC has traditionally cautioned against including members of the military service as offerees or purchasers in an intrastate offering, since "[m]ere presence in the state is not sufficient to constitute residence." Release 4434, *supra* note 1, at 3, ¶ 2270 at 2609. Under paragraph (d) of the rule, presence in the state may be sufficient to constitute residence if it is prolonged. Thus, the warning to issuers relying on rule 147 becomes: "Temporary residence, such as that of many persons in the military service, would not satisfy the provisions of paragraph (d)." Release 5450, *supra* note 11, at 83,653.

90. "Business organizations generally have been considered to be residents of the state where they are organized." Release 5349, *supra* note 11, at 4, ¶ 79,168 at 82,548. In the past issuers have not been required to establish the residences of individual shareholders in a corporate purchaser of an interstate offering. *But see* Kulshan Village Associates, [1973] CCH FED. SEC. MICROFILM, roll 1, frame 00249 (Dec. 13, 1972), where twelve Canadian citizens sought to participate as purchasers in an intrastate offering in the state of Washington. They sought to accomplish their objective by forming a Washington corporation that would act as purchaser for them. The SEC staff concluded that section 3(a)(11) was not available "since it appears that the Canadian-owned Washington corporation would be established primarily for the purpose of acquiring the limited partnership interests."

Rule 147(d) continues the emphasis on the residency of offerees as well as purchasers. This emphasis is hard to understand. Under the Securities Act the word "offer" is given a broad definition.<sup>91</sup> As such, any offering will probably be deemed to have been made to a large number of offerees, which obviously increases the possibility that a nonresident will receive an offer and thus the exemption under rule 147 will be defeated. Since an offeree that does not purchase suffers no harm, it is difficult to see why the SEC continues to adhere to this requirement, which restricts the use of section 3(a)(11). The inclusion of offerees seems particularly inappropriate in light of the proposed rule 146, where the number of offerees in a nonpublic offering is irrelevant.<sup>92</sup> If the SEC can ignore the number of offerees in determining compliance by an issuer under section 4(2), it should similarly be able to ignore the residence of offerees in an offering under rule 147.

#### E. Resales to Nonresidents

The intrastate exemption requires not only that the securities be offered and sold in a single state, but also that they come to rest in the hands of persons resident within the state.<sup>93</sup> Rule 147(e) offers an objective test for determining when securities have come to rest so that resales to nonresidents may commence:

##### (e) Limitation of Resales

During the period in which securities that are part of an issue are being offered and sold by the issuer, and for a period of nine months from the date of the last sale by the issuer of such securities, all resales of any part of the issue, by any person, shall be made only to persons resident within such state or territory.<sup>94</sup>

Rule 147(e) clearly rejects any suggestion that might have been found in earlier SEC releases that a purchaser in a section 3(a)(11) offering has to exhibit some form of investment intent.<sup>95</sup>

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91. See SEC Securities Act Release No. 3844 (Oct. 8, 1957), 1 CCH FED. SEC. L. REP. ¶ 3250 (1973); 1 L. Loss, *supra* note 30, at 512.

92. See Proposed Rule 146, *supra* note 11.

93. Release 1459, *supra* note 1, at 1-2, ¶ 2260 at 2605-06.

94. Two notes accompany rule 147(e):

1. In the case of convertible securities, resales of either the convertible security, or if it is converted, the underlying security, could be made during the period described in paragraph (e) only to persons resident within such state or territory. For purposes of this rule a conversion in reliance on Section 3(a)(9) of the Act does not begin a new period.

2. Dealers must satisfy the requirements of Rule 15c2-11 under the Securities Exchange Act of 1934 prior to publishing any quotation for a security, or submitting any quotation for publication, in any quotation medium.

95. The issue of investment intent for purchasers in an intrastate offering stems from references to "investors" in some SEC releases. During its administration of the Act,

Traditionally, the SEC has interpreted section 3(a)(11) as limiting both reoffers and resales to nonresidents until the entire issue "comes to rest,"<sup>96</sup> a process that the SEC has suggested could take a full year.<sup>97</sup> If a single resident purchaser makes a reoffer outside the state during the distribution period, the issuer loses its exemption despite good faith efforts to control the offering. In adopting rule 147, however, the Commission stated that "it would be difficult for an issuer to prohibit or even learn of reoffers,"<sup>98</sup> so paragraph (e) places a limitation only on improper resales. The paragraph also reduces the holding period on interstate sales from one year to nine months.<sup>99</sup> It requires only that a purchaser delay resale to nonresidents<sup>100</sup> until nine months after the last sale of securities in the primary distribution.<sup>101</sup> Although avid intrastate trading among residents is permit-

the Federal Trade Commission (FTC) stated that, if the exemption is to be available, "it is clearly required that the securities at the time of completion of ultimate distribution shall be found only in the hands of *investors* resident within the state." FTC Securities Act Release No. 201 (July 20, 1934), 1 CCH FED. SEC. L. REP. ¶ 2255 (1974) (emphasis added). The SEC supported this interpretation:

[S]ecurities which have actually come to rest in the hands of resident investors—*persons purchasing for investment and not with a view to further distribution or for purposes of resale*—may be resold by such persons, whether directly or through dealers or brokers, to non-residents without in any way affecting the exemption of the issue. The relevance of any such resales to the existence or non-existence of the exemption would consist only in the evidentiary light which such resales might cast upon the question whether the securities had in fact come to rest in the hands of resident investors. If the securities were resold but a short time after their acquisition, this fact, although not conclusive, would strengthen the inference that their original purchase had not been for investment, and that the resale therefore constituted a part of the process of primary distribution . . . .

Release 1459, *supra* note 1, at 2, ¶ 2260 at 2606 (emphasis added).

The Commission modified its position, however, in Release 4434:

This is not to suggest, however, that securities which have actually come to rest in the hands of resident investors, *such as persons purchasing without a view to further distribution or resale to non-residents*, may not in due course be resold by such persons, whether directly or through dealers or brokers, to non-residents without in any way affecting the exemption.

Release 4434, *supra* note 1, at 3, ¶ 2270 at 2610 (emphasis added).

The critical issue, then, is not whether the purchaser has taken for investment, a concept usually associated with the nonpublic offering exemption, but rather whether he has taken "without a view to further distribution or resale to non-residents."

96. See Release 4434, *supra* note 1, at 3, ¶ 2270 at 2610. See also note 5 *supra*.

97. See text accompanying 36 *supra*.

98. Release 5450, *supra* note 11, at 83,653.

99. Traditional SEC policy and proposed rule 147 require a twelve-month limitation on resales. See text accompanying note 36 *supra*; Proposed Rule 147(e) in Release 5349, *supra* note 11, at 11.

100. Sosin argues that a purchaser in an intrastate offering may resell to nonresidents only if such a resale was not originally intended. Sosin, *supra* note 35, at 117. Under rule 147(e) it is not necessary for a purchaser to clear his mind of future sales. He may purchase with a view to future resale, even though such a mental state would not qualify under traditional criteria for investment intent.

101. In the past the SEC has seemed to use a one-year holding period.

Although there appears to be no particular magic in a fixed time period for determining when an intrastate sale of securities comes to rest in the hands of

ted,<sup>102</sup> as a practical matter an issuer might wish to curtail or at least severely limit any trading for a period of nine months in order to guarantee total compliance with the rule.

Because the nine-month period contained in rule 147(e) commences "from the date of the last sale by the issuer of such securities," issuers should also proceed with caution when marketing their securities pursuant to installment agreements. If the parties contemplate an actual sale at the time the installment agreement is signed, but postpone delivery of the securities until full payment is made, the "sale" for purposes of rule 147(e) would occur at the time of signing. But if the parties to the installment agreement contemplate a series of sales, a "sale" under rule 147(e) would not occur until the last installment was paid.<sup>103</sup>

#### F. *Precautionary Measures*

Anyone who is about to embark upon an intrastate offering should take precautionary steps to ensure that the risks of noncompliance with section 3(a)(11) are minimal.<sup>104</sup> The offeror has the burden of establishing the exemption and should attempt throughout the offering to construct a proper documentary record. A defense of due care or good faith belief is unavailable.<sup>105</sup> Rule 147(f) requires the issuer

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residents, the safest bet appears to be to wait one year before resales are made to nonresidents. This one-year measure of safety is also consistent with the one-year statute of limitation period in section 13 for instituting suits under the civil liabilities provisions of section 12.

Goldman, *supra* note 36, at 190. The one-year period was first suggested by the Commission in Brooklyn Manhattan Transit Corp., 1 S.E.C. 147 (1935). It was intended to be only a "presumption of fact subject to refutation upon a showing of fact that distribution was completed in less than one year." 1 S.E.C. at 163. In responding to requests for no-action letters, the SEC refuses to express any view on whether securities have come to rest. *See, e.g.*, Hynes & Howes Mortgage Co., [1973] CCH. FED. SEC. MICROFILM, roll 2, frame 01825 (Dec. 1, 1972).

102. Note 2 to paragraph (c) reminds dealers that they must satisfy the requirements of SEC rule 15c2-11, 17 C.F.R. § 240.15c2-11 (1973), before entering any quotation medium. In essence, that rule specifies the information that must be available to the public before trading is allowed in the securities of companies that do not file reports under the Securities Exchange Act of 1934.

103. 1 L. Loss, *supra* note 30, at 600; Hertz, *supra* note 36, at 306-07. *See* Whitehall Corp., 38 S.E.C. 259, 269 (1958), for an example of an installment agreement that was held to constitute a continuing offer to sell. Installment agreements can also present problems for an issuer where a purchaser under such an arrangement changes his residency between the time of the first and last installment payments.

104. *See generally* Bloomenthal, *The Federal Securities Act Intra-state Exemption—Fact or Fiction?*, 15 WYO. L. REV. 121 (1960).

105. *See* Peoples Sec. Co., 39 S.E.C. 641 (1960); Whitehall Corp., 38 S.E.C. 259 (1958). Professor Loss has criticized the policy of denying a defense of due care:

Yet it is difficult to believe that Congress intended to make the issuer an absolute insurer of every offeree's residence (or—worse—his *animus manendi*) and of every salesman's integrity. Unless the standard is one of due care—which includes

to take certain steps that most prudent attorneys have traditionally urged upon clients contemplating an intrastate issue:

(f) *Precautions Against Interstate Offers and Sales*

(1) The issuer shall, in connection with any securities sold by it pursuant to this rule:

(i) place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the limitations on resale contained in paragraph (e);

(ii) issue stop transfer instructions to the issuer's transfer agent, if any, with respect to the securities, or, if the issuer transfers its own securities, make a notation in the appropriate records of the issuer; and

(iii) obtain a written representation from each purchaser as to his residence.

(2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are part of the same issue that are presented for transfer during the time period specified in paragraph (e), take the steps required by subsections (f)(1)(i) and (ii).

(3) The issuer shall, in connection with any offers, offers to sell, offers for sale or sales by it pursuant to this rule, disclose, in writing, the limitations on resale contained in paragraph (e) and the provisions of subsections (f)(1)(i) and (ii) and subparagraph (f)(2).

Rule 147(f) does, however, omit two measures that should be adopted by issuers that employ salesmen and dealers. Because an offeror's exemption can be destroyed by anyone who participates in the distribution, an offeror should obtain a signed statement from every salesman and every dealer stating that he knows that the securities can be offered only to residents of the state and that he has in fact offered them only to such persons.<sup>106</sup> Also, offerors should be discouraged from offering securities at increasingly higher prices, a practice that can have the effect of inducing residents to sell their stock for a quick profit to other individuals, who may include nonresidents.<sup>107</sup>

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reasonable supervision of all selling agents and may well require something more than automatic acceptance of the buyer's representation—the exemption is virtually read out of the statute. Perhaps it should be. But that presumably is why Congress sits.

1 L. Loss, *supra* note 30, at 604-05. Cf. *Chapman v. Dunn*, 414 F.2d 153 (6th Cir. 1969), where the issuer argued on appeal that, at the time securities were sold, "he believed that all the investors were Michigan residents." 414 F.2d at 155. Except for acknowledging the issuer's argument, the court of appeals did not discuss the sales to nonresidents or the defense of good faith belief.

106. See *Capital Funds, Inc. v. SEC*, 348 F.2d 582 (8th Cir. 1965) (salesman for the underwriter subscribed for the shares offered intrastate and within a few days sold the shares to nonresidents).

107. See, e.g., *Armstrong, Jones & Co.*, SEC Securities Exchange Act Release No. 8420 (Oct. 3, 1968), *affd.*, 421 F.2d 359 (6th Cir. 1970), *cert. denied*, 398 U.S. 958 (1970). The case is discussed in *Goldman*, *supra* note 36, at 188-89. If it becomes necessary to offer

## II. SOME INTERPRETATIVE PROBLEMS

The objective criteria contained in rule 147 make some strides toward enabling issuers to determine with more certainty whether they may sell their securities pursuant to section 3(a)(11). Individually, most of the objective criteria can be applied with almost mathematical assurance. Confusion and uncertainty returns, however, when the standards are assembled and applied to specific factual situations. The critical issue is the interrelationship among the objective guidelines, including the questions of when, if at all, they apply during three distinct phases of the transaction: (a) the pre-offering stage, (b) the offering itself, and (c) the post-offering period. Six criteria included within paragraphs (b), (c), and (e) of the Rule are the starting point for the analysis.

(1) *Nonintegration period*—The time references here are fixed. According to paragraph (b) of rule 147, the first operative moment is the date of either the first or last offer or sale of a security in a rule 147 offering. Linked to the first operative moment are two additional periods: the six-month period either preceding or following it and the time period prior to or subsequent to the relevant six-month period. So, one must take note of rule 147(b) in both the pre-offering stage and the post-offering stage.

(2) *Eighty per cent gross revenues*—Under rule 147(c)(2)(i) an issuer must have the requisite amount of in-state gross revenues for the appropriate calculation period. The selection of a calculation period turns on whether the first offer of any part of the issue is made during the first or last six months of the issuer's current fiscal year. The point of reference is the commencement of the offering. Apparently, an issuer's concern for this criterion arises only once, during the pre-offering period.

(3) *Eighty per cent of assets*—Rule 147(c)(2)(ii) requires an issuer to have at least eighty per cent of its assets located within the state "at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue." This condition is either satisfied or not at the time of the first offer by the issuer.

(4) *Eighty per cent use of proceeds*—Subsection (c)(2)(iii) requires that a specific percentage of the proceeds be spent in connection with the issuer's local business. Unlike the other requirements, this condition spans all three stages of the intrastate offering. The

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securities with escalating prices, the issuer should disclose the absence of a market for the securities, "the arbitrary nature of the increase, the lack of any relationship to market, book, or other value and the fact that subscribers will ordinarily be unable to dispose of the shares at the increased price." Bloomenthal, *supra* note 104, at 129-30.

determinative phrase is "the issuer *intends to use and uses* at least 80% of the net proceeds" for intrastate activities. The subsection does not indicate how much time an issuer may take in using the proceeds. In most cases an issuer will probably commit the proceeds from the offering within a relatively short time, but what are the consequences if the issuer takes one, two, or three years to utilize eighty per cent of the funds within the state? The problem will be considered below.<sup>108</sup>

(5) *Principal office*—Rule 147(c)(2)(iv) requires that the issuer's principal office be "located within such state or territory." No time period is given: Must the principal office be so located only at the beginning of the offering or must it continue to be located there from the beginning until at least eighty per cent of the proceeds are used locally? The SEC's position is discussed below.<sup>109</sup>

(6) *Nine-month limitation on resales*—The time period on the rule's proscription against resales to nonresidents is unambiguous. Rule 147(e) identifies the period as any time "[d]uring the period in which securities that are part of an issue are being offered and sold by the issuer, and for a period of nine months from the date of the last sale."

If the suggested interpretations of these six criteria are correct, they should create little or no difficulty in most cases. But consider the following factual settings:

*Illustration 1.* Company *A* is incorporated in and doing business within State *X*. Its fiscal year begins on July 1. *A* can demonstrate that, as of June 30, it has at least eighty per cent of its assets in *X*, earns at least eighty per cent of its gross revenues from property located within *X*, has its principal office within *X*, and has not offered or sold any of its securities to anyone within the past twelve months. On July 10, *A* proposes an intrastate offering under rule 147. It intends to use at least eighty per cent of the proceeds in *X*. The offering commences on August 1 and terminates successfully on October 15. All the proceeds are spent for *A*'s business in State *X*.

As stated, illustration 1 presents nothing novel. Assuming that Company *A* limits its offers and sales to residents, protects against resales to nonresidents before the securities come to rest, and effects no offers or sales of its securities that could be integrated with the rule 147 offering, it could claim a valid exemption under rule 147.

*Illustration 2.* Same facts as in illustration 1 except that on July

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108. See text accompanying note 113 *infra*.

109. *Id.*

26, five days before the commencement of its offering, Company *A* relocates ninety-five per cent of its assets from State *X* to State *Y*. Also, seventy per cent of *A*'s gross revenues for the period from July 1 to September 30 are earned from property located within *Y*.

Illustration 2 suggests what can happen if rule 147(c)(2) is applied literally and the definition of "doing business" is interpreted as requiring an issuer to meet the eighty per cent assets test and the eighty per cent gross revenues test only once, prior to the offering. *A* could claim an exemption under rule 147 for its so-called local offering despite the fact that at the completion of the offering ninety-five per cent of its assets would be outside the state and seventy per cent or more of its gross revenues would be from out of state, because it meets the literal requirements of subsections (c)(2)(i) and (ii), continues to operate its principal office within the state, and uses at least eighty per cent of the proceeds from the offering within the state. Such a literal interpretation of the rule is inconsistent with the purpose behind the intrastate exemption. An issuer that generates a substantial percentage of its gross revenues from assets located outside the state hardly qualifies as a "local business." Probably for this reason, the SEC has included within the introductory language of paragraph (c) a phrase that seems designed to prevent the type of problem raised in illustration 2. Paragraph (c) states that the issuer of securities "shall at the time of any offers and the sales be a person resident and doing business within the state." Subparagraphs (c)(1) and (2), respectively, define "person resident" and "doing business within." As noted above, these subparagraphs do contain references as to when they must be met. These are inconsistent with the introductory language of paragraph (c).<sup>110</sup> To give meaning to paragraph (c)'s language, the wordings of subparagraphs (c)(1) and (2) must be considered modified so as to require that their conditions be satisfied more than once. Extending the time for compliance with the requirements of subparagraphs (c)(1) and (2) to the period measured by the commencement of the intrastate offering and the last offer and sale under the offering provides further protection for investors without adding to burdens traditionally imposed on issuers in an intrastate offering. It is also consistent with current SEC and judicial interpretations of section 3(a)(11).<sup>111</sup>

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110. Release 5450 contains language that suggests the tests need only be met once. In its capsule description of subparagraph (c)(2) it omits any reference to the introductory language of paragraph (c). In fact, the release characterizes similar language in the proposed rule as having to be met only at the time specified in the rule. See Release 5450, *supra* note 11, at 83,651-52.

111. See *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (1957). The issuer in that



However, special problems could arise if an issuer is forced to satisfy the gross revenues requirements of subsection (c)(2)(i) more than once. For example, in the case of an issuer whose business has a seasonal character, subsection (c)(2)(i) allows the issuer the option of using a moving twelve-month calculation period. Without the flexibility of subsection (c)(2)(i) such an issuer might not otherwise meet the gross revenues test.<sup>112</sup> Does the introductory language to paragraph (c), nonetheless, require such an issuer to demonstrate compliance with subsection (c)(2)(i) "at the time of any offers and the sales" under its intrastate offering? If so, how and when must the revenues test be met? Daily, weekly, semiannually? Neither the rule nor the release provides an answer.

The weakness in paragraph (c) is not in the policy it attempts to incorporate. The doing-business requirement has traditionally been viewed as applying throughout the entire period of the intrastate offering. The paragraph contains useful guidelines for the pre-offering period but suffers because it fails to specify how the objective criteria apply, if at all, during the offering and post-offering periods.

*Illustration 3.* Same facts as illustration 1 except that after the last offer and sale of its securities under rule 147, Company A relocates its principal office and ninety-five per cent of its assets from State X to State Y. It still intends to use at least eighty per cent of the net proceeds from the offering in X.

Illustration 3 depicts an issuer in literal compliance with paragraph (c). It satisfied the conditions in subparagraphs (c)(1) and (2) during the pre-offering stage and was "at the time of any offers and the sales" a person resident and doing business within X. Yet a technical reading of rule 147(c) undermines administrative and judicial attempts to protect investors after the offering ceases.<sup>113</sup> One

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case was incorporated in California and had its principal place of business in California, where it operated a wholesale pharmaceutical business with total assets of approximately 13,000 dollars. The issuer planned to raise more than 4 million dollars in capital and ran an advertisement in the *Los Angeles Times* offering for sale some 4,000 shares of common stock at 1,000 dollars per share. The offering was expressly limited to bona fide residents of California. The issuer expected to use the proceeds to purchase, renovate, and operate a hotel located in Las Vegas, Nevada. Since the business venture would have had the operative effect of shifting the corporation's business from California, its state of incorporation, into another state, the intrastate exemption was held not to apply.

112. See text following note 75 *supra*.

113. Judicial concern for purchasers in an intrastate offering is exemplified by *SEC v. McDonald Inv. Co.*, 343 F. Supp. 343 (D.C. Minn. 1972). McDonald Investment Co. was a Minnesota corporation with its principal and only business office and all books, correspondence, and other corporate records located in Minnesota. It had been in business "for some period of time." McDonald proposed an intrastate offering of unsecured installment promissory notes and registered the offering with the Minnesota

could argue that investors are still protected by the requirement that the issuer infuse at least eighty per cent of the proceeds from the offering into the state where purchasers reside since the purchasers would then presumably be in a position to reach the proceeds by lien or attachment, but this is, at best, an illusory weapon. Rule 147(c)(2)(iii) permits the issuer to use the proceeds "in connection with the operation of business or . . . the rendering of services within" the state. Thus, the proceeds could easily be spent in ways that would not provide shareholders with any assets that they could attach.

Furthermore, the SEC and the courts have consistently taken the position that section 3(a)(11) is a transactional exemption.<sup>114</sup> If it is, it could be argued that the entire transaction, from its inception to the final allocation of proceeds, must be tested against the "doing business" requirement. If the location of an issuer's assets, its principal office, and the source of its gross revenues are to be included within the definition of "doing business," as the rule provides, traditional SEC policy would demand an interpretation of rule 147(c) that is not explicit in the language used in that paragraph. Since it seems unlikely that the SEC would deviate without an explanation from its earlier position on what constitutes "doing business," one can assume either that the ambiguous language in paragraph (c) will be corrected<sup>115</sup> or that the SEC will issue its own interpretation of the

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Commissioner of Securities. The proceeds from the installment notes were to be lent to land developers outside Minnesota with security taken from them in the form of mortgages or other liens running to McDonald. The individual installment note purchasers would not, however, have had any direct ownership or participation in the mortgages or other lien security, nor in the businesses of the borrowers. In its petition for an injunction to permanently enjoin the offering, the SEC challenged the availability of section 3(a)(11) on the ground that the issuer would, after using the proceeds of the intrastate offering, be engaged in a business where the income-producing operations would be located outside the state in which the securities were to be offered. Although stating that it was a close question, the court held that registration was required and issued a permanent injunction against the sale of the unregistered notes. Referring to *Chapman v. Dunn*, 414 F.2d 153 (6th Cir. 1969), the court stated:

This language [from *Chapman*, requiring that the issuer conduct a predominant amount of its business within the same state] would seem to fit the instant case where the income producing operations of the defendant, after completion of the offering, are to consist entirely of earning interest on its loans and receivables invested outside the state of Minnesota. While the defendant will not participate in any of the land developer's operations, nor will it own or control any of the operations, the fact is that the strength of the installment notes depends perhaps not legally, but practically, to a large degree on the success or failure of land developments located outside Minnesota, such land not being subject to the jurisdiction of the Minnesota court. The investor obtains no direct interest in any business activity outside of Minnesota, but legally holds only an interest as a creditor of a Minnesota corporation . . . .  
343 F. Supp. at 345.

114. See text accompanying note 14 *supra*; Release 5450, *supra* note 11, at 83,649.

115. The traditional scope of section 3(a)(11) could be reflected in paragraph (c) by amending the introductory language in rule 147(c) to read: "The issuer of the securities

rule.<sup>116</sup>

*Illustration 4.* Same facts as illustration 1 except that Company *A* does not immediately use at least eighty per cent of the proceeds of the offering. Six months after the last sale of its securities on October 15, *A* begins negotiations for a private placement of additional securities in reliance upon section 4(2). At the time of closing under the private placement, *A* has used only sixty per cent of the net proceeds from its earlier intrastate offering but still plans to use at least eighty per cent for local purposes.

Illustration 4 raises a question about the interrelationship between paragraph (b) of the rule, the nonintegration standard, and subsection (c)(2)(iii), the requirement that eighty per cent of the proceeds be used within the state. An analysis of these two paragraphs suggests that counsel for *A* should be concerned about proceeding with a second offering of unregistered securities when the first offering does not yet clearly qualify for an exemption. The danger is that the issuer may not ever use at least eighty per cent of the proceeds within the state. In that event, rule 147 would be unavailable, and the issuer would face two potential problems as a result of the first offering. First, if the issuer cannot satisfy the requirement of rule 147, it may not be able to establish an exemption under section 3(a)(11) for the first offering. Without an exemption, it would be in violation of section 5 of the Act, with all of the resulting liabilities. Even if *A* could comply, not with the rule, but with the relevant administrative and judicial interpretations of section 3(a)(11) in effect at the time of the transaction,<sup>117</sup> nothing in the current law suggests that rule 147(b)'s standard for nonintegration would apply to transactions outside the rule.<sup>118</sup> Thus, *A* runs the risk of having its first offering, which may qualify under section 3(a)

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shall at the time of any offers, the sales and the use by it of at least 80% of the net proceeds be a person . . . ."

116. Release 5450 states that the staff will issue interpretative letters to assist persons in complying with the rule. However, the staff will issue no-action letters in regard to "transactions in reliance on Section 3(a)(11) outside the rule only on an infrequent basis and in the most compelling circumstances." Release 5450, *supra* note 11, at 83,654. The Commission withdrew from the position it took in release 5349, where it stated that, if proposed rule 147 were adopted, it would cease issuing no-action letters in regard to transactions in reliance on section 3(a)(11) outside the rule. Release 5349, *supra* note 11, at 7, ¶ 79,168 at 82,549.

117. Release 5450 and preliminary note 3 to rule 147 state that the rule is nonexclusive. Section 3(a)(11) would also be available "if the issuer satisfied the standards set forth in relevant administrative and judicial interpretations at the time of the offering but the issuer would have the burden of proving the availability of the exemption." Rule 147, preliminary note 3.

118. See note 46 *supra* and accompanying text.

(11), integrated with the second offering despite the fact that the company has waited six months between offerings. The moral seems obvious. Although no explicit relationship exists between paragraph (b) and subsection (c)(2)(iii), protection under the nonintegration standard may assume full compliance with all the requirements of rule 147.

A similar problem is presented where an issuer waits six months after an intrastate offering and then files a registration statement to cover a subsequent offer and sale of its securities. Again assume that the issuer expects to claim an exemption under section 3(a)(11) and rule 147 for its first offering but has not yet used at least eighty per cent of the proceeds. If the first offering fails to qualify for an exemption under section 3(a)(11) by reason of rule 147, the first offering might be integrated with the subsequent registered offering.

An ironic consequence of rule 147 and the SEC's attempt to assist issuers in their interpretation of section 3(a)(11) is that the rule probably enhances the likelihood of integration problems, such as the one raised by illustration 4. Without the rule, an issuer would wait a full year, not just six months, before launching a second offering of its securities.<sup>119</sup> The longer an issuer is forced to delay its plans for a subsequent offering, the more likely it is that all of the proceeds from an earlier intrastate issue will be spent, and the longer the time interval between offerings, the weaker the case for integration. An issuer that, in reliance on rule 147, begins a second offering only six months after an earlier offering could find itself with integrated offerings under traditional tests if it fails to satisfy the rule.<sup>120</sup> A further problem with rule 147 is a result of the very specificity and clarity of its standards. The objective criteria are either satisfied, or they are not. Without rule 147, an issuer such as Company *A* might conclude that an exemption under section 3(a)(11) existed since it had already spent sixty per cent of the proceeds from its earlier intrastate offering and intended to commit the remainder to its local business. Under rule 147, an issuer must overcome the potentially difficult problem of identifying and tracing the use of the monies raised in the intrastate offering. Partial use of proceeds and good intentions are not enough.

In addition to possible dangers from integration, illustration 4 presents a problem of disclosure. Whether the issuer follows its intrastate offering with a private placement or a registered public offer-

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119. See text accompanying note 36 *supra*.

120. See text accompanying note 34 *supra*.

ing, it must explain the legality of the first offering under the Securities Act of 1933.<sup>121</sup> If the issuer has not satisfied all the requirements of Rule 147 by the time that it either approaches potential investors in a private placement or drafts the preliminary prospectus for a public offering, it could not state that its earlier offering was exempt by reason of rule 147. Counsel to the issuer may be able to opine that an exemption exists, independent of rule 147, and that no integration problem should arise. Short of such professional assurance, however, an issuer would have to disclose fully the tentativeness of the exemption and the consequences that would follow if an exemption does not exist.

*Illustration 5.* Same facts as in illustration 1 except that, despite its good faith efforts to comply with rule 147, Company A neglects to obtain from one of the two hundred purchasers in the offering the written representation required by rule 147(f)(1)(iii). Believing that rule 147 applies to its transaction, A instructs its transfer agent to process resales to nonresidents nine months after the last sale of securities under the intrastate offering.

This illustration suggests the effect that noncompliance under paragraph (f) can have on other paragraphs of the rule that have changed traditional interpretations of section 3(a)(11). Paragraph (f) incorporates precautionary measures that were regularly employed before the rule as evidence of the existence of an exemption but that are now mandatory. The paragraph becomes a trap for the unsuspecting issuer that inadvertently effects less than full compliance,<sup>122</sup> because a violation of paragraph (f), regardless of how immaterial or accidental it might be, means that the issuer is not one that offers and sells "in accordance with all of the terms and conditions of this rule," as required by subparagraph (b)(1). If rule 147 is unavailable, the nine-month standard in paragraph (e) for determining when an issue "comes to rest" is irrelevant. Company A has

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121. See note 52 *supra*. For registered offerings, see, e.g., Form S-1, item 26, 1 CCH FED. SEC. L. REP. ¶ 7124, at 6213-3 (1973), and Rule 408, 17 C.F.R. § 230.408 (1973).

122. The SEC does not explain why the precautionary measures are mandatory. Paragraph (e) provides a specific time period during which resales to nonresidents are prohibited. In the opinion of the SEC, the nine-month period in rule 147(e) "provides the necessary protection to investors against interstate trading markets springing up before the securities have come to rest within the state." Release 5450, *supra* note 11, at 83,654. As an additional precaution, a note to paragraph (e) reminds dealers of rule 15c2-11. See note 102 *supra*. Instead of requiring the precautionary steps in rule 147(f), the SEC could have insisted that the issuer and any person acting on its behalf take reasonable care to assure that the purchasers in the rule 147 offering do not resell to nonresidents. Such reasonable care could include taking the steps set forth in paragraph (f). It was precisely this type of position that the SEC took in proposed rule 146(h) in putting the burden on issuers to assure that purchasers did not become underwriters. Proposed Rule 146(h), *supra* note 11, at 2908.

the burden of establishing that its intrastate offering came to rest in nine months in accordance with "the judicial and administrative interpretations of Section 3(a)(11) in effect at the time of the offering."<sup>123</sup> The issuer may discover that it authorized interstate resales prematurely and has become liable to any investor who wishes rescission under section 12(1)<sup>124</sup> of the Act.

### III. EVALUATION

An evaluation of rule 147 should include an examination of whether the SEC premises behind the new rule are consistent with the purposes of the intrastate exemption in section 3(a)(11) and, if they are, whether the rule represents sound regulatory policy.

The SEC has stated that "[s]ection 3(a)(11) was intended to allow issuers with localized operations to sell securities as part of a plan of local financing";<sup>125</sup> a company with operations restricted to one area should be able to offer a limited amount of its securities to "investors in the immediate vicinity without having to register the securities with a federal agency."<sup>126</sup> Such statements are no doubt true, but they are also conclusory. They do not explain why Congress believed that the protective disclosure required by the Act should not apply to local financing. The following reasons have been offered from time to time in support of the intrastate exemption: (1) In terms of economic policy, it is useful to allow securities offerings by a small businessman to his friends, relatives, business associates, and others, without federal restrictions;<sup>127</sup> (2) registration for such small offerings would, as a practical matter, be almost impossible;<sup>128</sup> (3) investors in local financings are protected by the sanctions of public opinion;<sup>129</sup> (4) such investors are protected by their proximity to the issuer;<sup>130</sup> (5) such investors are protected by state regulation;<sup>131</sup> and (6) intrastate offerings do not present questions of national interest.<sup>132</sup>

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123. Rule 147, preliminary note 3; Release 5450, *supra* note 11, at 83,654.

124. 15 U.S.C. § 77f(1) (1970).

125. Release 5450, *supra* note 11, at 83,649.

126. *Id.*

127. 1 SPECIAL STUDY, *supra* note 68, at 570-71.

128. *Id.* at 571.

129. Throop & Lane, *supra* note 14, at 108. Mr. Throop was General Counsel for the SEC at the time he co-authored this article.

130. Release 5450, *supra* note 11, at 83,649. *See also id.* at 83,650: "[T]he primary purpose of the intrastate exemption was to allow an essentially local business to raise money within the state where the investors would be likely to be familiar with the business and with the management . . . ."

131. Release 5450, *supra* note 11, at 83,649.

132. *Cf.* H.R. REP. NO. 85, 73d Cong., 1st Sess. 10-11 (1933). The House report does

Each of these arguments should be re-evaluated to determine whether it still justifies section 3(a)(11). In forty years much has happened to the disclosure system of the Act. The obligations of disclosure are dramatically more sophisticated and more demanding today than they were in 1933;<sup>133</sup> they have become the most effective method available to the SEC for protecting investors in the securities market.<sup>134</sup> Furthermore, the expanding definition of "security" now includes methods of financing not contemplated when Congress exempted certain securities and certain securities transactions from the registration process of the Act.<sup>135</sup> These are fundamental changes in federal securities law, and they have influenced administrative and judicial interpretations of section 3(a)(11). The exemption that permitted local financing in 1933 has been so narrowly construed in recent years that many respected securities attorneys avoid it.<sup>136</sup> It may be that the exemption has outlived its usefulness and should be eliminated from the Act. If the exemption is to survive, persuasive support must be found.

Arguments (1) and (2) raise policy issues that the courts and the SEC have considered and restated since 1933. The first of these, phrased in terms of economic policy, presumably explains the presence of sections 3(a)(11) and 4(2) in the Act. But, even though it may make sound economic sense, it leads to certain adverse consequences. Investors in the exempted transactions may receive little or no information about the issuer to use in making their investment decisions. Without external pressure the issuer may choose to reveal only what it considers important for investors to see. Blue-sky regulation by the states is certain to be uneven,<sup>137</sup> and many investors will be left to fend for themselves. Also, the economic policy may be

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not contain any specific criticism of state regulation of intrastate sales of securities. One of the major purposes of the Securities Act was to make state control "more effective by preventing evasion of State security legislation by the device of selling in interstate or foreign commerce from outside the State." *Id.* at 10.

133. For a discussion of disclosure under the Act and the changes that have occurred since 1933, see SECURITIES & EXCHANGE COMMN., DISCLOSURE TO INVESTORS—A REAPPRAISAL OF ADMINISTRATIVE POLICIES UNDER THE '33 AND '34 ACTS (1969) (WHEAT REPORT); Schneider, *Reform of the Federal Securities Laws*, 115 U. PA. L. REV. 1023 (1967).

134. See SECURITIES & EXCHANGE COMMN., *supra* note 133, at 9-11.

135. See, e.g., SEC v. Glenn W. Turner Enterprises, Inc., 348 F. Supp. 766 (D. Ore. 1972), *aff'd.*, 474 F.2d 476 (9th Cir. 1973), *cert. denied*, 42 U.S.L.W. 3194 (U.S., Oct. 9, 1973) (franchises); Financial Analytics Corp., [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,498 (SEC, July 16, 1973) (sale, leaseback, and re-lease of equipment); SEC Securities Act Release No. 5018 (Nov. 4, 1969), [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,757 (whiskey warehouse receipts).

136. See text accompanying note 10 *supra*. One attorney has suggested that any lawyer who advises a client to rely upon the intrastate exemption should have his head examined. Goldman, *supra* note 36, at 194 (statement attributed to James C. Sargent, former SEC commissioner). Nonetheless, the exemption is popular in a few states—California, Texas, Ohio. Comment, *supra* note 8, at 534-35.

137. See text accompanying note 145 *infra*.

abused. Substantial offerings by financially successful businessmen could be made, under the guise of this exemption, to investors who are not friends, relatives, or business associates.<sup>138</sup>

As a result of such abuses one might expect that the economic policy will eventually be modified to allow for the imposition of federal standards of disclosure. The amended approach need not necessarily include a formal administrative review, such as the registration process requires. For instance, in the case of the non-public offering exemption under section 4(2), owners of small businesses may offer securities to their friends, relatives, and associates without complying with the registration requirements of section 5 of the Act, but investors are accorded protections not originally provided.<sup>139</sup> The experience under section 4(2) indicates that a modified form of mandatory disclosure is a workable alternative to complete exemption.<sup>140</sup> Logically, therefore, there is no reason to accept without change the economic arguments that may have once explained the desirability of section 3(a)(11). This experience also undercuts the force of argument (2), which also seems to pit full compliance with the registration requirements of section 5 against the complete noninvolvement now found in section 3(a)(11).<sup>141</sup>

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138. It is impossible to determine exactly how many offerings are made in reliance on section 3(a)(11), "but the number unquestionably is substantial in view of the fact that there are over a million corporations in the United States, most of which are not represented in the trading markets." 1 SPECIAL STUDY, *supra* note 68, at 571. In 1957, the regional offices of the SEC made a "rough estimate" of the number of filings that would have been made in their offices if issuers making intrastate offerings were required to notify the Commission. The Chicago regional office estimated 921 offerings; the Fort Worth office estimate was 510. *Id.* at 573 n.225.

The size of intrastate offerings is not prescribed by section 3(a)(11). Neither the courts nor the SEC has ever suggested a ceiling on the amount that may be raised under the exemption. The legislative history, however, indicates that the exemption was designed for small, local financing by small businessmen. *Id.* at 570-76. Moody's Industrial Manual for 1961 reported that at least 90 offerings were apparently made pursuant to section 3(a)(11). Fifteen of these offerings were for amounts totalling at least 1 million dollars; another 15 were for amounts between 500,000 dollars to 1 million dollars. *Id.* at 573. In August 1967, the Attorney General of New York announced that intrastate offerings in New York had totalled almost 100 million dollars during the preceding three years. 4 L. Loss, *supra* note 20, at 2605.

139. *See, e.g.*, SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC v. Continental Tobacco Co. of S. Car., Inc., 325 F. Supp. 588, *rev'd.*, 463 F.2d 137 (1972). *See also* Proposed Rule 146(e), *supra* note 11.

140. *See, e.g.*, the disclosure requirements for exemptions relating to fractional individual interests in oil or gas rights. Regulation B, 17 C.F.R. §§ 230.300-346 (1973).

141. The all-or-nothing approach can be found in Emens and Thomas. The authors urge the retention of the intrastate exemption because

[t]here is ample evidence that the intrastate exemption is extensively utilized and it appears vital to many businesses that its use be continued. It would be almost impossible to require federal registration for most intrastate offerings. At a time when the SEC is overworked and understaffed, and when a typical full scale SEC registration of a new offering usually involves total costs of approximately \$100,000 and consumes two to six months, it does not appear wise to attempt to eliminate the intrastate exemption.

Emens & Thomas, *supra* note 81, at 783.



The thrust of arguments (3), (4), and (5) is that federal control or review is unnecessary in an intrastate offering because protection already exists. Leaving aside for the moment the question of state regulation, arguments (3) and (4) assume an ideal that, if present in the 1930's, is rarely achieved today. Argument (3) evokes the image of a small business located amid a tightly knit community where residents know each other and respond to the subtlest expressions of social disapproval. The securities offering is made to townsfolk who chat informally with company officials about the prospects of success. This is a romantic view, to be sure. To believe that, more often than not, the opinion of the community can substitute for the registration process<sup>142</sup> is to dream of days gone past. This is not to suggest that section 3(a)(11) should not apply when the ideal community, or one approaching it, can be identified. It should. But section 3(a)(11) has never been limited to such situations.

Much the same can be said for argument (4). The assumption that the investor's proximity to the issuer yields protection in the form of inspection and control may be correct in some situations, but, again, section 3(a)(11) is not sufficiently limited. Issuers may use the intrastate exemption to sell securities to residents who live hundreds of miles away from corporate offices and plants. Proximity is a relative term and means much more to residents of Rhode Island than it does to residents of Texas.

Argument (5) is the strongest reason for an intrastate exemption. In theory, if an offering of securities is properly restricted to the issuer's state of residence, investors should be adequately protected by the blue-sky-law requirements. In *Chapman v. Dunn*,<sup>143</sup> the Sixth Circuit concluded that section 3(a)(11) was designed to exempt only those offerings that could be effectively regulated under the applicable blue-sky law. The defendant in that case was a life-long resident of Michigan who maintained the offices and management staff for his oil and gas business in Michigan. However, his oil and gas properties, which represented the defendant's sole income-producing assets, were located in Ohio. The defendant sold securities in Michigan and relied upon section 3(a)(11) for an exemption from the registration requirements. However, the court held that the defendant was not doing business in Michigan and, consequently, that the securities offering was not exempt. The court expressed concern for Michigan investors, whose blue-sky administrators faced serious impediments in supervising assets located in another state. Effective regulation, with corresponding protection to investors, requires that the income-

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142. Throop & Lane, *supra* note 14, at 108.

143. 414 F.2d 153 (6th Cir. 1969). See notes 66 & 105 *supra* and text accompanying notes 69-70 *supra*.

producing properties be located in the state of the offering, for this enables state officials to "issue cease and desist orders, injunctions and even appoint a receiver to manage the assets of a Company that violates the provisions of the State Statute."<sup>144</sup>

As is so often true in the law, the theory suffers in practice. It is common knowledge among securities lawyers that the enforcement of blue-sky regulations among the states is far from uniform. Some states provide minimal legislative protection. Other states with formidable blue-sky regulations do not provide adequate financial support for investigatory and supervisory personnel.<sup>145</sup> In short, state regulation as a form of investor protection is fortuitous and depends upon where and when a need arises.

In 1933, as suggested by argument (6), intrastate offerings may not have presented a question of national interest. There was, to be sure, the far more pressing problem of regaining national trust and confidence in the securities markets and in the entire capitalistic structure. But argument (6) should be tested against today's national issues, which certainly include many matters of consumer protection. As consumers, investors may be exposed to threats and assaults that the states are unable to repel.

The traditional arguments in favor of an intrastate exemption have lost their forcefulness. A strong case can be made for abolishing the exemption altogether,<sup>146</sup> but the SEC seems to have kept it alive with rule 147. Or has it? Is rule 147 a reaffirmation of some or all of the pro-exemption arguments discussed above, or does it represent a retreat from or even an abandonment of the theory behind section 3(a)(11)?

In Release 5450, which contains the text of rule 147, the SEC offered the following commentary on the rule:

Congress, in enacting the federal securities laws, created a continuous disclosure system designed to protect investors and to assure the maintenance of fair and honest securities markets. The Commission, in administering and implementing these laws, has sought to coordinate and integrate the disclosure system with the exemptive provisions provided by the laws. Rule 147 is a further effort in this direction.<sup>147</sup>

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144. 414 F.2d at 158.

145. See generally L. LOSS & E. COWETT, BLUE SKY LAW 43-86 (1958).

146. See ALI, FEDERAL SECURITIES CODE § 301, Comment on Exemptions Generally (4) (Tent. Draft No. 1, 1972). But see Emens & Thomas, *supra* note 81, at 782-83.

147. Release 5450, *supra* note 11, at 83,649. Except for minor changes, the SEC used the same language in its promulgation of rule 144, SEC Securities Act Release No. 5223 (Jan. 11, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,487; in its promulgation of rule 145, SEC Securities Act Release No. 5316 (Oct. 6, 1972), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,015; and in its announcement of proposed rule 146, Release 5336, *supra* note 11.

At first, the quoted statement seems inappropriate. The SEC announces that it seeks "to coordinate and integrate the disclosure system with the exemptive provisions provided" in the Act. Rule 147 is intended to further the process. But rule 147 and the exemptive provision, section 3(a)(11), do not require any disclosure by the issuer. How, then, can the SEC claim that rule 147 represents another effort by the Commission to integrate the "disclosure system" with section 3(a)(11)? Had the SEC adopted rule 147 in its proposed form, which was more restrictive than the present rule, one could answer the question by surmising that the Commission was achieving its goal of protection through disclosure in an indirect way. As proposed, rule 147 would have narrowed the availability of section 3(a)(11) to such an extent that very few issuers could use it. Issuers would then have either filed a formal registration statement, with full disclosure, or have relied upon another exemption, such as section 4(2)<sup>148</sup> or Regulation A, both of which require some disclosure.<sup>149</sup> Proposed rule 147 might not have abolished section 3(a)(11), but it would have struck a crippling blow. The rule as adopted embodies at least ten major modifications that breathe some life back into section 3(a)(11).<sup>150</sup> As a result, it is difficult to understand how rule 147 coordinates and integrates the disclosure system.

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148. Because use of the intrastate exemption carries with it the need for extraordinary caution, see note 28 *supra*, section 4(2) (non-public offerings) is frequently suggested as an alternative exemption available for the same issue. See, e.g., 1 L. Loss, *supra* note 30, at 603; Comment, *Securities Regulation: Problems Involved in Understanding and Utilizing the "Intrastate" 3(a)(11) Exemption*, 31 ROCKY MOUNTAIN L. REV. 186 (1959). It is argued that after one limits section 3(a)(11) to situations where the offering is small enough to be manageable, where the offerees are known to be bona fide residents, and where the announced intentions as to resale can be relied upon, the issuer can usually rely on the exemption under section 4(2). Comment, *supra*, at 204-06.

149. See note 140 *supra*; Rule 256, 17 C.F.R. § 230.256; and schedule I of form 1-A under regulation A. 1 CCH FED. SEC. L. REP. ¶ 7327 (1972).

150. Rule 147 as adopted made the following changes in proposed rule 147: (1) Paragraph (b) in proposed rule 147 would have been "too restrictive" and was revised; (2) paragraph (c) in the final rule reversed the SEC's earlier position on the residency of a partnership; (3) as proposed, the rule would have required the issuer to meet the gross revenues and assets conditions at the end of its most recent fiscal year and its most recent fiscal quarter, burdens that the SEC changed in rule 147(c)(2) because they "might have been difficult for many small businesses"; (4) subparagraph (c)(2) allows an exception to the revenues test for certain issuers that were not excluded under the proposed rule; (5) the requirement that an issuer intend to use and use at least 90 per cent of proceeds intrastate, as it appeared in the proposal, was reduced to 80 per cent in the revised rule, "since it appeared to be unduly restrictive"; (6) a moving twelve-month calculation is permitted in some instances for determining gross revenues, a flexibility not originally provided for in the proposed rule; (7) under rule 147(d) the requirement relating to an individual's residence does not include the proposed rule's requirement that he not have any present intention of moving his principal residence to another state; (8) the location of a company's principal office, rather than its place of organization or incorporation, establishes residency under rule 147(d); (9) as adopted, the rule eliminates the proposed rule's limitations on reoffers to nonresidents; and (10) the limitation on resales was reduced from twelve to nine months under paragraph (e). Although the SEC usually follows a practice of publishing revisions in proposed rules and inviting public comment on the changes, it did not do so in the case of rule 147. For examples

Release 5450 contains a second SEC justification for the rule:

Congress apparently believed that a company whose operations are restricted to one area should be able to raise money from investors in the immediate vicinity without having to register the securities with a federal agency. In theory, the investors would be protected both by their proximity to the issuer and by state regulation. Rule 147 reflects this Congressional intent *and is limited in its application to transactions where state regulation will be most effective.*<sup>151</sup>

Nowhere in the rule or in the release does the SEC explain the interrelationship between rule 147 and state regulation. The assumption must be that the SEC has so limited the type of transaction that will qualify under the rule that even those states with minimal blue-sky controls will be able to regulate intrastate offerings effectively. The assumption, if accurate, can be challenged in several ways. No evidence exists to support the assertion that state regulation will be effective in all cases where the issuer satisfies the conditions and terms of the rule.<sup>152</sup> Certainly, nothing in the rule prevents an issuer from offering or selling its securities pursuant to rule 147 in a state where regulation is minimal or ineffective. Furthermore, the SEC seems committed to integrating the disclosure system into the exemptive provisions of the Act.<sup>153</sup> If the state regulation referred to in release 5450 does not ensure disclosure to its residents, and the form of state regulation can vary dramatically,<sup>154</sup> then the SEC is pursuing a policy for section 3(a)(11) that differs from the one intended for other exemptions. Finally, rule 147 is nonexclusive. In many respects, it is less attractive to issuers than the traditional interpretations of the exemption.<sup>155</sup> Assuming that rule 147 is by its terms limited to transactions where state regulation will be most effective, how has the SEC furthered its goals of protecting investors and assuring the maintenance of fair and honest markets in those cases where issuers choose to effect intrastate offerings outside the rule?

If the SEC intends to coordinate and integrate the disclosure system with section 3(a)(11), as it says it does, rule 147 falls short of the

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of where it has done so, see Rule 144, 17 C.F.R. § 230.144 (1973) (proposed in SEC Securities Act Release No. 5087 (Sept. 22, 1970), [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,909; revised in SEC Securities Act Release No. 5186 (Sept. 10, 1971)); Rule 145, 17 C.F.R. § 230.145 (1973) (proposed revision of rule 133 in SEC Securities Act Release No. 5012 (Oct. 9, 1969), [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,748; substitution of proposed rule 145 for rule 133 in SEC Securities Act Release No. 5246 (May 2, 1972), [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,753); Rule 146, discussed in note 11 *supra*.

151. Release 5450, *supra* note 11, at 83,649 (emphasis added).

152. See text accompanying note 145 *supra*.

153. See note 147 *supra* and accompanying text.

154. See 4 L. Loss, *supra* note 20, at 2214-15.

155. For example, the risks involved under paragraph (b) may be greater than the risks of integration outside the rule. See text accompanying note 48 *supra*.

mark. What is needed is an administrative interpretation of section 3(a)(11) and a revision of rule 147 that conditions the availability of the exemption on disclosure by the issuer of certain material information. Such disclosure could be achieved in several ways. The SEC could frame standards for disclosure in intrastate offerings and expect issuers to establish compliance as part of their burden of proof under rule 147 or section 3(a)(11).<sup>156</sup> An alternative approach might offer greater protection to investors and allow states a role that Congress intended. The SEC would again establish the standards. But the availability of section 3(a)(11) would depend on a showing by the state or territory of the issuer's residence that (a) the disclosure required under its blue-sky regulations equaled or exceeded that required by the SEC and (b) administrative and financial support existed for the implementation of the state regulations. Under such an approach the administrator charged with coordinating and enforcing blue-sky regulations might qualify his state with the SEC, thereby relieving prospective issuers of that burden. This form of control would permit the SEC truly to limit section 3(a)(11) to those "transactions where state regulations will be most effective." Another alternative would involve a combination of the first two approaches. In states that have qualified their blue-sky regulation under SEC standards, an issuer would be free to use the exemption and, where applicable, rule 147, without a showing of disclosure. In states that have not so qualified, an issuer would be required to show as part of its burden of proof under the exemption that it had complied with the SEC disclosure standards.

In its present form, rule 147 perpetuates the theories that have supported section 3(a)(11) from its inception. Many of these theories are no longer viable. If the SEC wishes to move section 3(a)(11) into the continuous disclosure system, it must abandon many of the traditional justifications for the exemption and adapt its disclosure philosophy to the purposes that Congress intended section 3(a)(11) to serve.

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156. The SEC could adapt disclosure forms and requirements used in connection with other exemptions, such as Regulation A. It could also borrow standards from those states that have enacted specific legislation to deal with intrastate offerings. One example is the New York Intra-State Financing Act. N.Y. GEN. BUS. LAW § 359-ff (McKinney Supp. 1973). Under the New York Act, it is "unlawful for any person, directly or indirectly, to offer or sell any security which is part of an issue offered and sold only to persons resident within this state unless an offering prospectus which makes full and fair disclosure of all material facts is first filed by the issuer of such security with the department of law . . ." N.Y. GEN. BUS. LAW § 359-ff(1) (McKinney Supp. 1973). The New York act contains detailed requirements on what must appear in the prospectus. See N.Y. GEN. BUS. LAW § 359-ff(1). (McKinney Supp. 1973). See generally Comment, *Blue Sky Laws In the Empire State and the Uniform Securities Act*, 22 SYRACUSE L. REV. 925, 941-55 (1971).