Maryland Law Review

Volume 31 | Issue 1 Article 4

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Recommended Citation

Ronald M. Shapiro, & Alan R. Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always ....*, 31 Md. L. Rev. 3 (1971)
Available at: http://digitalcommons.law.umaryland.edu/mlr/vol31/iss1/4

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Maryland Law Review

VOLUME XXXI 1971 NUMBER 1

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INTEGRATION UNDER THE SECURITIES ACT: ONCE AN EXEMPTION, NOT ALWAYS . . . .

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and
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Invent and Improve, directors and shareholders of a successful and growing "private" company, Autotex, Inc., enter the office of recently retained securities counsel and proudly display a "letter of intent" that commits a reputable underwriting firm to "take their company public" on good financial terms. They understand that the public offering of Autotex's securities must fully comply with the federal securities laws and are ready, willing and able to go through the rigors of the registration process prescribed by the Securities Act of 1933[1] (the Act). Several days later, however, elation is dampened when counsel advises Invent and Improve that despite their desire to comply scrupulously with the Act's registration provisions, it is possible that the company has already engaged in a course of conduct which would be deemed a registration violation when it makes its proposed public offering. Counsel explains that the corporate minute book reveals that Autotex issued shares of stock for significant consideration to a number of persons during the year preceding the receipt of the underwriter's letter of intent. Invent and Improve attempt to mollify counsel's fears by stating that each of the prior issuances of stock was a "private offering" by the company and was, therefore, exempt from the registration provisions of the Act.[2] They further explain that each purchaser took his shares for "investment" in order to preserve the exemption.[3] Nevertheless, counsel informs his clients that, although each of the earlier issuances of securities, considered separately (or possibly even in combination), may have been cast in the mold of a

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1. Securities Act §§ 5–8, 15 U.S.C. §§ 77e–77g (1964).

2. Securities Act § 4(2), 15 U.S.C. § 77d(2) (1964), exempts from the registration provisions "transactions by an issuer not involving any public offering." *See* notes 21–29 *infra* and accompanying text.

3. *See* note 21 *infra*.

private offering, these issuances may suddenly be deemed to have been a public and non-exempt offering. The earlier, ostensibly private sales of stock by the company may be "integrated" with each other and considered together as being merely components of one public offering; or they may be integrated with the proposed public offering and considered a part of that public offering. Invent and Improve, believing that the term "integration" somehow had legal significance only in the civil rights area, now find that, by virtue of the securities law integration concept, they and their corporation may be confronted with liability for failing to register.

The transformation, by operation of the integration doctrine, of an offering's status from one of exemption to one of illegality as part of an unregistered public offering is a phenomenon which is not limited to situations in which the private offering exemption is claimed. The status of offerings sought to be made pursuant to certain other exemptions under the Act may be similarly altered as a result of integration.

This article will outline those exemptions most frequently affected by integration and the circumstances under which integration will most likely affect them. It will also suggest remedial solutions to present integration problems and will propose guidelines which should be enunciated by the Securities and Exchange Commission in order to assist corporate counsel confronted with the maze of integration predicaments.

I. THE EXEMPTIONS FROM REGISTRATION

Prior to an examination of specific applications of the integration doctrine, it is necessary to examine briefly its foundations — the registration requirements and exemptions therefrom under the Act. The registration provisions were designed to protect investors by promoting full disclosure of information in the interstate distribution of securities where the securities are publicly offered for sale by an issuing company or by a person in control of such company.[4] Accomplishment of this objective is sought by requiring the issuer of such securities to file with the Commission a registration statement, including a prospectus, containing financial and other information about the company's business and management and about the offering of its securities.[5] Although the provision of the Act requiring registration is itself couched in absolute terms, it is modified by two other sections of the Act which provide exemptions from registration for certain types of securities and transactions.[6] Such exemptions permit a security to be offered and sold without putting the issuer through the lengthy and costly process of registration.[7] Whether an offering will always

4. *See* Landis, *The Legislative History of the Securities Act of 1933*, 28 GEO. WASH. L. REV. 29 (1959).
5. Securities Act §§ 6–7, 15 U.S.C. §§ 77f–77g (1964).
6. Securities Act §§ 3–4, 15 U.S.C. §§ 77c–77d (1964).
7. It is not uncommon for a first public offering to take as long as from four to six months from the beginning of preparation to the effective date of the registration statement. The expense of such offering, exclusive of underwriting commissions, may be anticipated to range between $40,000 and $90,000 (including legal, accounting, printing and filing fees). For a brief summary of steps which must be taken in order

retain its exempt status, however, depends upon integration concepts. The bases of these exemptions must first be comprehended before their integration weaknesses are probed.

Exemptions from registration fall into two categories: (i) the less common exemptions for particular types of *securities*[8] and (ii) the exemptions for particular types of *transactions*.[9] The so-called "exempt-securities" exemption 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, which activities are the focal point of integration. Therefore, if a particular type of security is itself exempt, registration will not be required for its offer and sale regardless of the nature of the transaction, albeit public and interstate.

A. Transactional Exemptions — Section 3

Section 3 of the Act contains four transactional exemptions, three of which have integration implications.[10] Of the latter, the first exempts from the registration requirements those transactions in which securities are exchanged by an issuer "with its existing security holders exclusively" if no remuneration is paid for soliciting the exchange.[11] In addition to possible integration problems,[12] Commission regulations[13] impose a "good faith" requirement on those claiming this exemption in an attempt to insure that the exchange is not merely a step in a plan to effectuate an unregistered public distribution of securities. Factors considered by the Commission in determining whether or not an exchange of securities is made in "good faith" include (i) the length of time during which the securities received by the issuer were outstanding prior to their surrender or exchange, (ii) the number of holders of the securities originally outstanding, (iii) the marketability of such securities, and (iv) whether the exchange was dictated by fi-

for a company to "go public," see Shapiro & Katz, *The "Going Public Through the Back Door" Phenomenon — An Assessment,* 29 MD. L. REV. 320, 321 (1969).

8. These exempt securities are generally those offered or sold to the public prior to July 27, 1933; a broad range of government and bank securities; short-term commercial paper; securities of non-profit organizations; securities of building and loan and farmers' cooperative associations; securities of carriers subject to the jurisdiction of the Interstate Commerce Commission; certificates of receivers or trustees; insurance policies and annuity contracts; and, under certain circumstances, securities of small business investment companies. *See* Securities Act §§ 3(a)(1)-(8), 15 U.S.C. §§ 77c(a)(1)-(8) (1964).

9. A transaction which is exempt from registration may not, however, necessarily be exempt from certain *anti-fraud* provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 which impose liability for material misstatements or omissions in certain defined contexts. *See* Securities Act §§ 12, 17, 15 U.S.C. §§ 77*l*, 77q (1964); Exchange Act § 10b, 15 U.S.C. § 78j(b) (1964).

10. The exemption which is not affected by integration is set out in § 3(a)(10) of the Securities Act, 15 U.S.C. § 77c(a)(10) (1964), and applies to securities issued in exchange for outstanding securities, in exchange for claims or property interests, or "partly in exchange and partly for cash" under certain specified conditions.

11. Securities Act § 3(a)(9), 15 U.S.C. § 77c(a)(9) (1964).

12. *See* note 39 *infra.*

13. 17 C.F.R. § 231.646 (1970).

nancial considerations of the issuer rather than primarily in order to enable one or a few persons to distribute their securities to the public.[14]

The remaining two section 3 exemptions are more commonly invoked and are replete with integration problems. The first, section 3(a)(11), exempts from the registration and prospectus requirements of the Act "[a]ny security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory."[15] The Securities and Exchange Commission has described this so-called "intrastate" exemption as being designed only to apply to a local financing that, as a practical matter, may be consummated in its entirety within the state or territory in which the issuer is both incorporated and doing business.[16] Although there is no limit on the dollar amount of the offering or on the number of offerees, the availability of this exemption is specifically conditioned upon the *entire* issue of securities being offered and sold exclusively to residents of that particular state. The issuer's good faith in intending to sell only to residents of the state of issuance will not insure the applicability of the exemption; the making of a single offer or sale outside the state of issuance, regardless of the manner of such offer or sale, will destroy the exemption for all the securities in that issue, including those already sold pursuant to the exemption.[17] All securities offered for sale and sold as part of a single issue pursuant to this exemption must "come to rest" in the hands of buyers actually residing within the state of issuance, and the resident buyers must continue to own the securities which they purchase in the offering until the distribution is completed.[18]

The other common section 3 transactional exemption is the so-called "Regulation A" exemption promulgated by the Securities and Exchange Commission pursuant to authority granted to it under section 3(b) of the Act to exempt certain "small issues" of securities from the registration requirements.[19] While qualification for exempt status under Regulation A is not conditioned upon the offer or sale of the issue being made within any numerical or geographical limitations, the total offering price for the issue may not exceed $500,000 in any one year. Computation of the total offering price necessi-

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14. *Id.*

15. 15 U.S.C. § 77c(11) (1964). For a recent discussion of this exemption, see Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969).

16. Securities Act Release No. 4434 (Dec. 6, 1961). It must be emphasized that, even if the corporation is a local one, the funds raised from the issuance of the securities must be used for purposes primarily local in nature. SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957).

17. *See* SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830, 871 (S.D. Cal.), *aff'd*, 285 F.2d 162 (9th Cir. 1960); SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86 (D.N.H. 1958), *aff'd*, 276 F.2d 665 (1st Cir. 1960). Even if the securities sold outside the state could qualify for another exemption such as the private offering exemption, such an extrastate offer or sale would destroy the intrastate exemption. *See* Associated Investors Sec., Inc., First Equity Sec. Corp., Exchange Act Release No. 6859 (July 24, 1962).

18. Securities Act Release No. 4434 (Dec. 6, 1961).

19. 15 U.S.C. § 77c(b) (1964) is the statutory authority; Regulation A consists of SEC Rules 251-63, 17 C.F.R. §§ 230.251-.263 (1970).

tates careful consideration of the rules of the Regulation.[20] Regulation A requires that a Notification on Form 1-A and, in the case of offerings in excess of $50,000, an Offering Circular be filed with an appropriate regional office of the SEC; these filings are best described as a simplified form of registration statement and prospectus. Despite the need for documentation and occasional slowdowns in the SEC regional offices, Regulation A provides a relatively quick means of distributing a substantial quantity of securities on an interstate basis without a rigorous audit and with less expense than is ordinarily involved in making a registered offering.

B. Transactional Exemptions — Section 4

Section 4 of the Act creates four transactional exemptions, only one of which has integration implications[21] — the "private offering" ex-

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20. SEC Rules 253–54, 17 C.F.R. §§ 230.253–.254 (1970).

21. Securities Act § 4(1), 15 U.S.C. § 77c(1) (1964), exempts "transactions by any person other than an issuer, underwriter, or dealer." While this particular exemption does not have integration implications, it is necessary to understand the effect thereof because, under the normal operation of the integration doctrine, a sale by an "underwriter" may be sufficient to trigger the integration of two or more allegedly exempt offerings.

The major difficulty presented by this exemption is that of determining whether or not an underwriter is involved in a secondary or resale transaction. At the outset, it must be understood that, for a person to be an underwriter within the meaning of the statute, he need not be in the investment banking business, but may be a mere investor who makes a sale of unregistered stock that is subject to investment restrictions. The person who purchases unregistered stock from the *issuer* "with a view to, or offers or sells for an issuer in connection with, the distribution of" such security will be considered to be a statutory underwriter. Securities Act § 2(11), 15 U.S.C. § 77b(11) (1964). The Securities Act does not provide any specific guide with respect to the meaning of "a distribution," the key concept used in ascertaining whether or not a person is a statutory underwriter. Recently, the Commission in Securities Act Release No. 5087 (Sept. 22, 1970) issued proposed Rule 144, which attempts to inject a degree of objectivity into the determination of whether an underwriter is involved in a transaction. Among other requirements, the proposed rule provides that an eighteen-month period must elapse before securities acquired in a non-public offering may be offered for sale. This proposed rule has been consistently criticized for its lack of clarity, *see, e.g.*, WANDER, PROPOSED RULE 144, THE REVIEW OF SECURITIES REGULATION 843 (1970), and may not be adopted by the Commission. For a discussion of the rules originally proposed by the *Wheat Report* to inject objectivity into the "distribution" problem, see Shapiro & Katz, note 7 *supra*, at 332.

A further important qualification of a section 4(1) exemption relates to the meaning of the word "issuer" as used for purposes of determining whether another person is an "underwriter." In addition to the issuing company, the term "issuer" is defined to include "any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." Securities Act § 2(11), 15 U.S.C. § 77b(11) (1964). The public distribution of unregistered securities by a control person is severely limited by the strict terms of this exemption because of the inevitable involvement in such distribution of a middleman or statutory underwriter. The wide-reaching definitions of "control persons" or "control groups" further deflate the effectiveness of the section 4(1) exemption. While directors, officers and principal shareholders are commonly considered to comprise a control group, the term "control group," the term "control" as well as the terms "controlling," "controlled by," and "under common control with" also mean, *inter alia*, "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." 17 C.F.R. § 230.405(f) (1969). For an excellent discussion of the multi-faceted concept of control, see Sommer, *Who's in Control? — S.E.C.*, 21 BUS. LAWYER 559 (1966).

There are two transactional exemptions set forth in section four which do give some exemptional leeway to "dealers" and also to "control" persons or groups who may not otherwise avail themselves of the section 4(1) exemption. One of these

emption, which ranks ahead of the intrastate and Regulation A exemptions as that most commonly relied upon. Despite the fact that significant problems are generally involved in qualifying for the exemption, it has appeal because it is not subject to the geographic parameters of the intrastate exemption and does not involve the dollar limitations of Regulation A.

Private offerings or, in the language of section 4(2), "transactions by an issuer not involving any public offering," are exempted from the registration requirements of the Act.[22] While neither the Act nor the rules and regulations promulgated thereunder provide a universally applicable definition of the statutory term "public offering," the Commission has suggested several significant criteria which may be used in order to determine whether an offering is public.[23] These include the number of offerees and their relationship to the issuer (including their access to relevant information and their ability to fend for themselves in matters of investments), the number of units of securities offered, the size of the offering, and the manner in which it is made.

The most popular conception of a non-public offering is that made to a limited number of persons. To the extent that mere numbers may bear on the determination of whether an offering is public, it is the number of *offerees,* and not the number of actual purchasers, which is the crucial factor. It cannot be said that a precise maximum number of offerees exists above which the offering will no longer be considered private. As a practical matter, however, an offering to twenty or thirty offerees will not be disputed by the SEC except in unusual circumstances.[24] But there is a popular misconception that the numbers game alone will be determinative of the existence of a private offering exemption. It is important to realize that a numbers test is reflective only of custom and practice and not of the technical state of the law. As a purely legal matter, regardless of how small the number of offerees is kept, an offering cannot be considered "private" within the meaning of section 4(2) unless both the nature of the offerees and

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provisions, section 4(4), 15 U.S.C. § 77d(4) (1964), is intended to free brokers from the registration requirements when they are engaged in ordinary trading transactions on behalf of control persons, as distinguished from participating in the distribution of securities. *See also* SEC Rule 133, 17 C.F.R. § 230.133 (1970); SEC Rule 154, 17 C.F.R. § 230.154 (1970). The second transactional exemption, section 4(3), 15 U.S.C. § 77d(3) (1964), is a strictly circumscribed exemption for certain transactions made by a dealer *qua* dealer "and not transactions by dealers *qua* underwriters." L. Loss, SECURITIES REGULATION 2329 (Supp. 1969).

22. 15 U.S.C. § 77d(2) (1964). As with other exemptions, the burden of proving the availability of this exemption is upon the claimant. SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

23. Securities Act Release No. 4552 (Nov. 6, 1962).

24. As to the limited significance of the twenty-five offeree "rule of thumb," see United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir.), *cert. denied,* 389 U.S. 850 (1967); Hayden Lynch & Company, Inc., Exchange Act Release No. 7935 (Aug. 10, 1966); Schimmer v. Webster, 225 A.2d 888 (D.C. Ct. App. 1967). *See also* SEC v. Ralston Purina Co., 346 U.S. 119 (1953). In proposed Rule 181 the Commission has proposed that, in the very limited context of an acquisition transaction, an offering to not more than twenty-five offerees (including as one offeree certain closely related holders) is not a public offering. Securities Act Release No. 5012 (Oct. 9, 1969), Exchange Act Release No. 8711 (Oct. 9, 1969). For a discussion of proposed Rule 181, see Shapiro & Katz, note 7 *supra,* at 339.

their relationship to the issuer fulfill certain criteria. In *Securities & Exchange Commission v. Ralston Purina Co.*,[25] the Supreme Court stated that, in order for an offering to qualify as a private offering, the offerees must be able to "fend for themselves" in obtaining and evaluating information which would be considered essentially equivalent to the content of a registration statement.[26] This decision rested on the fact that the private offering exemption was included in the Act on the theory that the disclosure which would otherwise have been required by the Act was unnecessary where securities were offered to sophisticated investors; closely regulated disclosure was required only where offerings were made to members of the general public. Thus, to secure the exemption on firmer ground than a mere limit on the number of offerees, it is crucial that the issuer assure itself that the offerees are sophisticated and have either a sufficiently close relationship with the issuer and its management or sufficient leverage to obtain full disclosure and thereby become fully knowledgeable about the issuer.[27] In addition, even if all offerees have the requisite ability to "fend for themselves," all purchasers involved in the transaction must take the securities for investment purposes and not with a view to their distribution. If but one of such purchasers shortly thereafter makes a public resale,[28] that purchaser would be presumed to be a statutory underwriter;[29] and, unless the presumption were rebutted, the entire offering would lose its private status.

This discussion of the private offering exemption concludes a brief explanation of the exemptions from the registration rigors of the Securities Act of 1933 which may fall prey to the integration doctrine. Those exemptions most commonly relied upon by issuers not only require a careful understanding of their provisions, but also frequently demand analysis of their integration implications before the issuer can offer and sell its securities within the safe harbor of an exemption from registration.

II. THE INTEGRATION DOCTRINE

Policy determinations at the congressional level led to codification of the various exemptions from the registration provisions of the Act. The doctrine of integration, however, developed administratively as part of an effort by the SEC to restrict use of the exemptions to situations within the scope of the policies upon which they were based. The basic abuse at which the integration doctrine was specifically aimed

25. 346 U.S. 119 (1953).

26. *See* Ralston Purina Co. v. SEC, 346 U.S. 119 (1953); Value Line Fund, Inc. v. Marcus, CCH FED. SEC. L. REP. ¶ 91,523, at 94,971 (S.D.N.Y. 1965). *See also* United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967). For an extensive discussion of "qualified offerees," see Shapiro & Katz, note 7 *supra*, at 324–29.

27. The existence of these factors does not reduce the responsibility of the issuer to make full disclosure so as to be in compliance with the anti-fraud provisions of both the Securities Exchange Act of 1934 and the Securities Act of 1933.

28. If, however, a purchaser makes a resale found to be private, *i.e.*, not in connection with a distribution by him thereof, then he would not be an "underwriter" within the meaning of section 2(11); his resale would be exempt from registration under section 4(1).

29. *See* note 21 *supra*.

was the artificial fragmentation of a single non-exempt, public issue of securities into what appeared to be one or more separate offerings, for each of which an exemption from the registration requirements would, but for integration, have been available. The heart of the integration doctrine, the concept of treating all of the parts of such an artificially fragmented issue as a "single issue," became the device with which the Commission limited the otherwise free accessibility to such exemptions.

The far-reaching effects of integration, especially upon the unwary, can best be demonstrated by viewing its potential application in a typical factual setting — the organization of the closely-held, but potentially public, corporation. Let us assume that in our previous hypothetical, Invent and Improve, prior to incorporation, obtained United States Letters Patent on an electronic specialty unit, the "Autotex," a device easily adaptable for use in most computer systems which accomplishes a heretofore manually performed operation. A functional prototype was built and exhibited to the computer industry and was warmly received. Invent and Improve, after careful consideration, decided to manufacture and market the Autotex themselves — initially in a form usable in only one of the larger computers, the manufacturer of which has already placed a firm order for one thousand units. With the prototype and purchase order in hand, but with no capital in pocket, the inventors retain legal counsel to organize their business and to assist in financing the commencement of its operations.

The business is incorporated as Autotex, Inc., a Maryland corporation, which is authorized to issue 100,000 shares of common stock. In exchange for the assignment to the corporation of the Autotex Letters Patent, each of the inventors is issued 10,000 shares of the corporation's stock. Invent and Improve estimate that a minimum of $50,000 will be required to begin limited manufacture of the Autotex. The corporation makes a "private offering"[30] of 5,000 shares of the corporation's common stock at the price of $10 per share in order to raise the needed funds. It is thought that this manner of financing would permit the investors to share in the potential growth of the corporation through their equity position while allowing Invent and Improve to retain working control. In the discussions between counsel and the inventors at this stage, it is mentioned that, if the corporation were successful with its initial venture, larger amounts of capital to finance expanded operations could later be obtained through a "public offering" of the corporation's securities. The initial 5,000 shares are offered and sold "privately" to twenty-five friends and relatives of Invent and Improve, all of whom, with the exception of one New Yorker, reside in the State of Maryland. In connection with the private offering, counsel carefully requires each of the investors to execute an "investment letter" in which the purchaser warrants that the shares are being acquired for investment only.[31] Each stock certificate is stamped with a legend prohibiting any transfer of the certificate which would be in violation of the Act.

30. *See* notes 21-27 *supra* and accompanying text.
31. *See* note 21 *supra*.

The capital so raised is prudently put to work by Invent and Improve, and the corporation begins to manufacture the 1,000 Autotex units. For a period of six months, operations proceed normally until Invent and Improve come to the harsh realization that they have drastically underestimated working capital requirements and that substantial amounts of additional capital will be required to complete the 1,000-unit order. They impulsively telephone counsel and request that he do whatever is legally necessary to have a second private offering of an additional $25,000.

This is the point at which serious integration problems may arise. If a second offering were now attempted, the corporation would be faced with a substantial possibility that the Commission would integrate the first offering with the second and consider the combination as a single offering. Such integration would present no problem to the issuer if the integrated offering were non-public; it would remain exempt from registration by virtue of section 4(2). However, if the single issue resulting from the integration of two ostensibly private offerings is deemed a public offering, then the corporation will have violated the registration provisions of the Act. Integration of two "private" offerings into one "public" offering will depend upon the issuer's basis for claiming private offering exemptions for the two heretofore separate offerings. If both are offerings only to persons who meet the qualifications set forth in *Ralston Purina* for private offerees — that is, if all of the offerees have the requisite ability to "fend for themselves" — then the two offerings are private as a matter of case law; and their integration would not alter the private status of the resulting single issue because all of the offerees would still have met the *Ralston Purina* tests. On the other hand, if the basis for the claim of private offering status for one or both of the offerings was merely numerical and if not all of the offerees in both offerings met the *Ralston Purina* tests, then there is no basis for claiming that the integrated single offering is private.

If an issuer is to maintain a private exemption for the integrated offering, both of the ostensibly private offerings must conform to the *Ralston Purina* tests. If the claim of private status for either of the offerings is not supported by law, then the integrated single issue will not be entitled to that exemption. The reason for this is clear. The application of the doctrine of integration to two or more ostensibly private offerings of securities is based upon the Commission's literal construction of the language of section 4(2). The Commission early took the position that section 4(2) did "not exempt every transaction which [was] not itself a public offering, but only transactions *'not involving any public offering.'* "[32] Since only a transaction or an offering of securities not "involving" a public offering was itself exempt from registration, the Commission's inquiry into a claim of section 4(2) exemption extended far beyond the distinct offering for which such exemption was claimed. If the offering for which the exemption was claimed together with other offerings of the issuer comprised but fragmented parts of what was a "single issue" of securities, then all

32. Securities Act Release No. 2029 (Aug. 8, 1939) (emphasis added).

of the offerings would be integrated and, if deemed to be public in nature, would be subject to the registration provisions of the Act. In the language of the Commission: "[A]n issuer . . . may not separate parts of a series of related transactions comprising an issue of securities and thereby seek to establish that a particular part is a private transaction if the whole involves a public offering of its securities."[33] Accordingly, whenever reliance is placed on a section 4(2) exemption for two or more private offerings of securities, closely related in time, the issuer is immediately and squarely faced with a "single issue" question and thus the potential applicability of the integration doctrine.

The criteria which the Commission will apply in determining whether such a single issue exists are listed in Securities Act Release No. 4552:

> A determination whether an offering is public or private would also include a consideration of the question whether it should be regarded as a part of a larger offering *made or to be made*. The following factors are relevant to such question of integration: whether (1) the different offerings are part of a single plan of financing, (2) the offerings involve issuance of the same class of security, (3) the offerings are made at or about the same time, (4) the same type of consideration is to be received, (5) the offerings are made for the same general purpose.[34]

A prior release,[35] however, indicates that the single-issue question need not be resolved on the basis of *all* criteria set forth in Release No. 4552; the inapplicability of two or more such criteria may justify a determination that the several offerings do not constitute a single issue. In Securities Act Release No. 2029, the General Counsel of the Commission was requested to opine as to the applicability of sections 3(a)(9) and 4(2) of the Act to the following facts. The issuer had an "open end" mortgage on its property with an issue of bonds designated as Series A outstanding thereunder. It proposed to create two new series of bonds under the mortgage, to be called Series B and Series C bonds, respectively, for the purpose of refunding the outstanding bonds. The proposed Series B and Series C bonds differed from each other in respect to maturity date, interest rate, redemption prices and default provisions. It was contemplated that the Series B bonds would be offered in exchange to the holders of the outstanding Series A bonds on the basis of an equal principal amount of Series B bonds for those of Series A, with interest adjustment. The necessary funds to redeem any unexchanged Series A bonds would be raised by the sale for cash of Series C bonds. The issuer proposed to offer and sell the Series C bonds to no more than twelve insurance companies.

> Initially, the General Counsel pointed out that, if the proposed exchange offer and the proposed cash offer were isolated transactions, . . . no registration under the Securities Act would

33. Crowell-Collier Publishing Co., Securities Act Release No. 3825 (Aug. 12, 1957).
34. Securities Act Release No. 4552 (Nov. 6, 1962) (emphasis added).
35. Securities Act Release No. 2029 (Aug. 8, 1939).

> be required. The Series B bonds would be exempted as securities "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;" and the offering and sale of the Series C bonds would be exempted by [section 4(2)], as "transactions by an issuer not involving any public offering."[36]

The difficulty was encountered by reason of the "interdependence of the two offerings." With respect to the section 4(2) exemption, the General Counsel concluded that "the exemption is not available to securities privately offered *if any other securities comprised within the same issue* are made the subject of a public offering."[37] The question, therefore, was limited to whether or not the Series B and Series C bonds were separate issues or merely parts of a single issue. The General Counsel held that the two offerings would not be deemed to be one issue due to the different classes of the bonds and the rights appurtenant to each class, stating:

> Whatever may be the precise limits of the concept of "issue" when all securities involved are of the same class, I do not believe that securities of different classes can fairly be deemed parts of a single "issue."
>
> . . . In expressing this opinion I do not mean to imply that any difference in the incidents of two blocks of securities, however trivial, renders the blocks separate classes and consequently separate "issues" for the purposes of the Act. In this case, however, the differences between the Series B and Series C bonds are . . . sufficiently substantial to warrant treating them as separate classes even though they will be issued under the same mortgage indenture.[38]

When the criteria set forth in Release No. 4552 for resolution of the "single-issue" question are applied to the facts underlying the two proposed offerings considered in Release No. 2029, it is clear that the offerings differed only in the class of security involved and the type of consideration received by the issuer for the securities of each class. Yet these differences alone were, in the opinion of the Commission's General Counsel, sufficient to allow the SEC to treat the offerings as two separate issues and thus to preclude integration.[39]

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36. *Id.*

37. *Id.* (emphasis added).

38. *Id.* The rules applicable to private offerings of stock are intensified upon application to privately placed convertible securities. With respect to problems of private offering requirements in connection with convertible securities, see Securities Act Release No. 4450 (1962) and Securities Act Release No. 4248 (1960). *See also* Gadsby, *Private Placement of Convertible Securities*, 15 BUS. LAWYER 470 (1960).

39. In determining the applicability of the section 3(a)(9) exemption to the facts stated in Securities Act Release No. 2029, the General Counsel was confronted with the same single-issue question that was presented by the claim of the section 4(1) exemption.

Although the section 3(a)(9) exemption contained no language expressly limiting the applicability thereof to securities forming "part of an issue the whole

The case of *Value Line Fund, Inc. v. Marcus*[40] involved the only express, albeit cursory, judicial application of the Commission's criteria for determining whether several allegedly private offerings constitute a single issue. In *Value Line,* the defendant corporation, whose shares of common stock were listed on the New York Stock Exchange, had been engaged in a program of corporate acquisitions. Although the opinion is not entirely clear, it appears that such acquisitions were financed by the defendant corporation through the issuance, on an investment letter basis, of notes convertible into shares of its common stock in exchange for eighty percent of the outstanding securities of each of the acquired corporations. Between 1955 and 1956, the defendant corporation acquired twenty such subsidiaries; and a section 4(2) exemption was relied upon for the issuance of its unregistered convertible notes in connection with each such acquisition.

During June, 1956, the plaintiff corporations purchased through the defendant Van Alstyne, Noel & Co., a member broker of the New York Stock Exchange acting as principal, large blocks of the defendant corporation's unregistered common stock. This stock had been owned by the latter's president, who was also joined as a defendant. The defendant broker made the sales involved in reliance upon the offering having been exempt from registration under section 4(1) because the sale was by a person "other than an issuer, underwriter, or dealer."[41] A year later, following a drastic decline in the value of the defendant corporation's common stock, the plaintiffs instituted suit, claiming, *inter alia,* that they were entitled to rescind their purchase of the stock from the defendant Van Alstyne, Noel & Co. Among the grounds claimed for rescission was the allegation that the sale of the defendant president's stock should be integrated with the earlier offerings of the defendant corporation's securities in connection with its acquisition program.[42] Plaintiffs further con-

of which is sold as specified in the exempting provision," the General Counsel held that, based upon the use of the word "exclusively" in section 3(a)(9), "the exemption [was] available only to securities *constituting part of an issue* which, as a whole, is exchanged in conformity with the requirements of the section" (emphasis added):

> At first reading . . . Section 3(a)(9) appears to confer exemption upon any security exchanged with the issuer's existing security holders, even though other securities of the same class, as a part of the same plan of financing, are sold to others than existing security holders, or to existing security holders otherwise than by way of exchange. Such a construction, however, gives insufficient weight to the use of the word "exclusively," as employed both in Section 3(a)(9) and in its predecessor, former Section 4(3). In neither section is the grammatical function of the word entirely clear; but in order to avoid an interpretation which would reject the word as pure surplusage, it is necessary to adopt the view that the exemption is available only to securities constituting part of an issue which, as a whole, is exchanged in conformity with the requirements of the section.

Since the General Counsel concluded that the Series B and Series C bonds constituted securities of different classes and thus were separate issues, the section 3(a)(9) exemption was held to be applicable.

40. CCH FED. SEC. L. REP. ¶ 91,523, at 94,971 (S.D.N.Y. 1965).

41. 15 U.S.C. § 77d(1) (1964). *See* note 21 *supra.*

42. It is the position of the Commission that, when a company is engaged in a *continuous program* of issuing securities in connection with acquisitions, the entire series of "private offerings" pursuant to which the acquisitions are made will be integrated into one public offering; and the securities, therefore, must be registered. *See* Prospectus of American Marietta Co. (Feb. 24, 1961).

tended that the totality of such integrated transactions amounted to a public offering with respect to which the defendant Van Alstyne, Noel & Co. was a statutory underwriter. The court held to the contrary, succinctly stating, "We do not think such an 'integration' is warranted on the facts of this case because (1) the offerings sought to be integrated were by two different persons; (2) they were not a part of a single plan of financing; (3) they involved different classes of securities; (4) they were not made at the same time; (5) they were not for the same kind of consideration . . . and (6) they were not for the same general purpose."[43]

Although *Value Line* did not present a difficult integration question, it is significant for two reasons. First, the District Court for the Southern District of New York was the first expressly and literally to apply each of the factors deemed relevant by the Commission in determining the applicability of the integration doctrine. Second, a sixth test was added by the *Value Line* court — whether the offerings were made by the same person; and it is noteworthy that the court considered its additional test prior to any of the Commission's.

When each of the factors enunciated by the Commission and adopted in *Value Line* are applied to the facts of the Autotex problem, the risk that will be incurred by our hypothetical corporation in making its proposed second offering is evident. The securities involved in both offerings will be of the same class and will be issued for the same form of consideration, cash. The proximity in time of the offerings is apparent. Moreover, the transactions arguably will be made for the same purpose — to raise sufficient working capital to meet the initial operating needs of the corporation. And although the proposed private offering was conceived of at a later time, it is possible that both transactions would be viewed by the Commission as being but parts of a single plan to finance the operations of the corporation. Therefore, if all offerees do not qualify as private offerees under *Ralston Purina,* the Commission would refuse to consider this plan as effecting a single integrated private offering.

Not wishing to face the vagaries of the *Ralston Purina* test as applied to the proposed new offerees, with the risk that the two offerings would be integrated into one illegal public offering, counsel and client decide to abandon the proposed private offering. Instead, Invent and Improve conclude that, even though the registration provisions of the Act have frustrated this second attempt to raise funds on a non-public basis, the same provisions can be utilized as a vehicle to obtain a potentially larger amount of capital on a public basis. Disposed toward relinquishing to investors a much greater portion of the equity in the corporation and already acclimated to the costs incident to securities transactions, Invent and Improve advise counsel to begin the immediate preparation of a registration statement for a registered public offering under the Act.

They soon discover, however, that the integration doctrine is not limited in application merely to two or more ostensibly private transactions. The Commission has applied the single issue concept to

43. CCH FED. SEC. L. REP. ¶ 91,523, at 94,971 (S.D.N.Y. 1965).

integrate a prior private offering with a subsequent *registered* public offering. *Cameron Industries, Inc.*[44] was a proceeding under section 8(d) of the Act[45] to determine whether or not a stop order should issue suspending the effectiveness of a registration statement which had been filed by the issuer with respect to a proposed public offering of 300,000 shares of its common stock. Within a six-month period ending during the month in which the registration statement was filed, the issuer had sold 291,500 shares of its common stock. In the issuer's prospectus it was stated that the sale of the 291,500 shares had been exempt from registration under section 4(2). Of the 291,500 shares, 23,500 were sold directly by the issuer to three persons for approximately $10,000. The remaining 268,000 shares were distributed to various persons through a promoter of the issuer.

The Division of Corporate Finance of the Commission argued that all of the alleged private offerings were a part of the issue of common stock publicly offered pursuant to the issuer's registration statement and should be integrated with that public offering. The issuer contended that the sales of the 23,500 shares constituted an exempt "pre-under-writing offering"[46] designed to "raise funds to pay general corporate expenses, including the costs in connection with the contemplated public offering"[47] of its securities and that the sales of the remaining shares were also private transactions exempt under section 4(2). Despite the fact that the stock certificates representing the 23,500 shares were legended with the traditional representation of investment intent and provisions restricting their subsequent transfer in violation of the Act, the Commission held that the "sale of these shares was made *in connection with and as part of a plan for the public distribution of [the issuer's] securities.*"[48] With respect to the remaining 268,000 shares, the Commission found "the issuance and distribution of such shares [to be] *an integral part of the public offering of [the issuer's] shares* proposed pursuant to the registration statement filed shortly thereafter."[49] As a result, the Commission integrated all of the prior private offerings into the subsequent public offering and held that the exemption claimed in the issuer's prospectus for the prior offerings was not available. The prior sales, therefore, were held to have been in violation of the registration provisions of the Act. Accordingly, the issuer's registration statement was found to be materially misleading in that it falsely represented that the sales of 291,500 shares of the issuer's stock were exempt from registration and in that it failed to disclose the issuer's contingent liabilities resulting therefrom.[50]

While *Cameron Industries* was decided in the context of an administrative proceeding and involved the imposition of a stop order suspending the effectiveness of the issuer's registration statement, the ramifications of the decision from a civil standpoint are clear. A

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44. 39 S.E.C. 540 (1959).
45. 15 U.S.C. § 77h(d) (1964).
46. 39 S.E.C. at 546.
47. *Id.*
48. *Id.* (emphasis added).
49. *Id.* (emphasis added).
50. *See* SEC Regulation S-X, 17 C.F.R. § 210.3-19(g).

judicial integration would result in civil liability being asserted against the issuer and its controlling persons under sections 11,[51] 12 (1) and (2),[52] and 17[53] of the Act and under sections 18(a),[54] 10(b)[55] and Rule 10(b)(5)[56] of the Securities Exchange Act of 1934.

Despite the rather vague language used by the Commission in justifying integration in *Cameron Industries,* the Commission has indicated that it will apply the identical factors[57] that it deemed relevant in connection with the integration of two or more private offerings to the determination of whether or not a prior private offering should be construed to have been a part of a subsequent public offering made pursuant to a registration statement. The language of Securities Act Release No. 4552 clearly recognizes that a private offering may be "a part of a larger offering made or to be made. . . ."

The implications of *Cameron Industries* and the factors contained in Securities Act Release No. 4552 should be viewed in conjunction with Rule 152,[58] which has been promulgated by the Commission under authority given it in the Act. Rule 152 provides: "The phrase 'transactions by an issuer not involving any public offering' in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement." Although the language of Rule 152 is ambiguous, the *Cameron Industries* factual scenario can easily be read as falling outside the penumbra of protection afforded by the rule's language. Not only had the issuer in *Cameron Industries* reached a decision with an underwriter relative to the exact terms of the proposed public offering *prior* to the time that the illegal sales were made, but, in fact, the sale of at least the 23,500-share block was considered by the issuer itself to be merely a vehicle to finance the subsequent registration.

At the same time, it is questionable whether Rule 152 adds anything to the factors that the Commission will apparently consider in determining whether or not it will integrate a private transaction with a subsequent public offering. If the two offerings are part of a single plan of financing, involving the issuance of the same class of securities for the identical type of consideration and made at or about the same time and for the same general purpose, it is clear that the first offering *would* be deemed by the Commission to constitute a part of, and thus "involve," the subsequent public offering at the time that the private offering was made; therefore, the first offering would not be a transaction contemplated by Rule 152. Moreover, once it has been determined by the Commission that the first offering constituted a part of, and therefore involved, a subsequent public offering, it is

51. 15 U.S.C. § 77k (1964).
52. 15 U.S.C. § 77*l*(1)-(2) (1964).
53. 15 U.S.C. § 77q (1964).
54. 15 U.S.C. § 78r (1964).
55. 15 U.S.C. § 78j(b) (1964).
56. 17 C.F.R. § 240.10b-5 (1970).
57. *See* text accompanying note 34 *supra.*
58. 17 C.F.R. § 230.152 (1970).

normally implicit in such a determination that the issuer had "decided" to make the public offering at the time of the first private transaction. Accordingly, if the prior private offering is deemed to "involve" a public offering at the time it is made, the determination of when the "decision" was made to make the subsequent public offering has, in effect, been made. Thus, Rule 152 appears to be inapplicable to cases in which the doctrine of integration has been applied in accordance with the tests enunciated by the Commission.

Rule 152 also presents several interpretative questions. The rule is couched in negative terms: the fact that an issuer decides after making a private offering to make a subsequent public offering shall not preclude private exemption status for the first offering. The rule does not provide in absolute terms, however, that the section 4(2) exemption shall be applicable to a prior private offering unless the issuer had decided at the time of that offering to make a subsequent public offering. It is arguable that the section 4(2) exemption may still be denied to the first offering, despite the fact that the issuer's decision to make a public offering was arrived at subsequent to the first offering, if the Commission should determine that integration is otherwise appropriate. For the SEC to make such a determination, despite the subsequent decision to go public, would require it to ignore the absence of a single financing plan and to base its decision upon the more objective integration criteria, *i.e.*, that the offerings were made at or about the same time, and involved the issuance of the same class of securities, for the same type of consideration. It may be arguable that a decision by the Commission to integrate should not hinge upon the presence of intent on the part of the issuer to effect a single financing scheme. Nevertheless, it is at least questionable whether the issuer should be subjected to a full panoply of penalties for a violation of the Act which results from integration when Rule 152 is otherwise complied with.

A nice question is also presented with respect to the negative implications arising from Rule 152. Is an issuer always precluded from relying on a section 4(2) exemption for an otherwise private offering of its securities if the issuer *has* already "decided" to make a subsequent public offering — regardless of the nature of, and the circumstances surrounding, the public offering? Initially, the mere fact that, at the time a private offering is made, an issuer has "decided to make a subsequent public offering" should not per se preclude the applicability of a section 4(2) exemption to the private transaction. Unless the subsequent public offering actually takes place, the issuer's firm intention to make such an offering is irrelevant to the issue of whether the first offering was entitled to a section 4(2) exemption. The initial offering would be entitled to such an exemption unless it is integrated, and for integration to occur there must be a subsequent offering. Moreover, assuming that the subsequent public offering is attempted, the fact that the issuer had decided to do so at the time of the initial offering still should be considered only in connection with the other factors deemed relevant by the Commission respecting the integration question. In particular, such a "decision" would be relevant to the question of whether or not the offerings constituted a part of a "single

plan" of financing. To construe the negative implications of Rule 152 in any other manner would clearly preclude the applicability of section 4(2) to the numerous instances in which there exists no policy reason for prohibiting exempt status from attaching to a private offering despite a prior or contemporaneous decision to make a subsequent public offering. Such instances would include a private offering made to institutional investors to raise needed working capital when the issuer had previously "decided" to register its securities for distribution under a stock option plan or in connection with the acquisition of another company.

In addition to the problem of determining the extent to which a contemporaneous decision to make a subsequent public offering will bear on the Commission's determination of whether integration is appropriate, there is the problem of defining what is meant by a "decision." Specifically, to what point must an issuer have proceeded in order to be deemed to have made a "decision" respecting the subsequent public offering? It would seem that, unless and until there has been a *substantial formulation of the terms* of the subsequent public offering, the issuer should not be deemed to have made a "decision" with respect thereto. Any broader standard would raise difficult questions for a corporation, such as Autotex, that has merely contemplated or discussed a future public offering of its securities as part of its normal process of growth.

Returning to our Autotex hypothetical, it has been demonstrated that the integration doctrine could be applied to preclude the corporation from making a second private offering in reliance upon section 4(2) and from making a registered public offering of its securities under the registration provisions of the Act. Rule 152 does not seem to affect these results. The integration doctrine will also effectively preclude the corporation from issuing its common stock in reliance upon exemptions other than section 4(2), most notably the section 3(a)(11) "intrastate" offering exemption[59] and the Regulation A exemption.[60]

The section 3(a)(11) exemption is, by its very terms, available only to a security "which is a *part of an issue*"[61] of securities offered and sold only to residents of a single state if the other requirements of the exemption are met. Accordingly, the "single-issue" concept and its concomitant doctrine of integration have an even clearer linguistic basis for application by the Commission to this exemption than to the section 4(2) exemption.

Neither the Act nor the regulations promulgated by the Commission thereunder define "issue" or "part of an issue." However, in *Shaw v. United States*,[62] the only case to construe the meaning of "issue" as used in section 3(a)(11), the Court of Appeals for the Ninth Circuit held that the determination of what constitutes an "issue" of securities under section 3(a)(11) is not governed by state law.

59. *See* notes 15–20 *supra* and accompanying text.
60. *See* notes 19–20 *supra* and accompanying text.
61. 15 U.S.C. § 77c(11) (1964) (emphasis added).
62. 131 F.2d 476 (9th Cir. 1942).

The defendant-appellant had argued that "each sale or exchange of originally issued shares of a common character [was] a separate issue within the meaning of 'issue' as used in section 3(11) [*sic*]."[63] The court rejected this construction and defined "issue" to include "all the shares of common character originally though successively issued by the corporation."[64] While a construction of "issue" that limits its meaning to "each sale" of "originally issued shares of a common character" clearly would frustrate the registration provisions of the Act, the court's definition of "issue" just as clearly goes too far in the opposite direction. It has been suggested that to construe "issue" to include "all the issued shares of common character though successively issued" would make "issue" synonymous with "class."[65] Such a construction, although perhaps overlooking the Ninth Circuit's use of the qualifying word "originally," would prevent an issuer from claiming an intrastate exemption for an offering of its securities if any of its securities of the same class were ever issued to non-residents, regardless of any other circumstances. Such a view would also render meaningless the modifying language *"part of an issue"* as used in section 3(a)(11).

In sharp contrast to the decision in *Shaw*, the Commission has stated that, in order to reach a determination of whether two offerings constitute a single issue for section 3(a)(11) purposes, it will consider factors identical to those to be considered in the private offering situation:

> Whether an offering is "a part of an issue", that is, whether it is an integrated part of an offering previously made or proposed to be made, is a question of fact and depends essentially upon whether the offerings are a related part of a plan or program. Thus, the exemption should not be relied upon in combination with another exemption for the different parts of a single issue where a part is offered or sold to non-residents.
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> . . . *Any one or more of the following factors may be determinative of 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, and (5) are the offerings made for the same general purpose.[66]

As was the case with the section 4(2) exemption, the Commission will not hesitate to integrate a prior "intrastate" offering with a subsequent public offering which is registered under the Act. In *Texas*

63. *Id.* at 480.

64. *Id.*

65. *See* McCauley, *Intrastate Securities Transactions Under the Federal Securities Act,* 107 U. PA. L. REV. 937, 943 (1959), *citing* L. LOSS, SECURITIES REGULATION 365 n.212 (1951).

66. Securities Act Release No. 4434 (Dec. 6, 1961) (citations omitted) (emphasis added).

Glass Manufacturing Corp.[67] the issuer, a Texas corporation, sold approximately 84,000 shares of its common stock from January, 1956, to June, 1957, in an "intrastate" offering that was registered under the blue sky laws of that state. In May, 1957, the issuer filed with the Commission a registration statement for a proposed public offering of common stock of the same class as that sold in the "intrastate" offering. The issuer's prospectus stated that the previous sales of the 84,000 shares of its common stock had been exempted by section 3(a)(11) from the registration provisions of the Act.

The Division of Corporate Finance of the Commission brought a proceeding under section 8(d) for a stop order suspending the effectiveness of the issuer's registration statement. The Division contended that the "intrastate" offering and registered public offering constituted a single issue of securities and should, therefore, be integrated. As a result, the Division argued, no exemption was available for the sales of the 84,000 shares, and the issuer's registration statement was materially misleading by stating that an exemption was available and by failing to disclose in the financial statements a contingent liability under section 12(1) arising from its unregistered sales. In integrating the offerings, the Commission found that they involved "securities of the same class, [with] no substantial differences in the circumstances under which they [were] proposed to be offered or in the purposes of the financing,"[68] and, accordingly, held that the sales of the 84,000 shares constituted "part of the same issue as the shares covered by the registration statement which [were] to be offered to non-residents of Texas. . . ."[69]

The Commission's indicia in *Texas Glass* of the application of the doctrine of integration in a section 3(a)(11) context cuts sharply against the propriety of an intrastate offering by the corporation in the Autotex hypothetical. If, as appears likely, the securities previously sold by the corporation in the private offering and those to be sold pursuant to the intrastate exemption are determined to constitute but a single issue, the sale of the corporation's stock in the *private* offering to the one non-Maryland resident, the New Yorker, would destroy the efficacy of a section 3(a)(11) exemption[70] for the pro-

67. 38 S.E.C. 630 (1958).

68. *Id.* at 634. The Commission defined the scope of the section 3(a)(11) exemption as follows: "The exemption pursuant to Section 3(a)(11) is limited to cases in which the entire issue is offered and sold exclusively to residents of a single state, and, if an issuer . . . is unsuccessful in selling the entire issue to residents of that state and offers the rest of the issue, even after registration, to residents of other states, the exemption is not available." *Id.*

69. *Id.*

70. *But cf.* Smith v. Jackson Tool & Die, Inc., 419 F.2d 152 (5th Cir. 1969). In *Smith,* the Fifth Circuit Court of Appeals refused to integrate the issuance of common stock to a non-resident of Mississippi (in exchange for the cancellation of a promissory note held by the non-resident) into an intrastate Mississippi offering registered under that state's blue sky laws shortly after the exchange, which offering involved the same class of security as that issued in the exchange. The only explanation given by the court for its conclusion was that the "exchange differed from the sale of the . . . shares included in the [intrastate] public offering . . . in that purchasers in the public offering paid a fifty cent per share commission or broker's fee and entered into stock subscription agreements with defendant [issuer], while [the non-resident] did neither. Also, while the public offering was on the agenda at

posed *intrastate* offering. The same rationale may be carried a step further to preclude an intrastate offering by the corporation, had no private offering been made, if either or both of the Autotex promoters, Invent and Improve, were not Maryland residents; if one or more promoters of a corporation who purchased originally issued equity securities were, in fact, non-residents and if the corporation within a time proximate to such issue attempts to make an intrastate offering of the same class of securities for the same type (albeit a greater amount) of consideration and for the purpose of raising additional working capital, then the conclusion is nearly inescapable that the offerings will be integrated and that the section 3(a)(11) exemption will not be available for the latter offering. Although the determination may be somewhat more difficult, the same result would appear to be appropriate even if a different class of equity security were sold in the intrastate offering, assuming that the rights incident to the two classes of securities were substantially identical.

Forestalled by integration obstacles from making private and intrastate exempted offerings, and from making even a registered public offering, the Autotex promoters might consider the third of the most commonly relied upon exemptions — Regulation A. The exemption afforded under Regulation A is expressly limited to an *"issue* of securities" with an aggregate offering price not in excess of $500,000. As a result, the single-issue concept and its web of integration problems are also applicable with respect to Regulation A offerings.

The single-issue doctrine arises in connection with a Regulation A offering with respect to the determination of whether or not the statutory ceiling on the aggregate offering price has been exceeded. "The purpose of the dollar limitation on the aggregate amount of an offering covered by Section 3(b) is to confine the exemption to cases of small financings." [71] To thus prevent "the segregation of portions of larger financing operations into separate issues exempt under Regulation A,"[72] the Commission will integrate prior[73] and subsequent[74]

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stockholder meetings, the exchange of the indebtedness of the corporation to [the non-resident] for securities was not." *Id.* at 153.

71. Herbert R. May & Russell H. Phinney, 27 S.E.C. 814, 818 (1948).

72. *Id.* at 818–19.

73. *E.g.*, Unity Gold Corp., 3 S.E.C. 618 (1938).

74. 27 S.E.C. 814 (1948). *May* was a proceeding brought by the Trading and Exchange Division of the Commission under section 15(b) of the Securities Exchange Act of 1934 to determine whether the registration as a broker-dealer of May and Phinney should be revoked for alleged violations of the registration provisions of the Act. In September, 1941, the issuer in question filed a letter of notification under Regulation A covering the offering of 74,000 shares of stock to be sold at one dollar per share. At that time, the statutory ceiling on the aggregate offering price of securities exempted under Regulation A was $100,000. In February, 1942, 50,000 additional shares were authorized by the issuer and offered for sale. The letter of notification was not amended to reflect the offering of the 50,000 shares. From September, 1941, to August, 1945, May and Phinney sold in excess of 100,000 shares of the issuer's stock for over $125,000.

The Trading and Exchange Division took the position that the 74,000 and 50,000 share blocks constituted a single issue of the issuer's securities and, therefore, that they should be integrated into a single offering, the totality of which was made in violation of the registration provisions. The Commission agreed, stating:

> Both blocks were distributed on the same general terms and were part of an uninterrupted program of distribution, with the very same methods of sale and distribution being employed. Both blocks were issued for the single purpose of

private offerings into the issue of securities being offered pursuant to Regulation A. If the aggregate offering price of all of the securities comprising the integrated issue exceeds $500,000, the exemption will not be available, and the issuer will be in violation of the registration provisions of the Act. Assuming that the aggregate offering price of all of the securities comprising the integrated issue does not exceed $500,000, the securities sold in the prior or subsequent private offerings would nevertheless be deemed to constitute an illegal unregistered distribution of shares in a public offering — regardless of the availability of the Regulation A exemption. Due to its prior $50,000 "private placement," if Autotex were to attempt a $500,000 Regulation A offering, it might receive a letter of comment from the SEC regional office advising not only that integration requires that the proposed $500,000 offering be reduced by the amount of its prior offering, but also that the company's prior "private placement" was in violation of the registration provisions as a result of the integration doctrine. The Commission has clearly sounded its warning:

> [S]ecurities of the same class, offered on the same general terms to the public in an uninterrupted program of distribution, cannot be segregated into separate single "issues" merely by claiming an exemption for a limited portion of such shares under Rule [251 *et seq.*], or under any other rules of the Commission adopted in accordance with Section 3(b) of the Act, and registering the remainder. Nor can this be accomplished . . . by the mere formality of filing successive prospectuses under one or more of these rules if in fact the shares thereby offered otherwise constitute a single "issue" within the meaning of Section 3(b).
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> The determination whether securities are being offered as part of a single "issue" will depend upon a consideration of various factors concerning the methods of sale and distribution employed to effect the offerings and the disposition of the proceeds. If the offerings may be segregated into separate blocks, as evidenced by material differences in the use of the proceeds, in the manner and terms of distribution, and in similar related details, each offering will be a separate "issue." In the main, of course, each case must be determined upon the basis of its own facts.[75]

III. CONCLUSION

An exemption from the registration provisions of the Act often provides a relatively inexpensive and time-saving means of undertaking a corporate financing, despite the fact that qualification for an

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obtaining funds to meet the installment payments due in connection with the purchase of the corporation's operating assets and the expenses of commencing operations. In other words, both blocks, in terms of the class of security, their purpose and manner of distribution, constituted a "single" issue of securities. 27 S.E.C. at 819.

75. Unity Gold Corp., 3 S.E.C. 618, 625 (1938). For an excellent discussion of the myriad of transactions to which the doctrine of integration may be applicable in a Regulation A context, see Weiss, *Highways and Byways Revisited,* 15 N.Y.L.F. 218, 242-44 (1969).

exemption generally requires that the issuer in some manner limit the scope of the offering. Such an exemption, however, may be destroyed by integration if there has been a prior or subsequent offering of the same issue of securities. The emergence of an integration problem not only may threaten eradication of the economies of an exempt offering, but also may impose additional burdens on the issuer and its control persons. Although criminal penalties may pose an improbable consequence, administrative sanctions and civil liabilities based on violations of the Act's registration provisions are likely.[76] Such liabilities may necessitate the expenditure of substantial funds for legal counsel and create a potentially disabling obligation to refund amounts received from a purportedly exempt financing. A deceptively uncomplicated exempt corporate financing may thus become a legal albatross around the necks of a corporation and its control persons.

Corporate finance efforts may not necessarily be choked off completely as a result of an integration problem. In a situation in which a prior exempt offering might be integrated into a proposed registered public offering, a rescission offer to those who purchased in the prior offering might take the corporation out of its integration predicament. Counsel might include such a rescission offer as a part of the registration statement prepared for the proposed public offering with little additional cost to the issuer. If the issuer's financial picture is sanguine enough to allow the issuer to sell the public issue while permitting its rescission offer to be rejected, the registration route could provide a remedial solution to integration problems in addition to a legal path to new capital.

The registered rescission offer resolution of integration problems may provide small comfort to a company contemplating a subsequent offering without registration. Frequently, for financial reasons or because of a shortage of public offering appeal, the issuer may view an attempted exempt private offering as its only alternative to extinction. In such a case, the infectious effects of the single issue concept on the prior and proposed offering may not be curable. The issuer will be confronted with the choice of incurring possible Securities Act violations or of undertaking no subsequent financing at all.

A pragmatic but perhaps legally inadvisable approach in circumstances in which integration is a possibility but not a certainty is to undertake the second offering with a plan and a prayer. The plan would be to make the offering, as if it were by itself exempt, with full disclosure — including the implications of potential integration problems.[77] The presentation to offerees of a well-prepared disclosure statement would at least reduce the possibility of anti-fraud violations arising from the offering and start the statute of limitations running with respect to registration violations, if any. The prayer would be that the company remain appealing enough to its shareholders for the period in which the applicable statute of limitations would run so as to put

76. *See* notes 51–56 *supra* and accompanying text.

77. It will be necessary to disclose the contingent liability of the company that may arise in the event that the first and second offerings are ultimately integrated and also are found to be part of one public offering. *See* discussion of *Cameron Industries* at notes 44–50 *supra* and accompanying text.

to rest the possibility of civil liability flowing from a finding of integration.

Such a "plan-prayer" approach may not be free from the threat of independent Commission action. Nevertheless, there have been instances in which the Commission staff itself has applied a gentle hand to potential integration problems. One leader of the securities bar ("Broker Attorney") has related an experience in which the possibility for integration attack seemed ripe, but in which the transactions somehow passed the Commission staff without objection. A non-public corporation had filed a registration statement for a common stock offering at approximately $10 per share. Immediately after filing, the corporation sought to make a private placement of its common stock at $5 per share through Broker Attorney's investment banker client. The proceeds of the private placement were, like the proceeds of the public offering, to be used for working capital purposes.

Broker Attorney instantly concluded that these facts posed a clear-cut integration problem. He was, however, advised by counsel for the corporation that the latter had discussed the matter with the Commission staff and that the staff had posed no objection. To be certain that there were no problems, Broker Attorney contacted the staff himself. The staff informally indicated that the matter indeed looked like integration and that probably on the basis of existing pronouncements it should be regarded as such. Nonetheless, the staff indicated a willingness to tolerate the transaction without objection, although they would not state that it was legal. According to Broker Attorney: "It appears that perhaps in some measure this tolerance stemmed from the fact that substantial delays were being encountered by companies going public for the first time and in many instances without the infusion of the capital raised on a private placement could not survive until the registration statement became effective."[78] The plan-prayer approach and this latter example of the toleration-survival treatment by the Commission staff suggest possible pragmatic approaches to certain integration problems. Neither possibility, however, provides counsel with a meaningful legal guideline to advise clients.

It is difficult to sympathize with corporations and persons who incur integration problems in circumstances as extreme as those in *Cameron Industries.*[79] In cases like *Cameron Industries,* the close coincidence of time and purpose for both the prior claimed exempt offering and the subsequent public offering reveals an attempted fragmentation of what really is one financing which is too blatant for the SEC to overlook. At the same time, the Commission should reconsider the plight of counsel in search of guidelines when confronted with possible, though not as clearly defined, integration issues. Otherwise, the doctrine of integration, tied as it presently is to numerous vague or subjective considerations, may provide a trap for the unwary counsel and the financially needy corporation.

The considerations underlying the single-issue concept, particularly as enunciated in the Commission releases on the private offering

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78. Letter dated February 8, 1971, to Ronald M. Shapiro.
79. *See* note 44 *supra.*

and intrastate exemptions, should not be forgotten entirely. Yet integration should be accomplished only in accordance with an objective standard. When financings occur at sufficiently distant points in time, they might well lie beyond the pale of the evils which integration has been created to extinguish. If offerings, *each satisfying all criteria of the exemption* upon which it is made without regard to the issue of integration, *are made at least twelve months apart,* it is difficult to conceive of each such offering as a contrived fragment of an otherwise single public issue of securities. Financial exigencies of corporate existence would not seem to permit financial planning built upon limited offerings at such intervals. The one-year line of demarcation for computing Regulation A offering amounts suggests that this approach is at least workable. Furthermore, such a rule could be qualified to ensure against its abuse by limiting the number of non-integrated exempt offerings made pursuant to it to two in any thirty-six-month period. The danger of a distribution program launched through a series of annual offerings is thus reduced. Hence, a one-year limit for integration doctrine application, with built-in controls of distribution abuse, would offer counsel a significant guide for analyzing the legality of proposed limited financings. Such a time concept would not seriously offend the policies which necessitate integration; the possibility of integration would still be a serious consideration with respect to offerings not falling within the scope of the rule.

Unless and until objective standards are enumerated by the Commission, integration problems will continue to inject uncertainty and potential liability into the lives of private entrepreneurs like Invent and Improve. Today a business organization may seem securely financed within the parameters of an exemption. Tomorrow such an exemption may disappear into the quagmire of integration.