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Securities Exemptions for Small Corporations

Leonard Lane*

A subject of growing importance to the small corporation is its ability to qualify for one or more of the exemptions provided for in the Securities Act of 1933 and the exemptions provided for in the securities statutes of the various states.

One of the great misconceptions of many lawyers today is that small corporations have no connection whatsoever with the Securities Act of 1933. Yet the small corporation's management must be cognizant of the fact that, although its business is small and its stockholders few, if jurisdiction over its securities transactions is obtained under Section 5 of the Act, it is subject to the provisions of the Federal Securities Act of 1933. Jurisdiction over the sale or offer to sell is usually present, because the corporation almost always utilizes the mails or other means of interstate commerce.

The attorney for the small corporation should fully comprehend why the corporation is not, if it is not, required to file any registration statement with the Securities and Exchange Commission. He should understand as well why, under Section 3(B) of the Act, the corporation is only required to file a much simpler registration known as a "Regulation A" filing. Equally important to the small corporation is knowledge of how to avoid the pitfalls of selling, or offering to sell, its stock or other securities without having qualified for a federal exemption, if its actions have subjected it to federal jurisdiction.

This subject has been touched on by the author in an earlier article.1 Because of its constantly growing importance, as well as

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[Editor's Note: This article consists of two extracts from a chapter on "Securities Problems of Smaller Corporations," especially written by Mr. Lane as contributed material to be published in the forthcoming Volume 2 of the 5 volume work entitled: Oleck, MODERN CORPORATION LAW (Bobbs-Merrill Co.), of which the first volume was published Sept. 1958. The opening section of the article is specially added for this Review. Pre-publication here, of course, is with permission.]

1 Lane, Securities and the Small Corporation, 2 Clev.-Mar. L. R. 1 1953.
as because of new decisions modifying certain previously existing concepts, a more exhaustive treatment of federal and state exemptions from securities laws seems warranted.

THE FEDERAL ACT

Exemptions Under the Federal Act

Among the classes of securities which are exempt from the Securities Act of 1933 are the securities of governments and banks. The reason generally advanced for the exemptions of these securities, and of all trading in them, is that since they are sufficiently supervised by other governmental or state authorities, it is not necessary for another commission such as the S. E. C. to duplicate the supervision. The inclusion of such an exemption in Section 3A (2) of the Securities Act of 1933 not only facilitates the financing of securities by these bodies but also saves the S. E. C. from a great deal of work. This exemption seems to have proved generally acceptable over a course of time, although not without some opposition.

Commercial paper used in usual current transactions also constitutes an exempt security. The exemption reads as follows:

"Any note, draft, bill of exchange, or banker's acceptance which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited. . . ." 4

One answer as to what constitutes a current transaction has been given by the General Counsel of the S. E. C.:

"The question of what is a 'current transaction' is one which must be considered in the light of the particular facts and business practices surrounding individual cases. In general, it would seem that the proceeds of notes having a maturity of not more than nine months, of the type normally issued by finance companies, may be regarded as used for current transaction if the following conditions are satisfied:

"The issuer of the notes for which exemption is claimed is in the business of making loans on or purchasing notes, installment contracts or other evidences of indebtedness.

2 Securities Act of 1933, Sec. 3(a) (2).
3 Ibid., Sec. 3(a) (3).
4 Ibid.
“The proceeds of these notes for which exemption is claimed are used for current transactions, which may properly include either (a) the making of loans upon or the purchasing of such notes, installment contracts or other evidences of indebtedness in the usual course of business, or (b) the payment of outstanding notes exempt under Section 3(a)(3).

“This opinion is to be considered as superseding the opinion expressed in Release No. 388.”

Securities of eleemosynary organizations are exempt under the Securities Exchange Act of 1933 as constituting

“Any security issued by a person organized and operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes and not for pecuniary profit, and no part of the net earnings of which inures to the benefit of any person, private stockholder, or individual.

...”

Since what constitutes a non-profit organization is of course sometimes quite debatable, it is wise to consult various state as well as internal revenue holdings to determine whether or not the particular organization is a non-profit corporation. Several cases have held that the particular organization in question was not, in fact, a non-profit corporation entitled to the exemption of this section.

Another exemption is granted to securities of building and loan associations, farmers cooperative associations, etc.

It has been held, however, that voting trust certificates issued in return for exempt stock under this section are not themselves exempt, and require registration.

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6 Securities Act of 1933, Sec. 3(a)(4).
8 Securities Act of 1933, Sec. 3(a)(5):

“Any security issued by a building and loan association, homestead association, savings and loan association, or similar institution, substantially all the business of which is confined to the making of loans to members (but the foregoing exemption shall not apply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 per centum of the face value of such security), or any security issued by a farmer's cooperative association as defined in paragraphs (12), (13), and (14) of Section 103 of the Revenue Act of 1932...”

Insurance policies and annuity contracts issued by corporations subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any state or territory of the United States or the District of Columbia, are exempt under the Securities Act of 1933.10

Any security exchanged by the issuer with its existing security holders exclusively, where no commission or other remuneration is given directly or indirectly for soliciting such exchange, is an exempt security.11 Rule 149 of the Securities Act of 1933 does not forbid the security holder to pay cash which may be necessary to effect an equitable adjustment, in respect to dividends or interest paid or payable on the securities involved in the exchange between such security holder and other security holders of the same class accepting the offer of exchange.12

"I believe Section 3(a)(9) is applicable only to exchanges which are bona fide, in the sense that they are not effected merely as a step in a plan to evade the registration requirements of the Act. For example, Corporation A, as part of such a plan, might issue a large block of its securities to Corporation B, and might then issue new securities to Corporation B in exchange for the first-issued securities, with the understanding that such new securities are to be offered to the public by Corporation B. In my opinion, the mere fact that the exchange in such case might comply with the literal conditions of Section 3(a)(9) would not avail to defeat the necessity for registration of the securities issued in such exchange. Cf. Gregory v. Helvering (1935) 293 U. S. 465.

"In determining whether a particular exchange had been effected merely as a step in a plan to evade the registration requirements of the Act, I believe that a court would take into account various facts such as the length of time during which the securities received by the issuer were outstanding prior to their surrender in exchange, the number of holders of the securities originally outstanding, the marketability of such securities, and also the question whether the exchange is one which was dictated by financial considerations of the issuer and not primarily in order to enable one or a few security holders to distribute their holdings to the public. In any event, I call your attention to the fact that in the case of Borland v. Federal Electric Company, now pending in the

10 Securities Act of 1933, Sec. 3(a) (8).
11 Ibid., Sec. 3(a) (9).
12 Rule 149, Securities Act of 1933. (Adopted in Release No. 1495, July 1, 1937.)
Federal District Court for the Northern District of Illinois, the question has been presented under the Federal Declaratory Judgment Act as to the application of Section 3(a)(9) to a situation similar to the one which you describe. In view of this proceeding, I believe that it would be inadvisable for me to express my opinion other than that indicated above."  

However, Section 3(a)(9) of the Securities Act of 1933 does not permanently exempt from the registration provisions of the Act, securities exchanged with existing security holders. Dealings and transactions in such securities, following their original issuance, are not of themselves exempt by reason of the exemption found in Section 3(a)(9).  

It seems obvious that the exemption provided in Section 3(a)(9) relates only to bona fide exchanges. Exchanges of securities for the purpose of avoiding the registration requirements of the Act will not be countenanced. The General Counsel of the Commission stated that:

"Factors such as the length during which the securities received by the issuer were outstanding prior to their surrender in exchange, the number of holders of the securities originally outstanding, the marketability of such securities, and also the question whether the exchange is one which was dictated by financial considerations of the issuer and not primarily in order to enable one or a few security holders to distribute their holdings to the public."  

Exemption of Intrastate Issues Under the Federal Act

An intrastate exemption is granted to

"Any 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 such state or territory."  

In a case involving an exchange of stock for the assets of the company, the stock passed to the stockholders of the acquired company, and some of those stockholders gave a power of attorney to one person to sell the stock. The stock was sold to

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14 In the matter of Thompson Ross Securities Company, 6 S. E. C. 111 (1940).
16 Securities Act of 1933, Sec. 3(a) (11).
brokers and dealers who sold some to the general public and some to other brokers and dealers. Because the stockholders who gave the power of attorney were found to be in control of the company, they were "issuers" within the meaning of the Act. The brokers and dealers who purchased the stock from the attorney were underwriters within the meaning of the Act. The court ruled that the Securities Act provides no exemption of the unregistered stock which was sold publicly through the mails.17

The limitations of the scope of this exemption were explained by the General Counsel of the Securities and Exchange Commission thus:

"... In conclusion, I should like to stress once again the fact that Section 3(a)(11) is designed to apply only to such types of distribution as are genuinely local in character. From a practical point of view, the provisions of that Section can exempt only issues which in reality represent local financing by local industries carried out with purely local purchasers. In distributions not of this type, the requirements of Section 3(a)(11) will be extremely difficult if not impossible to fulfill. ..."18

The case of Brooklyn, Manhattan Transit Company19 involved an issuance of $8,000,000 in securities, which was sold to underwriting houses in New York state. The fact that about 15% of the securities found their way to nonresidents destroyed the exemption under Section 3(a)(11), even though the initial purchasers (underwriting house) were residents of the state of New York.

Employee's pension or profit-sharing plan interests which are limited to employees residing in the state in which the issuer is a resident or is incorporated and doing business, may be exempted under Section 3(a)(11).20

"The foregoing general outline will indicate that, as many people fail to appreciate, the so-called 'intrastate exemption' is not in any way dependent upon absence of use of the mails or instruments of transportation or communication in interstate commerce in the distribution. Section 3(a)(11) provides in effect that if the residence of the purchasers, the residence or place of incorporation of the issuer, and the place

19 1 S. E. C. 147 (1935).
20 Opinion of Assistant General Counsel of Commission (1941).
in which the issuer does business are all confined to a single state, the securities are exempt from the operation of Section 5 of the Act. Securities thus exempt may without registration be offered and sold through the mails, may be made the subject of general newspaper advertisement (provided the advertisement is appropriately limited to indicate that offers to purchase are solicited only from, and sale will be made only to, residents of the particular state involved) and may even be delivered in interstate commerce to the purchasers, if such purchasers, though resident are temporarily out of the state or should direct delivery to some non-resident agent or custodian. Similarly, subject to the general prohibitions of the Act against the use of false or misleading statements or omission in selling literature, securities exempt under Section 3(a)(11) may be offered without compliance with the formal prospectus requirements applicable to registered securities. Exemption under Section 3(a)(11), if in fact available, removes the securities from the operation of all provisions of the Act except those of Section 12(2) and 17.21

It can be seen, therefore, that when an issuer, whether a corporation or otherwise, wishes to issue securities and take advantage of the intrastate offering exemption afforded by Section 3(a)(11), there are certain basic criteria which are required. The Securities Exchange Commission must be satisfied that:

1. The corporation is incorporated in the state where the security is issued.

2. The corporation does business in the state of the security issuance.

3. The securities are offered to residents of the state in which the corporation is incorporated and does business.

4. The purchasers must acquire the stock for purposes other than resale to nonresidents of that particular state.

If the issuer is, in fact, a dummy organization in the particular state, and other similar dummy organizations have been organized in other states in order to circumvent the Act by effectuating what would amount to a nationwide security issuance not registered because of supposed compliance with Section 3(a)(11), such a plan will fail and the issuer will be subject to the penalties of the Act.

The issuer must be very careful to avoid offering such securities to nonresidents, even if no nonresidents are purchasers. As a

consequence of the broad definition of "sale" in the Act, such an offer would undoubtedly destroy the exemption under this section. The exemption is strictly limited to the wording of the statute; that is, only to bona fide intrastate offerings. Therefore, the character of the purchaser becomes somewhat important. If the purchasers of some of the securities are dealers, the presumption immediately arises that the dealers are taking the securities for purposes of resale to nonresidents of the particular state. The final resting place of securities is quite important in determining whether a 3(a)(11) exemption is valid.22

What then should an issuer that intends to comply with the terms of this exemption do in order to protect itself in case some of the purchasers do resell to nonresidents of the state of the exemption? The intention of the purchasers, being subjective, is virtually impossible to ascertain, but there are certain steps which the issuer can and should take. The issuer should require all purchasers to sign the following statement:

"I am a resident of the State of X and am purchasing shares of stock in the Y Corporation for purposes other than resale to nonresidents."

This statement, signed by all purchasers, will be of great aid to an issuer against whom a loss of exemption is claimed because of subsequent sale to nonresidents. Of course, the mere signing of the statement does not absolve the issuer, but it may be very important in establishing the good faith of the issuer in that it had no knowledge of the intent of the purchasers to sell to nonresidents. While there is no specific time limitation after which the securities may be sold to nonresidents, it has been generally understood that if the securities are not resold to nonresidents within one year, the exemption will not be lost. This principle, of course, cannot be regarded as absolute, since, if it appears that it is a part of a scheme of general distribution, the Commission may well act and the exemption provided by Section 3(a)(11) may be lost.

To re-emphasize, one of the most essential and often overlooked facts of this and other exemptions under the Securities Act of 1933 is that it is not to whom the securities are sold which determines whether or not the exemption is available, but to whom they were offered. Even in an instance where a thousand stockholders, all residents of one state, purchase securities, but

22 Brooklyn Manhattan Transit Corporation, 1 S. E. C. 147 (1935).
one offer was made to a nonresident of that state who did not purchase, the entire exemption, insofar as Section 3(a)(11) is concerned, is lost.

A California corporation violated the Securities Act when an advertisement offering to sell its common stock was placed in a Los Angeles paper, because no registration statement had been filed with the Securities and Exchange Commission and the mails had been used by the newspaper to send copies to its out-of-state subscribers. However, a preliminary injunction was not issued, since the corporation had no present intention to sell its stock. Its attorney stated that he would withdraw the corporation's application to the California Commissioner of Corporations for an extension of the permit to issue and sell securities. He also agreed that he would notify the S. E. C. of any further applications for permits to issue and sell securities and that he would notify the Commission if he ceased to be the corporation's attorney.23

Small Issue Exemption Under the Federal Act

"The Commission may from time to time by its rules and regulations and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this title with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering; but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds $300,000." 24

However, the Commission has quite correctly pointed out that the exemption from registration permitted by Section 3(b) is not a complete exemption from all provisions of this Act, but it is limited by the express provisions of Sections 12 and 17 which impose civil liabilities and prohibit the use of the mail to defraud.25

Section 3(b) of the Securities Act of 1933 exempts certain securities transactions which are, however, not free from registra-

24 Securities Act of 1933, Sec. 3(b).
tion with the Division. The registration requirements under Section 3(b), differentiated from those under Section 5, are minimal and can be accomplished much more easily and with a great deal less expense. A Regulation A registration may be considered in the nature of a "junior registration statement."

At least ten days before the date of the initial offering of any securities under Section 3(b), certain basic but not detailed information must be filed with the regional office of the commission on form 1-A. No written offer of securities of any issuer shall be made under Regulation A unless there is an offering circular containing the information required in Schedule 1 of form 1-A concurrently given, and no securities of such issuer may be sold unless this offering circular is given to the person to whom the securities were sold. Regulation A requires that there be no information given in any advertisement, article, or any other communication published except:

1. The name of the issuer of the security.
2. The title of the security, the amount offered, and the per unit offering price to the public.
3. The identity of the general type of business of the issuer.
4. A brief statement about the general character and location of its property.

At least five days prior to its use, every advertisement, article, or other communication proposed to be published in any newspaper, magazine, or periodical, and every script for radio or television broadcast, and every letter, circular, or written communication proposed to be sent to more than ten persons, except the offering circulars which were filed pursuant to Rule 256(F), must be filed with the Commission.

Within thirty days after the end of each six months period following the date of the original offering circular, a report on Form 2A, which contains the information about sales of the offering, must be filed.

The exemption provided in Section 3(b) is also binding upon the affiliates or controlling persons of the corporations, and if such affiliates use any portion of the exemption, the issuer can issue proportionately less securities.

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26 Rule 255, Securities and Exchange Commission.
27 Section A (1) and (2) of Rule 256, Securities and Exchange Commission.
Private Offering Exemptions Under Section 4(1) of the Federal Act

Section 4(1) of the Securities Act of 1933 exempts "transactions by an issuer not involving any public offering." The opinion of the Securities and Exchange Commission on exemptions under Section 4(1) has been given as follows: 29

"Some misunderstanding has arisen as to the meaning of this provision because correspondents have failed to confine previous opinions of the General Counsel to the exact facts on which the opinions were based. The present opinion indicates the many factors which must be considered in determining the availability of this exemption, and points out that a definite opinion in advance is impossible except in a few clear cases.

"The principal factors to be considered are: 1. The number of offerees and their relationship to each other and to the issuer; 2. The number of units offered; 3. The size of the offering; and 4. The manner of offering. Issuers are also warned of the practical difficulty which purchasers would have in redistributing securities originally issued without registration in reliance on this exemption."

The full text of the opinion, which was given in the case of a proposed offering of $1,766,000 of Preferred Stock to 25 offerees, follows:

"The opinion has been previously expressed by this office that an offering of securities to an insubstantial number of persons is a transaction by the issuer not involving any public offering, and hence an exempted transaction under the provisions of Section 4(1) of the Securities Act. Furthermore, the opinion has been expressed that under ordinary circumstances an offering to not more than approximately twenty-five persons is not an offering to a substantial number and presumably does not involve a public offering.

"As a result of such opinions there appears to be developing a general practice on the part of issuers desiring to avoid registration of their securities to seek to dispose of the same to insurance companies or other institutions, which at the time of purchase, state that they are acquiring such securities for investment and not with a view to distribution.

"I would call your attention to the fact that in previous opinions it has been expressly recognized that the determination of what constitutes a public offering is essentially a question of fact, in which all surrounding circumstances are

of moment. In no sense is the question to be determined exclusively by the number of prospective offerees. I conceive that the following factors in particular should be considered in determining whether a public offering is involved in a given transaction:

1. The Number of Offerees and Their Relationship to Each Other and to the Issuer

"You will note that this does not mean the number of actual purchasers, but the number of persons to whom the security in question is offered for sale. The word "offering" in this sense should not be limited to those cases wherein a formal proposal for a firm commitment is submitted. Any attempt to dispose of a security should be regarded as an offer. I have very serious doubt as to whether in many of those cases where it is stated that an offering is to be made only to an insubstantial number of persons, there may not be preliminary conversations for the purpose of ascertaining which of various possible purchasers would be willing to accept an offer of the security in question if it were made to them. Any such preliminary negotiations or conversations with a substantial number of prospective purchasers would, in my opinion, cause the offering in question to be a public offering, thereby necessitating prior registration of the security in question.

"Again, in determining what constitutes a substantial number of offerees, the basis on which the offerees are selected is of the greatest importance. Thus, an offering to a given number of persons chosen from the general public on the ground that they are possible purchasers may be a public offering even though an offering to a larger number of persons who are all the members of a particular class, membership in which may be determined by the application of some pre-existing standard, would be a non-public offering. However, I have no doubt but that an offering restricted to a particular group or class may nevertheless be a public offering if it is open to a sufficient number of persons.

"I also regard as significant the relationship between the issuer and the offerees. Thus, an offering to the members of a class who should have special knowledge of the issuer is less likely to be a public offering than is an offering to the members of a class of the same size who do not have this advantage. This factor would be particularly important in offerings to employees, where a class of high executive officers would have a special relationship to the issuer which subordinate employees would not enjoy.
2. The Number of Units Offered

"If the denominations of the units are such that only an insubstantial number of units is offered, presumably no public offering would be involved. But where many units are offered in small denominations, or are convertible into small denominations, there is some indication that the issuer recognizes the possibility, if not the probability, of a distribution of the security to the public generally. The purpose of the exemption of non-public offerings would appear to have been to make registration unnecessary in those relatively few cases where an issuer desires to consummate a transaction or a few transactions and where the transaction or transactions are of such a nature that the securities in question are not likely to come into the hands of the general public.

"In connection with a consideration of the number of units offered, I would also consider whether the same or other securities of the same issuer are being offered at the same time. I feel that this circumstance has a bearing on the character of the offering.

3. The Size of the Offering

"It should be noted that the exemption of Section 4(1) is of transactions by an issuer not involving any public offering. In view of this language, it would appear to be proper to consider not merely the specific transaction or transactions between the issuer and the initial purchasers, but also the extent to which a later public offering of all or part of the securities sold by the issuer is likely. Hence I feel that this exemption was intended to be applied chiefly to small offerings, which in their nature are less likely to be publicly offered even if redistributed.

"For the same reason I feel that a material consideration is whether the security in question is part of an issue already dealt in by the public, either on a national securities exchange or on the over-the-counter market, or, within the reasonable contemplation of the parties, is likely thus to be dealt in shortly after its issuance. This factor again may indicate whether public distribution of the security in question is likely within a reasonable time.

4. The Manner of Offering

"I have already indicated my opinion that the purpose of the exemption of non-public offerings is largely limited to those cases wherein the issuer desires to consummate a few transactions with particular persons. Consequently, I feel that transactions which are effected by direct negotiation by the issuer are much more likely to be non-public than those
effected through the use of the machinery of public distribution.

"I have gone into this matter at length in order that you may be apprised of the many elements which in my opinion go into the determination of what constitutes a transaction not involving any public offering. There may be some situations where all the facts are so clear that it would be possible to express a definite opinion. In a situation such as you present, however, I feel that the offering would be carefully scrutinized by any court before which it may come and that any letter which purported to describe the situation, and on which my opinion would necessarily be based, could not adequately advise as to the various factors which are involved.

"I call your attention to the fact that any dealer who might subsequently purchase from an initial purchaser the securities which you propose to offer, would be required to satisfy himself that the initial purchaser had not purchased with a view to distribution. If the initial purchaser had purchased with this intent, he would be an underwriter, and sales by a dealer of securities bought by him from such an initial purchaser would, as a general rule, not be exempt until at least a year after the purchase of the securities by the dealer. The sale of unregistered securities to a limited number of initial purchasers, therefore, leads to a practical situation in which such initial purchasers may have difficulty in disposing of the securities purchased by them. Any opinion which I might render in connection with the proposed offering might, I fear, be availed of by the issuer or by an initial purchaser as a means of satisfying a dealer, at a later date, that he might purchase the securities in question and market them without risk of violating the Act. You will appreciate that my opinion would not actually have this effect, since in the case of each transaction there would be involved various matters of fact on which I am not in a position to express an opinion.

"Accordingly, it seems a much wiser policy for me not to express an opinion in the situation which you present as to whether a public offering is involved." 29a

Where a corporation had agreed to purchase all of the assets of another corporation and to sell its securities to stockholders of both corporations in contemplation of a consolidation, the transaction has been held to be a "public offering" within the meaning of Section 4(1) of the Securities Act. Such an offering, although it is confined to stockholders of the offering company, is a public offering where the offerees include the

29a Ibid.
stockholders of another company who are seeking to become stockholders of the offeror.\textsuperscript{30}

The famous case of \textit{Securities and Exchange Commission v. Ralston Purina Company}\textsuperscript{31} was a major test of the scope and meaning of Section 4(1). In that case a corporation's offering of common stock to an estimated 500 key employees, who constituted five to eight percent of total number of people in its employ, was held to be a private offering of securities under the terms of the Securities Act of 1933 and exempt from its registration requirements. In dismissing the Commission's complaint and dissolving the temporary injunction entered by agreement against the defendant, the District Court refused to follow conflicting committee reports of Congress in determining the meaning of the word "public" in the exemption clause of Section 4(1) of the Securities Act, and rejected the test of the number of offerees urged by the Commission, as resulting in arbitrary holdings. Following the line of reasoning in the \textit{Sunbeam Gold Mines} case,\textsuperscript{32} the court upheld the corporation's distinction of its offering as private, considering the circumstances surrounding the offering and the purpose or motives of its plan of part stock ownership of its business by operating personnel. The burden of proof, placed upon the defendant corporation, since it was the claimant for the exemption from the general policies of the Securities Act, was found to have been met.

The District Court's decision, that a corporation's offering of a common stock to an estimated 500 key employees was a private offering, was affirmed by the Court of Appeals.\textsuperscript{33} In upholding the judgment dismissing the complaint and declaring the offering exempt from registration under the Securities Act, the Court of Appeals held that the character of the offering, and not the number of offerees, was determinative of the exemption within the language and purposes of the Act. The court pointed out that the offering was made without solicitation to a selected group of key employees, most of whom were already stockholders when the offering was made, and with the sole purpose of enabling them to secure a proprietary interest in the company


\textsuperscript{32} Supra, n. 30.

\textsuperscript{33} 200 F. 2d 85 (----), U. S. Ct. Appeals, 8th Circ., No. 14611 (Nov. 21, 1952).
or to increase the interest already held by them. The court added that a different question would have been presented if the offering had been made to all employees or to employees selected at random, by lot, or without any logical basis.

The United States Supreme Court reversed the lower courts and held that a corporation's offering of common stock without solicitation to employees who take the initiative in showing an interest in buying the securities is a public offering, requiring registration if such offerees do not have access to the investment information afforded by a registration statement. In reversing the Court of Appeals affirmance of the District Court's judgment, dismissing the complaint and declaring the offering as a "private offering" exempt from registration under the Securities Act of 1933, the United States Supreme Court held that the right to an exemption depends upon the employees' need for investment facts, if the offerees are not shown to have had access to such facts. The policy of the Securities Act makes irrelevant the issuer's purpose in singling out its key employees for the stock offering. The court rejected the test of the number of offerees, pointing out that the registration requirements apply to a public offering regardless of the number of employees involved.

The court said:

"But once it is seen that the exemption questions turns on the knowledge of the offerees, the issuer's motives, laudable though they may be, fade into irrelevance. The focus of inquiry should be on the need of the offerees for the protections afforded by registration. The employees here were not shown to have had access to the kind of information which registration would disclose. The obvious opportunities for pressure and imposition make it advisable that they be entitled to compliance with Section 5."

The Securities and Exchange Commission has held that a private placement of $3,000,000 of debentures which were immediately convertible into common stock was a public offering which was not exempt from registration under Section 4(1) of the Securities Act, although commitments were obtained from only 27 persons, all of whom sent to the issuer identical "investment letters" stating that the purchase of the debentures was solely for investment and that there was no present intention of further distribution. The S. E. C. investigations found that,
in fact, there were at least 79 purchasers and that, on closing date for the sale of the debentures, about one-third of the 27 purchasers who had given investment letters had found others to purchase portions of their commitments or to participate with them in the commitments. Later, there was another private placement of $1,000,000 of convertible debentures with 22 purchasers who gave investment letters; three of them resold immediately to 15 additional purchasers who also gave investment letters. The Commission held that an issuer may not rely upon investment letters to establish an exemption from registration and to disclaim responsibility to investigate the transaction to ascertain that there is not a public offering.

The S. E. C. noted that an offering of one type of security which is immediately convertible into another type is a simultaneous offer of both securities, and not being exempt, both must be registered. The issuer was making a continuous offer of common stock to purchasers of the debentures and to anyone else who might thereafter acquire the debentures, and, although there might be an exemption for the transaction under Section 3(a)(9), it could not afford an exemption with respect to the sales of the common stock after conversion.

The investment letter in question reads as follows:

“In connection with the issuance and sale this day to the undersigned of ________ dollars in principal amount of the five percent convertible debentures of your company, the undersigned hereby confirm to you that said debentures are being purchased for investment and that the undersigned has no present intention of distributing the same.”

It has been held that the sales of fractional undivided interests in oil leases in three tracts of land were not public offerings within the meaning of the Securities Act. The court found that these sales were isolated security transactions, and stated that, in determining whether there was a public offering, it would consider the number of offerees, the circumstances surrounding the transactions, the relationships between the investors and their friend who is a middle man, and their experience in business, particularly in the oil business.

As to tract number one, there were five offers to sell, one by one person, four by another; as to tract number two, there

were three offerees, all by the same seller; as for tract number three, there was one offer. There were six buyers of interests, all of them experienced businessmen. Several personally inspected tract number one before investing. The court went on to say:

"The public offering concept should be considered in light of the purposes of the Securities Act. One of its purposes was to protect investors by promoting full disclosure of information necessary for informed investments. The line of demarcation between a public offering and a private offer may not at all times be too clear. It may be admitted that the mere fact that we have here a relatively few offerees is not necessarily determinative of the question, but in that regard reference may be made in the opinion of the general counsel in Securities Act Release 285 (1935), in that this statement is helpful in affording some tangible conception as to what may be a private offering as distinguished from a public offering . . . ."

The court considered the Ralston Purina case but thought that the present situation should not be classified as a public offering within the intent of the Act. 36

It was held that a lower court erroneously granted summary judgment against a bank which sold unregistered participation certificates in a mineral royalty, since there were facts before the court to justify its finding that the certificates were publicly offered. The appellate court, citing the Ralston Purina case, set forth that the test of whether an offering was public or private is whether the particular class of persons affected need the information made available by registration. 37

STATE BLUE SKY LEGISLATION

Exempt Securities

Usually, securities which are exempt from registration under the Blue Sky Laws of the various states are those of banks, building and loan associations, non-profit organizations, cooperative associations, and governmental securities or securities issued by governmental agencies or by political subdivisions, as well as by insurance companies. The rationale for this exemption for registration under the state Blue Sky Laws is that, since these institutions or organizations issuing the securities are supervised

37 Central Bk. & Tr. Co. v. Robinson (unrep. dec.), Colo. Supr. Ct. (—-).
by other organizations which exercise supervisory care over them, it is reasonable to assume that it would be repetitious for the various state security divisions to require registration and additional supervision.

Exemptions are usually given in the following circumstances: Valid obligations of any foreign government with which the United States is, at the time of sale, maintaining diplomatic relations; 38 an obligation of a national bank, corporation or governmental agency created by or under the laws of the Dominion of Canada; 39 securities other than notes, bonds or debentures or other evidences of indebtedness of non-profit corporations; 40 securities which are outstanding for a period of not less than five years, on which there has occurred no default in payment of principal, interest or dividend for the five years immediately preceding the sale. 41 There is some doubt as to the rationale for these exemptions. An excellent article on this question has been written by Professor Harper. 42

Other securities which are usually exempt are securities listed on one of the national stock exchanges. 43 This section is generally found in all states' securities acts, because the regulatory authorities of the national stock exchanges are usually very efficient, and the work of a state securities commission would, in almost all instances, be superfluous.

A very important exemption is almost always provided for commercial paper and promissory notes when they are not offered directly or indirectly for the sale to the public. 44 The reason for this exemption is that if it did not exist, normal commercial transactions would be unnecessarily complicated, difficult, and perhaps almost impossible to transact. Many states specify various lengths of time above which they will not permit such an exemption; generally, one year.

Colorado 45 and some other states have a time limit on the maturity of these promissory notes (usually, twelve months),

38 Ohio Rev. Code, Sec. 1707.02(3).
39 Ibid., Sec. 1707.02(C).
40 Ibid., Sec. 1707.02(I).
41 Ibid., Sec. 1707.02(J)(1).
43 Ohio Rev. Code, Sec. 1707.02(B)(1).
44 Ibid., Sec. 1707.02(G).
45 Colo. Rev. St., Sec. 125-1-13(8).
but if the notes are generally offered to the public rather than used in short term commercial borrowing, they are not exempt.46

The Colorado Securities Law exempts securities issued or guaranteed by any concern which has been in business for more than five years or by the immediate successor of such concern, by way of reorganization or consolidation, where such concern, merged by reorganization, has for at least five years had average net earnings equal to one and one-half times the interest on any bonds, debentures and notes outstanding. "Notes" as used in this section relate in general to the fixed interest or charges on borrowed funds which the concern is obligated by any bond, debenture or note to pay, and include any note executed by the company in connection with any commercial or private loan. The Attorney General went on to point out another very important point:

"Further, with respect to the exemption available under a guardian's or executor's sale under the Colorado Securities Law, if a security's broker acquires securities at such a sale, the initial sale to him would be exempt but any resale by him would not be exempt if he purchased the security involved as principal for resale. In such a situation it is my opinion that the security broker on such a resale would then be required to either cause the issuing company to file a prospectus with you in accordance with the provisions of law or an exemption would otherwise have to be availed and determined under the other applicable provisions of 125-1-15, '53 Crs."47

Securities issued by a cemetery corporation formed under an act providing for the incorporation of private cemetery associations are not exempt under provisions of the Blue Sky Law, providing for exemption of securities "issued by a corporation organized and operated exclusively for religious purposes," unless the cemetery corporation is proved, in fact, to be a religious organization.48

Exempted Transactions

Exempted transactions differ from exempt securities in that exempt securities are in and of themselves exempt from the various Blue Sky Laws, with nothing further being done, while in exempted transactions the particular transactions in these

securities are exempt rather than the securities themselves. In most states, exchanges of stock are exempted when the total number of shareholders is less than a prescribed amount, or when there are sales of securities in isolated transactions.

It has been held that an exchange of stock, where preferred stock is retired by the issuance of common stock in exchange, is exempt.\textsuperscript{49}

As to isolated transactions, there is no definitive rule that states whether or not a transaction in and of itself is exempt. It depends to some extent on whether there is only one sale or more than one sale; important other factors are the type of the offer that is made, the number of securities offered, the manner of the offering, and the relationship, if any, of the seller to the offerees. Evidence is usually admissible for the purpose of showing the motive and intent of the seller of the securities.

Usually, a bona fide owner of securities may sell his securities under the exemption provision of the state securities laws where such owner is not engaged in the business of buying and selling securities. However, these sales must not be made in the course of continued and successive transactions of a similar nature.\textsuperscript{50} Sales of individually owned stock by an unregistered owner, which recur within such a time as to indicate the association of these acts, are prohibited by the state securities acts.\textsuperscript{51}

\textsuperscript{50} State v. Swain (1934) 147 Ore. 207, 31 P. 2d 745 (1934).