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SEC¹ ASPECTS OF OIL AND GAS FINANCING

HAROLD S. BLOOMENTAL*

INTRODUCTION

Oil and gas financing can involve essentially the same problems encountered in financing generally. When the Standard Oil Company of New Jersey, for example, makes a public offering of securities, the problems involved are essentially the same as those involved in any offering by a large corporate entity. To the extent that oil and gas financing problems are similar to financing problems generally, there is little justification for a specialized discussion of them. However, the development of our oil and gas resources is frequently financed by the sale of various types of oil and gas interests giving the purchaser a participation in the proceeds from the sale of oil and gas when and if discovered on the tract in which such interests are purchased. To the extent that financing is accomplished in this manner a number of SEC problems peculiar to this type of financing are encountered. This article is primarily concerned with problems of this nature.

The reader who is familiar with the niceties of oil and gas law will excuse this brief explanation of the various types of interests and legal relationships created in and with respect to oil and gas properties. However, the requirements of the federal securities laws as applied to oil and gas financing are not intelligible to the uninitiated without some understanding of the types of legal interests commonly encountered in oil and gas financing.²

The exploitation of our oil and gas resources has been accompanied by the creation of legal interests which are, in many respects, *sui generis*. The law relating to these interests combines familiar principles of the law of property, contracts, landlord-tenant, and tenancy-in-common; however, in no other field are they combined in the particular pattern and with the particular overtones that are found in oil and gas law.

* Assistant Professor of Law, University of Wyoming. The author was formerly employed as an attorney by the United States Securities and Exchange Commission. Many of the views expressed in this article were reached while employed by the Commission and after discussions with members of the legal staff of the Commission's Denver office. The author wishes to acknowledge his debt in this respect to Mr. William L. Cohn, Mr. Alec J. Kellar, Mr. Joseph F. Krysz, and to the late John L. Geraghty. However, the views expressed are those of the author and should not be attributed to the Commission or to any member of the Commission's staff.

1. The United States Securities and Exchange Commission will frequently be referred to in this article as the SEC.
2. The outline of the legal status of various types of oil and gas interest set forth in this article is not by any means an authoritative analysis of oil and gas law. With respect to problems relating to oil and gas law generally see Kulp, *Oil and Gas Rights* in II AMERICAN LAW OF PROPERTY 540-585 (Casner ed. 1952); SUMMERS, THE LAW OF OIL AND GAS (Perm. ed. 1938); THORNTON, THE LAW RELATING TO OIL AND GAS (5th ed. 1932).

While many variations are encountered, the exploitation of oil and gas resources frequently involves the creation of legal interests which follow a basic pattern. The legal theories employed sometimes differ,³ but regardless of the theory employed the fee owner of the land has the right to explore for and remove oil and gas from his property.⁴ The fee owner is, however, rarely in a position to exploit the oil and gas resources relating to his property as ordinarily he is not engaged in the oil and gas business. Companies regularly engaged in the business of exploring and developing oil and gas properties, on the other hand, are reluctant to purchase the entire fee as this would be unduly expensive in view of the uncertainty of encountering oil or gas and the limited use intended to be made of the land. The general practice, therefore, is for the owner of the oil and gas rights, who generally but not necessarily is also the owner of the surface rights, to enter into an oil and gas lease with a party or parties interested in acquiring the right to explore for and develop the oil and gas potentialities of the acreage in question.

Under the terms of the typical oil and gas lease the lessee is granted the right to ingress and egress and the other rights essential to the exploration and development of the acreage.⁵ The lessee ordinarily is not required to drill a well or wells on the acreage involved but generally must pay a specified annual rental, in lieu of drilling, or forfeit the lease.⁶ The lessee generally has the exclusive right to remove and sell oil and gas from the property subject to the payment to the lessor of a specified royalty.⁷ The lease is for a period of years, generally not more than ten, and invariably provides that in the event oil or gas is encountered the lease shall continue as long thereafter as oil or gas is produced from the lease in paying quantities.⁸

Leases are frequently acquired by lease brokers and others who acquire them with a view to reselling them to oil operators interested in developing the leases. In many instances the lease broker in assigning his lease to someone else will reserve to himself a specified percentage of the oil and

3. The two principal theories are (1) that the fee owner is the absolute owner of the oil and gas in place and (2) the fee owner merely owns a *profit a prendre* giving him the right to reduce oil and gas to possession. Texas is an example of an ownership state and California is an example of a state following the profit theory. See generally Kulp, *op. cit. supra* note 2, at 511-515.

4. *Id.* at 515.

5. McRae, *Granting Clauses in Oil and Gas Leases* in PROCEEDINGS OF THE SECOND ANNUAL INSTITUTE ON OIL AND GAS LAW AND TAXATION 53 (1951).

6. For the varying legal consequences resulting from the different types of delayed rental clauses see Williams, *Primary Term and Delay Rental Provisions* in *id.* at 93-140.

7. The lessor's royalty (commonly referred to as the landowner's royalty) is custom-12½% of all the oil and gas produced but occasionally is more. See generally Adoue, *Royalty and Pooling Provisions in Oil Gas and Mineral Leases*, in *id.* at 195-235.

8. See generally Moses, *The Evolution and Development of the Oil and Gas Lease*, in *id.* at 20. For a good discussion of the different legal consequences resulting from the employment of varying phraseology see Kulp, *op. cit. supra* note 2, at 587-593.

gas produced. The percentage reserved is normally a small one and is known as an overriding royalty.

While the variations are numerous,⁹ there are, in summary, four principle types of oil and gas interests:

1. The mineral rights as such—until severed these rights are the property of the fee owner of the surface.¹⁰

2. The landowner's royalty—this interest does not come into being until the lease has been granted and theoretically differs from the ownership of the mineral rights in that the royalty interests exists only for the life of the lease creating it. However, inasmuch as the word "royalty" is frequently used in common oil parlance to indicate all of the fee owner's rights in oil and gas, some courts have construed a conveyance of the landowner's royalty as if it were a conveyance of the mineral rights. A royalty owner under the latter construction owns the mineral rights subject to any outstanding lease and his interest in the minerals continues after the termination of a particular lease.¹¹ The owner of a landowner's royalty receives a specified part of all oil and gas produced by the lessee and normally does not contribute to the cost of drilling the wells or to the cost of producing the oil and/or gas.

3. The overriding royalty—this interest is similar to the landowner's royalty except that it is created by a different party and normally is for a smaller percentage of the production. This interest normally does not contribute to the cost of drilling wells or to the cost of operating the wells.

4. The leasehold interest—the lease owners control during the continuance of the lease the development of the oil and gas potentialities of the lease, they finance the cost of drilling and completing the wells, and they receive the proceeds from the sale of all oil and gas subject to the payment of the outstanding landowner's and overriding royalties. The lease owners normally pay the expenses incurred in producing and marketing the oil.

The foregoing discussion relates to land held in fee, that is, land owned by private parties. However, much of the oil and gas lands of the West are owned by the federal government and by state governments and various governmental agencies.¹² Similar interests are generally created with respect to such lands although the leasing thereof is made pursuant to the appropriate federal and state statutes and regulations. The owner

9. In addition to the types of oil and gas interests outlined in the text another common arrangement is a provision requiring the lessee to pay a certain percentage of the proceeds from production until a specified amount has been paid (generally known as an "oil payment"). See also the various "carried interests" described in note 17.

10. Kulp, *op. cit. supra* note 2, at 515-519.

11. See Tippit, *Creating Mineral and Royalty Interests*, 29 *Dicta* 186-193 (1952).

12. For a good discussion of leasing on federal lands see HOFFMAN, *OIL AND GAS LEASING ON THE PUBLIC DOMAIN* (1951) *passim*.

of the landowner's royalty interest in such instances is the federal or state government involved, and, unlike the ordinary landowner's royalty, such interests are not ordinarily sold. Overriding royalties with respect to such lands can be created by the leaseholder although, in the case of federal lands, the amount of the overriding royalty percentage-wise is restricted.¹³ The leaseholder has similar rights and obligations with respect to the development of the acreage except that the rental, drilling, and other obligations are in the case of federal lands¹⁴ and generally with respect to state lands determined by the appropriate statutes and regulations.

With respect to the four types of interests discussed above, the owners can and frequently do (except when the owner is the federal or a state government) divide their interest into fractional undivided interests and sell the fractional interests. The landowner can, and frequently does when he wants to share a part of the risk, sell fractional undivided interests in his royalty. The owner of the overriding royalty may, and sometimes does, sell fractional undivided interests in his royalty. The leaseholder in turn can, and frequently does, sell fractional undivided interests in the lease. The purchasers of all such interests, it should be noted, are acquiring a fraction of a fraction since the interests themselves are fractions.¹⁵ The fractional interests sold are normally undivided interests entitling the purchaser to his fractional part of the production from any part of the acreage involved.

The sale of fractional undivided interests in the mineral rights, the landowner's royalty, or in the overriding royalty is not normally a device for financing the drilling of a well, but is, rather, a method of sharing the risk involved and/or receiving the immediate enjoyment of an income that would otherwise be spread over a period of years. There are a number of oil royalty dealers who purchase such interests and resell them to the public either in the form acquired by them or after further fractionizing the interests. These interests may relate to acreage in the production stage or may relate to acreage that has no present production.

There are in most oil areas individuals who purchase and sell oil and gas leases. Frequently, such individuals acquire the leases for major oil companies and are compensated for the leases by an agreed upon sales price or commission depending upon whether they act as agent or principal

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13. An agreement, the effect of which is to subject a lease to royalties in excess of 17½% (hence, ordinarily an override in excess of 5% inasmuch as the royalty reserved to the government is usually 12½%) must provide that the obligation to pay royalties in excess of 17½% will be suspended during any period when the average production per well per day is 15 barrels or less. 43 Code Fed. Reg. 192.83 (1949 ed.).
 14. The Geological Survey Oil and Gas Operating Regulations set forth detailed instructions that must be followed in drilling on federal leases and in operating wells and marketing oil from wells located on federal acreage. 30 Code Fed. Reg. 221.1-221.67 (1949 ed.).
 15. For example, someone purchasing one-half of the customary one-eighth landowner's royalty is entitled to one-sixteenth (one-eighth multiplied by one-half) of all the oil and gas produced from the tract.

in the transaction.¹⁶ Some lease brokers are also engaged in the business of selling leases to members of the public. The purchasers generally hope (and are sometimes promised) that a drilling to be undertaken in the same general area will enhance the value of their lease enabling them to resell the lease at a substantial profit. In some instances such leases are bought in the hope that subsequent developments may enable the purchaser to have a well drilled on his acreage on a farm-out basis.¹⁷

A fairly common method of financing the drilling of a well is the sale of fractional undivided interests in the lease. Such interests are frequently sold on the representation that the proceeds will be used to drill a well on the acreage involved and such interests are commonly referred to as "working interests." The interest ordinarily is a fractional undivided interest in the described tract on which the well is to be drilled although, in some instances, it may be an interest only in the particular well and sometimes only in a particular underlying horizon believed to have oil or gas potentialities. Frequently such interests are sold subject to an operating agreement setting forth the rights and obligations of the party designated as "operator" and of the interest holders.¹⁸ An interest holder ordinarily acquires, subject to payment of royalties and of his proportionate part of the operating cost, a fractional part of the proceeds from the sale of all oil and gas produced.

OIL AND GAS INTERESTS AS SECURITIES

In determining whether it is necessary to comply with the requirements of the Federal Securities Act, one must first determine whether or not the sale of a "security" is involved. Section 2 (1) of the Federal Securities Act of 1933 defines a security to include, among other things, "fractional undivided interests in oil, gas, or other mineral rights."¹⁹ In view of this provision it is clear that the sale of fractional undivided interests in the mineral rights, in the landowner's royalty, in an overriding royalty, or in a lease all involve the sale of security.²⁰ This is true regard-

16. In many instances the lease broker retains a small overriding royalty (for example, 2½%) which will become a source of income to him in the event oil or gas is encountered.

17. A "farm-out" is an arrangement under which a party agrees to drill a well at his expense for the lessee in return for an interest in the lease. Ordinarily the lessee has to have acreage which is attractive from a geological standpoint before he can find someone willing to enter into an arrangement of this nature. There are numerous variations including agreements to drill all wells free of cost to lessee in return for a specified interest in the lease; agreements to drill only the first well free of cost to the lessee; agreements to finance the drilling and completion of the well (or wells) but with a provision that the party financing the drilling and completion is to recover the cost from production in the event the well is productive.

18. See generally Smith, *Operating Agreements for Oil and Gas Development*, 29 *Dicta* 166 (1952).

19. 48 Stat. 74 (1933), 15 U.S.C.A. 77b(1). To change U.S.C.A. section citations to correspond to those of the original statute disregard the 77 and convert the letter to its numerical order in the alphabet. Thus 77b is section 2 of the original act since b is the second letter of the alphabet.

20. *Fisher v. Schilder*, 131 F. 2d 522 (10th Cir. 1942).

less of whether under the appropriate state law such an interest is considered an interest in realty or whether it is considered an interest in personalty.²¹

The really troublesome situation from the standpoint of determining whether the sale of a security is involved is that in which an entire lease rather than a fractional part of a lease is sold. As an original proposition, it could be argued that the sale of the entire lease involves the sale of fractional undivided interests in oil and gas rights inasmuch as a lease in effect entitles the owner thereof to a fractional part of all the oil and gas produced from the property.²² However, the Commission has never made this argument and has always taken the position that each type of oil and gas interest is to be considered in its entirety as a separate interest and that fractional undivided interests are involved only when they are created in one of these particular types of interests.²³ In order for the sale of the entire lease to involve the sale of a security the interest sold must come within some other aspect of the Securities Act definition of a security. Section 2 (1) of the Securities Act defines as security to include an "investment contract"²⁴ and accordingly if the entire lease is sold under circumstances involving the sale of an "investment contract" the sale comes within the purview of the Act.

The question of whether the sale of an oil and gas lease involves the sale of an investment contract can be best understood by reference to the factual situation involved in *S.E.C. v. C.M. Joiner Leasing Corporation*.²⁵ In the *Joiner* case the defendant sold oil and gas leases relating to small specifically described tracts which never exceeded twenty acres and which

21. *S.E.C. v. C.M. Joiner Leasing Corporation*, 320 U.S. 344 (1943); *Mansfield v. United States*, 155 F. 2d 952 (5th Cir.) *cert. denied sub nom. Browne v. United States*, 329 U.S. 792 (1946).

22. Any possibility of now contending that the entire lease involves a fractional undivided interest is probably foreclosed by Justice Jackson's dictum in *S.E.C. v. C.M. Joiner Leasing Corporation*, *supra* note 21, at 348, to the effect that the sale of "naked leasehold rights" does not in and of itself involve the sale of a security.

23. Accordingly, if the entire landowner's royalty, the entire override or the entire lease is sold as distinguished from fractional interest in the landowner's royalty, overriding royalty or lease no sale of a fractional undivided interest is involved. Securities Act Release No. 185 (1934) says this explicitly with respect to royalty interests: "... The Act applies, however, only to 'fractional' interests. The transfer of the whole royalty interest in any tract of land, though under the terms of the lease the holder may be entitled only to a portion of the production, is not considered the transfer of a security under the Act." In 1938 the Commission's Oil and Gas Unit prepared a report in which they noted (Appendix B) that the securities acts of twenty-one states specifically define an oil and gas lease as a security and that the reasonable construction of the securities acts of thirteen additional states would include an oil and gas lease as a security. The same report (Appendix A) presented a very persuasive argument to the effect that an oil and gas lease is itself a fractional undivided interest in oil and gas rights. However, the Commission did not elect to adopt this position but chose to rely on the "investment contract" theory. See SEC (OIL AND GAS UNIT), A DISCUSSION OF THE APPLICATION OF SECTION 2(1) OF THE SECURITIES ACT OF 1933 TO THE ASSIGNMENT OF OIL AND GAS LEASES (1938).

24. 15 U.S.C.A. 77b (1).

25. 320 U.S. 344 (1943).

in some instances covered only two and one-half to five acres.²⁶ The promoter represented in the sale of the oil and gas leases that his company would undertake the drilling of a test well so located as to test the oil producing possibilities of the offered leaseholds. The Supreme Court, in an opinion written by Justice Jackson, held that the sale of oil and gas leases under these circumstances involved the sale of an investment contract and as such the sale of a security. Justice Jackson emphasized the fact that—"Drilling of the well was not an unconnected or uncontrolled phenomenon to which salesmen pointed merely to show the possibility of the offered leases . . . the undertaking to drill a well runs through the whole transaction as the 'thread on which everybody's beads was strung' . . ."²⁷

In view of the decision in the *Joiner* case it is clear that if oil and gas leases are sold on the representation or promise that the offeror or someone controlled by him will drill a well that may enhance the value of the offered leases that a sale of a security is involved. However, Justice Jackson's language suggests that no sale of a security is involved in the event that a well located in the same general area as the proffered leases is to be drilled by an uncontrolled third party. Yet from the standpoint of the investor it makes little difference whether the promoter points to a well being drilled by him or whether he points to a well being drilled by someone else. In both instances the purchaser of the oil and gas leases in order to make an informed investment must have available pertinent geological information.²⁸

There are unfortunately at the present time a number of promoters who, aware of the implications of the *Joiner* case, are offering oil and gas leases on small specifically described tracts and in connection with such sales point to wells being drilled or to be drilled by someone else in the area. As a rule very flamboyant literature featuring vague and general statements and predictions of future developments carefully drawn so as to make criminal prosecution under the mail fraud statute difficult if not impossible, is used in connection with such offerings. The situation is one calling for the type of disclosure that can be obtained through the registration requirements of the Securities Act or by the injunctive provisions of that Act. However, the Commission has no power to act if the sale of a security is not involved and the postal officials under the mail fraud statute do not have comparable disclosure powers.²⁹

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26. Most oil and gas states have spacing limitations permitting only one well per a specified number of acres. In Texas, where these leases were sold, the spacing regulations ordinarily permit only one well for each twenty acres. However, if tracts are separately owned the Texas regulations permit at least one well for each separate tract in existence at the time oil is discovered in the particular area. See Meyers, "Common Ownership and Control" in *Spacing Cases*, 31 Texas L. Rev. 19 (1952).
 27. S.E.C. v. C. M. Joiner Leasing Corporation, 320 U.S. 344, 348 (1944).
 28. Justice Jackson remarked in the *Joiner* case, *id.* at 349, that "The trading in these documents had all the evils inherent in the securities transactions which it was the aim of the Securities Act to end." The same can be said with respect to trading in leases of the type described.
 29. The mail fraud statute does not require the use of prescribed sales literature and

Language in another leading Supreme Court case on "investment contracts" suggests that the Court may, if the situation is presented to it, find that the described situation also involves the sale of an investment contract. In the *Howey* case,³⁰ involving the sale of specifically described citrus groves, the Supreme Court defined an "investment contract" as an investment of money in a common enterprise with the expectation that the investor "would earn a profit solely through the efforts of the promoter or of someone other than themselves."³¹ [emphasis supplied] The last clause of the quotation suggests that if oil and gas leases are sold to specifically described tracts too small to make development by the purchaser feasible³² and if the promoter points to a well being drilled by a third party in the same general area, that a sale of an investment contract is involved. This would be particularly true if the purchasers resided a long distance from the acreage involved,³³ if the purchasers were inexperienced in developing, buying and selling oil properties,³⁴ and if the promoter represented that he would resell the leases for the purchasers.³⁵

While the foregoing discussion has related to the sale of leaseholds, it should be noted that similar considerations can apply to the sale of the entire fee interest in the land. If the land involved has very limited, if any, other use possibilities, the sale of the fee simple title accompanied by a representation that the promoter will drill a well in the same area so as to test the oil and gas potentialities of the offered tracts involves the sale of an investment contract.³⁶ Various other devices employed to avoid the requirements of the Securities Act also have been found to involve the sale of investment contracts and as such to involve the sale of a security. In *SEC v. Crude Oil Corporation*,³⁷ for example, the offeror purported to sell the purchasers a bill of sale to a specified number of barrels of oil. However, in every instance no oil was actually delivered to the purchasers; they merely received a proportionate part of the proceeds derived by the Company from producing royalty interests held by the Company. The court held that while ordinarily the sale of oil does not

gives the United States no authority to enjoin or otherwise prohibit the use of false or misleading sales literature other than by criminal prosecutions. 18 U.S.C.A. 1341. The Postmaster General does have the power in a proper proceeding to enter a fraud order, the effect of which is to deny the party subject to the order the receipt of mail.

30. S.E.C. v. W. J. Howey & Co., 328 U.S. 293 (1946).
31. *Id.* at 301.
32. The fact that the tracts were too small to make development by the purchaser feasible was emphasized in the following cases: S.E.C. v. W. J. Howey Co., 328 U.S. 293 (1946); S.E.C. v. C. M. Joiner Leasing Corporation, 320 U.S. 344 (1944); Atherton v. United States, 128 F. 2d 463 (9th Cir. 1942).
33. This factor was emphasized in the *Howey* case, *supra* note 32.
34. This factor was emphasized in the *Howey* case, *supra* note 32.
35. S.E.C. v. W. J. Howey Co., *supra* note 32; Atherton v. United States, 128 F.2d 436 (9th Cir. 1942).
36. Mansfield v. United States, 155 F. 2d 952 (5th Cir.) *cert. denied sub nom.* Browne v. United States, 329 U.S. 792 (1946).
37. 93 F. 2d 844 (9th Cir. 1937).

involve the sale of a security, the purported sale of oil under the facts of this case involved the sale of an investment contract.

EXEMPTIONS—USE OF THE MAILS

It is unlawful under Section 5 (a) (1) of the Securities Act in the absence of an exemption to use the mails or means or instrumentalities of interstate commerce (hereafter, referred to as the required jurisdictional means) directly or indirectly in the sale of an unregistered security.³⁸ It is extremely difficult in an offering of any size not to use the required jurisdictional means directly or indirectly in connection with the offering.³⁹ As a rule no one other than professional confidence men, some of whom make a studious effort to avoid the use of the required jurisdictional means, rely on the absence of the use of such means in order to avoid the registration requirements of the Act. No discussion is attempted in this article of the jurisdictional requirements of the Act.

EXEMPTIONS—TRANSACTIONS BY SOMEONE OTHER THAN AN ISSUER, UNDERWRITER, OR DEALER

A transaction by someone other than an issuer, underwriter, or dealer, is exempt from the registration requirements of the Act.⁴⁰ A sale in which no issuer, underwriter, or securities dealer^{40a} has participated is, therefore, beyond purview of the registration requirements of the Act. Further, with respect to sales by a dealer they are exempt from the registration provisions after one year has elapsed from the date on which the securities were first offered to the public. However, during one year after the initial offering the dealer must comply with the registration provisions with respect to trading in the security in which he participates even if he does not participate in the original offering as such. During this one year period the dealer must furnish customers trading in a registered security with a copy of the statutory prospectus⁴¹ and as we note below⁴² a dealer may have a similar responsibility with respect to furnishing customers trading in securities offered pursuant to Regulation B, the common method of offering fractional undivided oil and gas interests, with an offering sheet.

38. 15 U.S.C.A. 77e (a).

39. The use of the mails may be no more than the forwarding of a check by a depository bank for collection. Compare *Kann v. United States*, 323 U.S. 88 (1944) with *United States v. Vidaver*, 73 F. Supp. 382 (DC Va. 1947).

40. 15 U.S.C.A. 77d (1).

40a. The Securities Act defines a "dealer" to include both a broker of and a dealer in securities, 15 U.S.C.A. 77b (12). In this respect it differs from the definition of a "dealer" in the Exchange Act. See *infra* page 83.

41. The prospectus must meet the requirements of Section 10 of the Securities Act (15 U.S.C.A. 77j) and must accompany or precede any other communication relating to the registered security sent through the mails or by means or instruments of transportation or communication in interstate commerce, and must accompany or precede the delivery of any registered security if the delivery is made through the required jurisdictional means. 15 U.S.C.A. 77e. The one year limitation with respect to use of the prospectus by a dealer is found in Section 4 (1) (15 U.S.C.A. 77d (1)). However, no prospectus has to be delivered by a broker-dealer with respect to any unsolicited brokerage transaction. 15 U.S.C.A. 77d (2).

42. See note 75 and related text.

An underwriter is defined by the Securities Act as a person selling securities for an issuer in connection with the distribution of a security or who purchases securities from an issuer with a view to distribution.⁴³ It is particularly pertinent to determine who is an issuer of fractional undivided oil and gas interests in view of the fact that transactions by both an issuer and an underwriter are subject to the registration provisions of the Act and the underwriters cannot be determined without first determining who is the issuer. Section 2(4) of the Securities Act defines an issuer of fractional undivided interests as the owner of any oil or gas right or interest in such right "who creates fractional interests therein for the purpose of a public offering."⁴⁴ In order to be an issuer of such interests one must (1) own an oil or gas right or interest in such right, (2) create fractional interests in such right, (3) for the purpose of a public offering.

The typical situation involves no problem in this respect inasmuch as the promoter ordinarily owns the oil or gas right in which he creates fractional undivided interests and ordinarily he directly participates in the public offering. It is not unusual, however, for a promoter to acquire an option to certain oil and gas acreage and on the basis of his rights under the option to sell fractional undivided interests in the acreage to the public. A frequently encountered variation of this procedure involves the placing of an oil and gas lease in escrow, delivery conditioned upon the payment of a specified sum or upon the drilling of a well. In both instances the promoter is not the owner of the oil and gas rights at the time he purports to sell fractional undivided interests in such rights and not an issuer under a literal interpretation of Section 2(4) unless he sells fractional undivided interests in the option or the escrow agreement as distinguished from fractional undivided interests in the lease. However, the Commission has taken the position that "A person will also be classified as an issuer even though not the present owner of the interests he contracts to convey, if the contracts he offers to the public will involve his acquisition of an interest in a specific tract and the conveyance of fractional interests therein."⁴⁵

The really troublesome interpretative problems relating to this provision involve the situations in which the owner of a lease or royalty interest creates fractions in a transaction not in itself involving a public offering but in which his purchaser fractionalizes and makes a public offering. If the party acquiring the oil and gas rights for the purpose of making a public distribution is acting as an agent for the original owner,

43. 15 U.S.C.A. 77b(11).

44. 15 U.S.C.A. 77b(4).

45. Excerpt from SEC, COMPILATION OF RULES, REGULATIONS, FORMS AND OPINIONS APPLICABLE TO OIL AND GAS INTERESTS (1935) in CCH Federal Securities Law Reports Par. 2131.15. See also Securities Act Release No. 185 (1934).

the original owner is, of course, an issuer. However, even in the situation in which there is no agency relationship the Commission has taken the position that one can be an issuer despite the fact that the public offering is made by someone else. Where, for example, a wholesale dealer sells fractional undivided interests to a limited group of retail dealers who in turn make a public offering, it is the Commission's position that the wholesale dealer is an "issuer" on the theory that "his sales to retail dealers are merely first steps in a contemplated public distribution."⁴⁶ The fee owner, on the other hand, ordinarily has no responsibility for a public offering made by his vendee, in the view of the Commission, as "his participation in the transaction ends with his sale to the dealer." If, however, the fee owner's sale is dependent upon direct or indirect sales to the public by his vendee he would, according to the Commission, be classed as an issuer as "he would be availing himself of the dealer's distributing facilities."⁴⁷

In view of the Commission's interpretation, a fee owner who sells part of his royalty is an issuer if his sale is dependent upon the resale of interests in the royalty to the public. While the Commission's interpretation is not explicit in this regard, any option or escrow arrangement under which the purchaser has an opportunity to raise the purchase price by the sale of interests in the optioned or escrowed royalty to the public would undoubtedly involve the fee owner as an "issuer."⁴⁸ However, if the fee owner sells his entire royalty or enters into a lease under similar circumstances he is not an issuer for he has not under current interpretations created fractions, and in view of the explicit language of Section 2(4) a person who does not create fractions presumably is not an "issuer" of fractional undivided interests under any circumstance. The fee owner, therefore, does not ordinarily have to concern himself with the possibility of incurring any liability under the Federal Securities Act because his lessee sells fractional undivided interests in the lease to the public.⁴⁹

46. Excerpt from SEC, *op. cit. supra* note 45. If, however, the retail dealers were registered with the Commission and the offering did not exceed \$100,000 the wholesale dealer would with respect to such transactions be conditionally excepted from the registration requirements. See note 64, and related text.

47. *Ibid.* However, sales to registered dealers would ordinarily be conditionally excepted from the registration requirements. See note 64 and related text.

48. If, however, the purchaser is a registered dealer the transaction would ordinarily be conditionally excepted from the registration requirements. See not 64 and related text.

49. See note 23 and related text. However, the Commission's language to the effect that in certain situations, the fee owner "would be availing himself of the dealer's distributing facilities" (See note 47 and related text) sounds very much like some sort of quasi-agency theory. If an imposed agency relationship is the basis for holding the fee owner an issuer in those situations then whether the fee owner or his vendee created fractions would be immaterial. In the view of the author the definition of an "issuer" was designed for the purpose of excluding the fee owner in all but the exceptional case and any such construction would be unwarranted. It is the lessee who sells fractional undivided interests to the public and not the fee owner who is ordinarily in a position to furnish the information required by the registration statement and who should be responsible for its accuracy. It might, however, be advisable for the lessor's protection in situations in which the lessee proposes to sell interests in an optioned or escrowed lease to include a provision to

A fairly common method of financing the development of oil and gas properties is for the lease owner to sell a specified portion of his lease in return for his vendee's promise to drill one or more wells. If these wells are financed by the sale of interests to the public the Commission's interpretation, although not expressly dealing with this problem, suggests that the original lessee is an "issuer" with respect to the sales made by his vendee to the public inasmuch as the lessee has created fractions and his transaction is dependent, at least indirectly, on the resale of interests to the public. If, on the other hand, the original lessee assigns his entire lease merely reserving an override or an oil payment under current interpretations he has not created fractions⁵⁰ and is not, therefore, an issuer under any circumstance.

It is apparent in view of the foregoing that an offering of fractional undivided interests may involve more than one issuer. It is also apparent that one issuer, at least, may occupy a dual position as an issuer (if he further fractionalizes) and as an underwriter (if he has acquired securities from an issuer with a view to distribution.). The Commission has suggested that in order to avoid duplication in the filing of registration statements that the original party creating fractions create fractions in terms of the smallest fraction to be ultimately offered to the public.⁵¹

EXEMPTIONS—"INTRA-STATE" OFFERINGS

Section 3(a) (11) of the Securities Act exempts from the registration provisions the sale of any security which is a part of an issue sold only to "persons resident within a single state where the issuer of such security is a person resident and doing business."⁵² Although the exemption is frequently referred to as an intra-state exemption, strictly speaking it is not, for the criterion is not the state in which the transaction took place, but the state in which the issuer and the purchasers reside. The fact that the mails or means or instrumentalities of interstate commerce are used

the effect that the lessee will comply with the laws of the United States and the various states involved in financing the development of the leased property and that he will reimburse the lessor for any liability incurred by the lessor as a result of the failure of the lessee or his assigns to comply with such laws.

50. See note 23 and related text.

51. "In order to avoid the necessity of multiple registration, it would seem advisable for the original owner of the interest who proposes to subdivide it for the purpose of a direct or an indirect public offering, to register the fractional interests in as small fractions as he may deem necessary to assure their ultimate placement with investors. Instead of registering, for example, a one-quarter royalty interest, he may register 32/128, if he considers that it will be unnecessary to divide the interest into portions smaller than 1/128. . . . This may avoid further subdivision by the purchaser from the registrant, and thus, as no new issuer will be involved, a second registration will be rendered unnecessary." Securities Act Release 185 (1934). While the objective of avoiding duplicate registration statements is desirable, it is difficult to see how one who purchases a 32/128th interest and then sells thirty-two 1/128ths is any less an issuer than one who purchases a one-fourth interest and then sells 1/32 interests in his one-fourth. From any realistic standpoint they have both created fractions and hence are both issuers.

52. 15 U.S.C.A. 77c(11).

in connection with the sale does not destroy the availability of the exemption.

In order for the exemption to be available the entire issue must be sold to residents of the single appropriate state and the sale to one non-resident destroys the availability of the exemption even with respect to the sales confined to the residents of the single state. There is, however, always the question of whether the sale to the non-resident was part of the same issue. Compliance with this exemption cannot be obtained by selling the issue exclusively to residents of the appropriate single state if the resident purchasers purchase with a view to resale to non-residents.⁵³

The issuer must be a resident of and doing business in the same single state in which the offerees reside. However, the appropriate state does not have to be the principal place of business of the issuer. A corporation incorporated under the laws of state A is entitled to the exemption if the offering is confined to residents of state A even if the corporation's principal place of business and its principal properties are located in state B provided the corporation does some business in state A. However, the corporation would probably have to be engaged in some business in addition to selling the securities in state A in order to qualify for the exemption. To hold otherwise would make the "doing business" requirement a redundancy for obviously, if selling securities in the state is "doing business" in the state, the offering in itself would satisfy the requirement.

As we have already noted, there are situations with respect to offerings of fractional undivided interests in oil and gas rights in which there may be more than one issuer involved in the same public offering. The Commission has taken the position that in such situations the exemption can be secured only if all the issuers are residents of and doing business in the single state in which the offering is made.⁵⁴

EXEMPTIONS—PRIVATE OFFERINGS

Section 4(1) of the Securities Act exempts from the registration provisions transactions by an issuer not involving any public offering.⁵⁵ In connection with offerings of fractional undivided interests in oil and gas rights one never reaches this issue under Section 4(1) for it must be resolved in determining whether or not an issuer is involved. As we previously noted an issuer of such interests is one "who creates fractional interests therein for the purpose of a public offering."⁵⁶ However, the criteria relating to the determination of what is or is not a public offering as developed in connection with the interpretation of Section 4(1) are

53. See Securities Act Release No. 1459 (1937) which discusses this and other points relating to the "intra-state" exemption.

54. Securities Act Release No. 185 (1934).

55. 15 U.S.C.A. 77d(1).

56. See note 44 and related text.

equally relevant in determining whether a person is an "issuer" of fractional undivided oil and gas interests.⁵⁷

In an interpretation⁵⁸ frequently cited with approval⁵⁹ the Commission's General Counsel has stated that whether a particular offering is a public offering is a question of fact to be determined in the light of all the circumstances of a particular case. This criterion is of no value as a practical guide. However, the same interpretation specified a number of more concrete criteria to be applied in determining whether an offering is a public offering. The principal factors to be considered as set forth in this interpretation are: (1) the number of offerees, (2) the relation of the offerees to each other and to the issuer, and (3) the mode of distribution.

If the offering is confined to a limited and predetermined number of individuals who are closely associated with the issuer and with each other and no underwriter is employed in distributing the securities, the offering is probably exempt as a private transaction.⁶⁰ On the other hand, an offering to a large group of individuals even if not open to the general public may be a public offering if the offerees are not closely associated with the issuer despite the fact that an underwriter is not employed in connection with the distribution.⁶¹ The really difficult cases are the borderline situations generally involving a moderate but not predetermined number of offerees who are acquainted with the issuer or friends of the issuer. The offeror can in some borderline situations protect himself from Commission action by obtaining a "no action" letter from the Commission's staff.⁶²

The "numbers test" although probably implicit in the language of the statutory exemption is a poor criterion on which to base an exemption from the registration provisions particularly with reference to oil and gas offerings. Frequently oil and gas financing of a particular well, and each well ordinarily is a separate offering, is confined to a relatively small group who nonetheless do not have available information necessary to make an informed investment. In many instances this type of offering is a legitimate offering in the sense that the promoter intends to use the proceeds to drill the well and is enthusiastic about its prospects. In many other

57. With respect to the term "public offering" as used in the definition of an issuer of fractional undivided interests, see Securities Act Release No. 185 (1934) and compare with Securities Act Release No. 285 (1935).

58. Securities Act Release No. 285 (1935).

59. S.E.C. v. Sunbeam Gold Mines Co., 95 F. 2d 699 (9th Cir. 1938); S.E.C. v. Ralston Purina Company, 102 F. Supp. 964 (E.D. Mo. 1952); Campbell v. Degenther, 97 F. Supp. 975 (W.D. Pa. 1951); Corporation Trust Co. v. Logan, 52 F. Supp. 999 D. Del. 1943). The interpretations and decisions are discussed in LOSS, SECURITIES REGULATION (1951) 394-403.

60. S.E.C. v. Ralston Purina Co., 200 F. 2d 85 (8th Cir. 1952); Campbell v. Degenther, *supra* note 59.

61. S.E.C. v. Sunbeam Gold Mines Co., 95 F. 2d 699 (9th Cir. 1938).

62. A "no action" letter will not, however, protect the offeror from possible civil liability. See note 129 and related text.

instances the promoter is a professional confidence man who typically has no intention of devoting a substantial part of the proceeds to the drilling of the well. In both situations, although to varying degrees, the offering is one that requires the close supervision provided for by the registration provisions of the Securities Act.

There are, of course, a number of insitutional investors and others who purchase various types of oil and gas securities who are in a position to make an informed investment without the assistance of a registration statement or offering sheet. Any private transaction exemption should be confined to offerings directed exclusively to such informed investors. In the case of oil and gas securities, informed investors would include those regularly engaged in the business of exploring and developing oil and gas properties, and corporations or other types of business associations regularly engaged in the business of buying oil and gas securities for their own account. While it is true that oil and gas securities, including leases and royalties, are frequently purchased by individuals in the upper income tax brackets, the fact that one is in the upper brackets does not in itself make one an informed investor. Such individuals sometimes employ expert assistance; however, all too frequently they are not any better informed than the average investor. Although Congress has provided certain tax advantages⁶³ designed to encourage the flow of capital into the development of our oil and gas resources, Congress certainly did not intend that such investment decisions should be made on an uninformed basis.

The entire question of exemptions for so-called "private offerings" is in need of careful re-examination. In the event the exemption provided for with respect to such offerings by Section 4(1) of the Act is amended, the necessity of amending the definition of an "issuer" of fractional undivided interests as defined in Section 2(4) should not be overlooked. However, with respect to amending Section 2(4) care should be taken to exclude the landowner from the definition of an "issuer" in all but the exceptional situation.

CONDITIONAL EXCEPTIONS—

SALES TO OIL EXPLORATION COMPANIES AND TO SECURITIES DEALERS

With respect to oil and gas offerings not exceeding \$100,000 the Commission has, in effect, by Rule 322 of Regulation B provided three other exemptions which, however, are styled "conditional exceptions."⁶⁴ Section 3(b) of the Securities Act gives the Commission authority to exempt offerings under \$300,000 pursuant to terms and conditions provided by Commission regulations.⁶⁵ As we note later in detail,⁶⁶ pursuant to this

63. The principal tax advantages are, of course, the 27½% depletion allowance. (INT. REV. CODE, Sec. 114(b)(3), and the option to expense intangible drilling and development costs (26 CODE FED. REG. 29.23(m)-16).

64. 17 Code Fed. Reg. 230.322 (1949 ed.).

65. 15 U.S.C.A. 77c(b).

66. *Infra* pages 65-70.

provision the Commission has adopted Regulation B, a so-called "conditional exemption from registration," for offerings of fractional undivided interests in oil and gas rights not exceeding \$100,000. This exemption ordinarily is available only if an offering sheet is filed with the Commission and the other requirements of the Regulation are met.⁶⁷ However, Rule 322 of Regulation B provides that certain types of transactions do not have to comply with the offering sheet requirements of the Regulation. Transactions entitled to this exception are (1) offers or sales to persons regularly engaged in the business of exploring for, or producing oil or gas, (2) offers or sales to persons duly registered as dealers under Section 15 of the Securities Exchange Act of 1934 and (3) offers or sales to a corporation or trust the assets of which consist principally of oil or gas rights and the stock of which, or certificates of interest or participation in which, are at the time of the offer registered under the Securities Act of 1933. The exception is automatic with respect to sales to persons engaged in the business of exploring for or producing oil or gas, but the other transactions are excepted from the offering sheet requirements only if exact copies of any advertising material sent through the mails or by means of any instrument of transportation or communication in interstate commerce to the offerees are simultaneously filed with the Commission. If under these provisions sales are made to registered dealers who are not residents of or who do not maintain a bona fide place of business in the same state in which the oil or gas property involved is located, and/or if sales are made to corporations or trust of the type described, a written report of such sales must be filed with the Commission on form 2-G within fifteen days after the sale.

The theory behind the conditional exception in the case of sales to a company engaged in the business of exploring or producing oil or gas apparently is that such companies do not need the protection afforded by the offering sheet. In the case of sales to the registered dealer and to the corporation or trust of the type described, the theory apparently is that the public is adequately protected by the offering sheet or registration statement that the dealer will have to file if he creates fractions and makes a public offering and by the registration statement filed by the described corporation or trust. However, the Commission has adopted a particularly cumbersome method of accomplishing this purpose in that it has adopted a general regulation conditionally exempting offerings meeting certain requirements, the most important of which is the filing and use of an offering sheet, and then provided that the exemption is available to these particular transactions without the filing or use of an offering sheet. These transactions could have been more readily exempted by adopting a rule to the effect that the described transactions are exempt from the registration requirements of the Act with the qualifications already noted in regard to filing of circular communications and form 2-G. As a result

67. 17 Code Fed. Reg. 230.320 (1949 ed.).

of the method employed by the Commission these transactions are "excepted" only from the offering sheet requirements and must meet the other requirements of Regulation B, some of which in the light of the rationale for the exceptions do not appear relevant—for example, the \$100,000 limitation.

EXEMPTIONS—REGULATION B

The exemptions and exceptions heretofore discussed are for the most part automatic in that if they are available there is no necessity to file any information with the Commission or to use any prescribed sales literature. As already noted,⁶⁸ the "exceptions" provided for by Rule 322 in some instances do have nominal filing requirements that have to be complied with. In addition to the exemptions and exceptions already discussed the Commission has adopted by regulation certain so-called "conditional exemptions" from registration. This is really confusing terminology for what these regulations provide for in effect is a less stringent form of registration. The "conditional exemption" from registration relating to offerings of fractional undivided interests in oil and gas rights is set forth in Regulation B.⁶⁹

Offerings of fractional undivided interests made pursuant to Regulation B cannot exceed \$100,000.⁷⁰ The exemption is not available until an offering sheet meeting the requirements of the Regulation has been filed with the Commission and become effective.⁷¹ An offering sheet does not become effective until eight days after it has been filed in quadruplicate with the Commission's Washington office and then only if the Commission has not entered a suspension order during the interim.⁷² An exact copy of the effective offering sheet must be furnished every prospective purchaser at the time of the initial solicitation.⁷³ The offeror must file with the Commission a written report of each sale on Form 1-G within fifteen days after the contract of sale is made.⁷⁴ While not entirely clear, dealers trading in such interests after they have been initially offered may for one year after the initial offering have to furnish prospective customers trading in the security with a copy of the offering sheet.⁷⁵

68. *Supra* pages 63-64.

69. 17 Code Fed. Reg. 230.320-230.356. In subsequent citations to Regulation B the rule number will be cited rather than the code citation. However, the rule number can be converted to its appropriate section number in Title 17 of the Code of Federal Regulations by prefacing it with 230 decimal point. Thus Rule 320 is section 230.320 of Title 17 of the Code.

70. Rule 310.

71. Rule 320. As to whom must file an offering sheet see *infra* pages 79-80.

72. Rule 342.

73. Rule 320(b).

74. Rule 320(e).

75. This is provided for in a rather indirect manner. Rule 300(g) defines an "offeror" to include a dealer. Rule 320 provides that the exemption provided for by Regulation B is not available to an offeror who does not file an offering sheet or have one filed on his behalf and who does not at the time of the initial offer to sell the security deliver to every person solicited a copy of the offering sheet. In the event an offeror fails to comply with these requirements he is, under Rule 320, subject to the same

The offering sheets are question and answer prospectuses in which the text of the questions as set forth in the appropriate schedule⁷⁶ must be repeated and in which the questions and answers must follow a prescribed order. The offering sheets are reviewed by the Commission's Oil and Gas Unit in Washington and the usual administrative practice in the event of deficiencies is for the Commission to enter a temporary suspension order directed to the offeror with a notice that the offeror may request a hearing. The suspension order is ordinarily accompanied by a detailed letter from the Oil and Gas Unit setting forth deficiencies and suggesting the manner in which the offering sheet should be amended. In most instances the offeror makes the appropriate amendments and the Commission then terminates the suspension order.

All information contained in the offering sheet must be as of a date not more than 110 days prior to the delivery of the offering sheet to the purchaser or of the date of the making of the contract of sale.⁷⁷ An offering sheet will, therefore, in effect, expire at the very latest 110 days after the offering sheet was originally filed with the Commission and ordinarily sooner. The information that becomes dated generally relates to production data and in order to prevent the early termination of the offering sheet the offeror should attempt to obtain data as of a date as close to the filing date as possible. When a geological report is used, a problem frequently arises in that the geologist may have prepared the report several months prior to the filing of the offering sheet and if included the offering sheet will expire 110 days after the date of the

liability which would be imposed upon him in the absence of the exemption provided by Regulation B for the sale of unregistered securities. Under Section 4(1) of the Securities Act (15 U.S.C.A. 77d(1)) a dealer is subject to the liabilities imposed for violation of the registration provisions for sales made by him within one year after the security was first offered to the public. It can, therefore, be argued that to avoid this liability, a dealer must file or have an offering sheet filed on his behalf and must deliver a copy to customers solicited during the twelve month period following the initial offering. On the other hand, the administrative construction of Section 4(1) is to the effect that a dealer is excused from the registration requirements in connection with trading in securities which were initially offered under an exemption. It can, therefore, be argued that inasmuch as the initial offering is exempt under Regulation B, trading in the security is also exempt. However, the administrative construction is a practical necessity with respect to initial offerings made under the private offering and intra-state exemptions, whereas it is not with respect to offerings made under the Regulation B exemption. In the latter type of offering, the issuer and underwriter already have on file an offering sheet which can be filed (Rule 324) on the dealer's behalf. However, a practical problem would arise with respect to trading in the security when the 110 day limitation relating to offering sheets has expired (See *infra* pp. 66-69). Applying this construction to Regulation B offerings makes the inclusion of "dealers" in the Rule 300(g) definition of an "offeror" surplusage. To a large extent the problem is academic as there is very little trading in this type of security and ordinarily, because of the peculiar definition of an "issuer" of fractional undivided interests (See *supra* pp. 58-60), what would constitute trading with respect to other securities involves an offering of a new issue with respect to fractional undivided interests.

76. The form and content of the offering sheets are prescribed by Schedules A through F. The appropriate schedule depends upon the type of interest being offered (producing landowner's royalty, non-producing landowner's royalty, producing working interests, etc). Rule 330(g) sets forth the appropriate schedule to be used for various types of offerings.
77. Rule 330(c).

report. To avoid this problem the geologist can ordinarily, if no new developments have occurred that affect the report, redate the report. If his report is based on surface geology, he could ordinarily republish his report as of a more current date without going over the acreage again; if, however, there have been recent developments relating to the acreage such as the drilling of a dry hole, he obviously would not be warranted in republishing his report without taking the new developments into consideration. In the latter event he could probably redate the report so as to comply with the 110 day requirement but if he failed to take the new developments into account the report would be misleading and a basis for entering a suspension order.

When the 110 day period has expired there is, unfortunately, no convenient method under the present regulations of amending the offering sheet. The offeror can at that time apply to the Commission for an order terminating the effectiveness of the offering sheet and then file a new offering sheet meeting the 110 day requirement for the unsold portion of the offering. However, under Rule 356 the Commission will enter an order terminating the effectiveness of the offering sheet only if an affidavit is filed to the effect that all persons on behalf of whom the offering sheet has been filed and to whom copies have been delivered⁷⁸ have been notified in writing of the intention to terminate the effectiveness of the offering sheet. As another alternative the offeror can rely on the fact that despite the 110 day limitation once the offering sheet becomes effective, it remains effective until withdrawn, voluntarily terminated or suspended by order of the Commission. The Commission will, if the offering sheet is used after the expiration of the 110 day period, have a basis for entering a permanent suspension order under Rule 340 (b) and once notice and opportunity for hearing in connection with the suspension proceeding is entered the offeror can, under Rule 352 (c), amend the offering sheet if the hearing with respect thereto has not been finally closed. The offeror is not otherwise free to amend the offering sheet unless no securities have been sold under the offering or unless a temporary suspension order is in effect and the hearing with respect thereto has not been finally closed.⁷⁹

The Commission apparently assumes that after the offering sheet has become dated because of the 110 day limitation the effectiveness of the offering sheet automatically terminates. This is evident from the fact that item 5 of Division I of the appropriate Regulation B offering sheet requires the offeror to state that "The information contained in the offering

78. See *infra* page 79 for those on behalf of whom offering sheets can be filed. Rule 356 is reasonable enough in view of its primary purpose to assure that all dealers participating in the offering are aware that it has been terminated.

79. However, the offeror could terminate the effectiveness of the offering sheet under Rule 356 and presumably could file a new offering sheet relating to the same interests. Rule 310 limits the exemption to issues of offerings which when issued, offered, or sold do not exceed \$100,000. However, nothing therein compels the conclusion that the unsold and unissued portion of the original offering must be included in computing the amount of the offering being made under the new offering sheet.

sheet will under the Rules and Regulations of the Commission, be out of date on, and the effectiveness of the offering sheet will expire on....." The blank is completed by inserting the date on which the offering sheet becomes dated because of the 110 day requirement. However, under Rule 342 an offering sheet becomes effective eight days after filed if no temporary suspension order is entered prior to that time and remains effective until notice of a hearing to enter a permanent suspension order is given. The original effectiveness of the offering sheet is, under Rule 342, qualified by the requirement that the offering sheet comply with the requirements of Regulation B, particularly Rule 330. The Commission has apparently construed Rule 342 to also provide that an offering sheet having become effective loses its effectiveness any time that it no longer complies with the requirements of Regulation B. In view of this construction the offeror at the expiration of the 110 day period should file a new offering sheet complying with this and other requirements of Regulation B covering the unsold portion of the offering. As an added safeguard it might also be advisable to terminate the previous offering by notifying all dealers on behalf of whom an offering sheet has been filed and filing an affidavit to that effect in accordance with the requirements of Rule 356.

Rule 320 (d) requires that the offeror deliver to the purchaser evidence satisfactory to the purchaser of the validity of the title which the purchaser is to receive. This evidence must be delivered prior to the making of each contract of sale and prior to the payment by the purchaser of any part of the consideration. Apparently under this hopelessly vague rule the offeror must make available some evidence of the title on which the interests are based even if the offeror does not ask for such information. However, presumably the offeror's statement that they have a valid title is sufficient if the purchaser does not demand more. In view of the fact that large sums of money are generally invested in developing oil and gas properties, as a very minimum anyone contemplating drilling an oil or gas well should have a title opinion relating to the acreage involved and it is difficult to understand why this is not required by Regulation B.

Regulation B does not require the offeror to set forth the purchase price or the underwriting commissions or discounts paid in connection with the transaction. In this respect the regulation differs from registration and from the other conditional exemptions provided for under the Act. The exclusion of this information is explained by the belief that if the offering price and underwriting commissions and discounts are set forth the purchaser will assume that the price and commissions or discounts are standard and that such price, commissions or discounts are approved by the Commission.⁸⁰ However, it is difficult to see why this erroneous

80. The appropriate schedules at one time required the offeror to state the maximum offering price. However, as a result of an investigation that led to a broker-dealer revocation proceeding the Commission became aware of the possibility of dealers leading customers to believe that the maximum offering price represented a recognized or established market price. Lawrence R. Leeb, 15 S.E.C. 499, 510 (1943). The Commission stated in the *Leeby* case that "in order to prevent such possible

assumption is more likely to occur in the case of the sale of fractional undivided interests than it is in other types of securities. The result of this exclusion is that investors are denied this obviously relevant information.

Until recently Rule 314 of Regulation B provided that the Regulation B exemption was not available to an offering (other than offerings of landowners' royalty interests) if the operating lessee or lessees would own unencumbered in their own names upon the completion of the offering less than 40 per cent of the working interest in the tract or less than 40 per cent of all the oil and gas or other hydrocarbons produced or to be produced from the tract. Operating lessee or lessees are defined by Rule 314 as the lessee or lessees of record actually engaged in the development and operation of the tract and all other owners of working interests who are regularly engaged in the business of exploring for, or producing oil or gas and who have consented in writing to the development and operation of the tract by such lessee of record.

This provision was designed to mitigate the possibility that the operating lessee (who ordinarily in the case of a public offering will be the promoter) would not complete the well or in the event the well is productive develop the field. However, the only real assurance an investor has that a well will be drilled—a tightly drawn escrow agreement, a drilling contract, and a provision that the operation will not be commenced until there is enough money on hand to assure its completion—was not and is not provided for by the Commission's regulations. While the 40 per cent requirement may have been some inducement to the promoter to drill the well and develop the field, it probably also had the overall effect of encouraging the promoter to set a higher price for the interests he sold to the public and to retain a larger interest in the venture that he might otherwise have retained.

The Commission recently modified Rule 314 and under the present rule there are no restrictions of this type with respect to offerings that do not exceed \$30,000, provided the smallest interest offered or sold is not offered or sold for less than \$300.^{80a} With respect to offerings under Regulation B in excess of \$30,000 or of undivided interests offered or sold for less than \$300, Rule 314 now requires that the operating lessee or lessees retain in any event a 20 per cent working interest and if the expense free royalties exceed 20 per cent a working interest equivalent percentage wise to the expense free interests.^{80b}

misuse of the offering sheets in the future, we have taken steps to eliminate the maximum offering price from the offering sheets." *Id.* at 510 note 19. This was accomplished by amending the appropriate schedules under Rule 330. See Securities Act Release No. 2925 (1943).

80a. Securities Act Release No. 3461 (December 12, 1952).

80b. *Ibid.*

ALTERNATIVE METHODS OF FINANCING OIL VENTURES COMPARED

The foregoing section briefly outlined the major provisions relating to financing pursuant to Regulation B. At the outset, however, the issuer of oil and gas securities must give serious consideration to the possible alternative methods of financing. In large part this decision will be influenced by factors not directly relating to the Securities Act such as the market for and saleability of various types of securities and the impact of the tax laws. Considerations of this nature, while important, are beyond the scope of this article. Accordingly, the following discussion is limited to the effect of the Securities Act on alternative methods of financing the development of oil and gas properties. The principal alternatives considered are (1) the sale of corporate securities, such as shares of stock, (2) the sale of leases under circumstances involving the sale of investment contracts and (3) the sale of fractional undivided interests in oil and gas rights.

In the event the offeror transfers the oil properties in question to a corporation and finances the development of the properties by the sale of corporate securities such as shares of common stock, in the absence of an appropriate exemption, the offering must either be registered or qualified under the "conditional exemption" provided by Regulation A.⁸¹ The offeror has the same alternatives in the event he proposes to finance the development of the properties by the sale of specifically described leasehold interests under circumstances involving the sale of investment contracts. Ordinarily such offering can be qualified under Regulation A if the aggregate offering price of the securities of the issuer does not exceed \$300,000 in any period of twelve months.⁸²

Regulation A has many advantages from the standpoint of the offeror over any other type of conditional exemption from registration or from full registration. The principal requirement of Regulation A is the filing of a letter of notification in the appropriate regional office of the Commission.⁸³ The required letter of notification is a very simple document consisting of only nine items relating principally to underwriting discounts and commissions and the purposes for which the proceeds from the offering are to be used.⁸⁴ The letter of notification becomes effective five days

81. 17 Code Fed. Reg. 230.220-224. Subsequent citations to Regulation A are by rule numbers as they appear in the Regulation. The rule numbers can be converted to the appropriate section number of Title 17 of the Code of Federal regulations by adding 230 decimal point. Thus Rule 220 is Section 230.220 of Title 17 of the Code of Federal Regulations.

82. Rule 220. Actually in certain situations more than \$300,000 can be sold in a twelve month period under Regulation A in that in computing the availability of the exemption only securities sold under an offering commenced within one year prior to the commencement of the proposed offering are included. Hence, if there is an unsold portion of an offering begun sometime prior to one year before the commencement of the proposed offering, the unsold portion of that offering may be sold in addition to the \$300,000 offered under the current offering. Rule 220(a).

83. Rule 222.

84. *Ibid.*

(excluding Sundays and holidays) after filing⁸⁵ compared with eight days in the case of an offering sheet filed under Regulation B⁸⁶ and twenty days in case of the filing of a registration statement.⁸⁷ The letter of notification is filed in the regional office of the region in which the offeror has its principal place of business⁸⁸ in contrast to the offering sheet required by Regulation B and registration statements which have to be filed in the Washington office of the Commission.

Under Regulation A,⁸⁹ in contrast to Regulation B and full registration the offeror is not required to use any sales material or a prospectus and in the event sales material is used it has to contain only certain minimal information relating to the offering price, underwriting discounts and commissions, and the purposes for which the proceeds of the offering are to be used.⁹⁰ The Commission presently has under consideration a proposal to revise Regulation A and the more stringent requirements of proposed Regulation A are discussed below.⁹¹

Regulation A is not available to an offering of fractional undivided interests in oil and gas rights. The offering of such interests is specifically excluded from qualifying under the provisions of Regulation A by Rule 221 (c). In the absence of an available exemption or "exception" such interests must be offered in accordance with the conditions of Regulation B or they must be registered. Form S-10 is the appropriate form for registration of fractional undivided interests of oil and gas rights and sets forth in detail the information required in the registration statement and in the prospectus relating to a registered offering of such interests.⁹²

As we note subsequently, offerings of fractional undivided interests have seldom been made pursuant to full registration.⁹³ However, there are situations in which the registration route may be the only route available and others in which it is the preferable one. Accordingly, a comparison of the pertinent requirements of Regulation B with the requirements of registration under S-10 is of more than academic interest.

A registered offering is not limited in amount whereas an offering

85. *Ibid.*

86. Rule 342.

87. 15 U.S.C.A. 77h (a).

88. Rule 222 (b). This is a matter of considerable importance to a small organization that cannot afford to send a representative to Washington inasmuch as differences of opinion between the offeror and the Commission's staff can usually be better handled by a conference than by correspondence.

89. Rule 223.

90. *Ibid.*

91. The proposed revision to Regulation A is set forth in Securities Act Release No. 3450 (August 15, 1952) and is discussed at *infra* pages 76-77.

92. Form S-10 is also the appropriate form for the registration of offerings of leaseholds under circumstances involving the sale of investment contracts. However, if the offering of investment contracts does not exceed \$500,000 it can be qualified under Regulation A.

93. *Infra* page 75. The author once made a hurried search of the index to registered offerings of the Denver office of the Commission which is reasonably complete and failed to find reference to a single S-10 registration statement or prospectus.

made pursuant to Regulation B is limited to \$100,000.⁹⁴ The information in a Regulation B offering sheet must be as of 110 days prior to its use or the completion of the sale;⁹⁵ whereas the information called for in S-10 must be furnished as of a specified date within 31 days prior to the filing of the registration statement⁹⁶ but having met this requirement is not subject to any further limitation in this respect other than the general fraud provisions. An offering relating to non-contiguous tracts can be made under Regulation B only with respect to producing landowner's royalties and then only under restricted circumstances,⁹⁷ whereas there are no similar limitations with respect to registered offerings. The operators under a Regulation B offering must, except with respect to offerings not in excess of \$30,000, own unencumbered at the conclusion of the offering at least a 20 per cent working interest;⁹⁸ there is no similar restriction with respect to a registered offering.

The offering sheet under Regulation B must be prepared in question and answer form and follow a prescribed order, whereas the prospectus required in registration can be prepared in narrative form and does not have to be arranged in a prescribed manner. Under Regulation B only an offering sheet has to be filed and used⁹⁹ whereas under registration both a prospectus and registration statement have to be filed.¹⁰⁰ However, the prospectus can be used as the registration statement by cross-indexing it to the items called for by the registration statement and by supplementing it with the additional information required in the registration statement.¹⁰¹

A so-called "tombstone" prospectus which states no more than from whom a prospectus (or offering sheet) may be obtained and in addition does no more than identify the security, state the price thereof, and state by whom orders will be executed can be used in connection with both registered offerings¹⁰² and offerings made pursuant to Regulation B.¹⁰³ "Tombstones" are used primarily in advertising the offering in newspapers and periodicals and without the special provisions relating to this type of advertisement it would be necessary to publish the entire prospectus or offering sheet as part of the advertisement. The Commission has recently adopted Rule 132¹⁰⁴ which permits offerors in connection with registered offerings to use as a screening device during the pre-effective

94. Rule 310.

95. Rule 330(c).

96. No. 8 of General Instructions to Form S-10.

97. Oil and gas interests involving non-contiguous tracts may be included only upon condition that: (1) All interests are producing landowner's royalty interests; (2) all tracts involved are currently producing and are located wholly within the limits of the same pool; (3) all tracts are being currently operated by the same operator and (4) the purchaser is entitled to the same fractional portion of the oil and gas produced from each of the tracts involved. Rule 334.

98. Rule 314 as amended. Securities Act Release No. 3461 (December 12, 1952).

99. Rule 320.

100. 15 U.S.C.A. 77e.

101. 17 Code of Fed. Reg. 230.404 (1949 ed.).

102. 15 U.S.C.A. 77b(10).

103. Rule 320(b).

104. Securities Act Release No. 3453 (October 1, 1952).

period of the registration statement and after it has become effective an "identifying statement" setting forth a brief synopsis of some of the pertinent information relating to the offering. Inasmuch as Rule 132 is phrased in terms of qualifying the definition of an "offer to sell" under Section 5 of the Securities Act it would be broad enough to cover Regulation B offerings except for the fact that it specifically provides that the "identifying statement" cannot be used "until ten days after it has been filed as part of a registration statement" [emphasis supplied] unless the Commission notifies the issuer that it may be used earlier and the required information is phrased in terms that assume a registered offering.

A registration statement does not become effective until twenty days after it is filed,¹⁰⁵ whereas the offering sheet becomes effective eight days after filed.¹⁰⁶ The issuer of a registered offering is absolutely liable for any false or misleading statement in the registration statement as is any other signatory who cannot maintain the burden of proof with respect to certain defenses set forth in the statute regardless of whether or not they participated in the sale.¹⁰⁷ As we note subsequently,¹⁰⁸ the issuer of an offering made under Regulation B is probably subject to a liability for false or misleading statements comparable to the liability of an issuer of a registered security. No fee is presently charged in connection with Regulation B offerings,¹⁰⁹ whereas under registration a small fee is charged.¹¹⁰ The fee for a registered offering, the aggregate offering price of which does not exceed \$250,000, is \$25.00.¹¹¹

The information called for in S-10 and in the various schedules under Regulation B is very similar although the requirements of S-10 are to a limited extent more stringent and detailed. The following information is basic to S-10 and the appropriate Regulation B schedules.¹¹²

A. Non-geological information:

1. Description of the interest being offered in terms of the smallest fraction being offered.
2. Whether or not the purchaser participates in production from any part of the tract or only from a particular well.
3. Extent to which the interests are chargeable with or subject to the cost of development, operation, production or maintenance of the tract or any wells on the tract.
4. Whether purchaser will participate in all future wells located on the tract.

105. 15 U.S.C.A. 77h (a).

106. Rule 342.

107. 15 U.S.C.A. 77k.

108. *Infra* pages 77-82.

109. The Commission has under consideration a proposal to charge a fee of \$25.00 for each Regulation B filing. See Securities Act Release No. 3433 (January 31, 1952).

110. The fee charged in connection with the filing of a registration statement is one-hundredth of one per cent of the maximum aggregate price at which the securities are proposed to be offered but in no event less than \$25.00. 17 Code of Fed. Reg. 230.457 (a).

111. *Ibid.*

112. The following discussion is based on a comparison of Form S-10 with the appropriate Regulation B schedules.

5. All outstanding leases pertaining to the tract and their main features relating to royalties, rentals, drilling requirements, etc.
6. By whom the proposed well will be drilled, estimated cost of drilling the well, and assurance, if any, that the well will be drilled.
7. Details of any operating or management agreement.
8. Manner in which payments from production will be made.
9. Applicable provisions, if any, relating to unitization, pro-rationing, and spacing restrictions or practices.
10. Information relating to whether the offeror's title is merchantable and as to whether the interest being sold are subject to any liens or encumbrances.

B. Geological information:

1. Non-producing tracts:
 - a. Horizons with oil and gas potentialities represented to be underlying the tract.
 - b. Producing wells in the area supporting the representation relating to possible producing horizons with completion and production data relating thereto.
 - c. Location of the tract with respect to the nearest well, pool, and field.
 - d. Location of tract with respect to nearest oil or gas pipeline and other transportation facilities.
 - e. Data relating to dry holes and abandoned wells affecting the tract in question.
2. Producing tracts:
 - a. Number of and location of producing wells.
 - b. Complete production history of each well in summary form.
 - c. Monthly production record (for preceding twelve months under Regulation B and from date of initial production under S-10) for each well.

A geological report is not required either in connection with registration under S-10 or the filing of an offering sheet under Regulation B although a geological report can be used if the offeror desires. In connection with producing interests there is no requirement under the appropriate Regulation B offering sheet for the filing of an estimate of the total barrels of oil recoverable from the tract although the offeror can include such an estimate. Under S-10, on the other hand, the registration statement and prospectus relating to producing interests must contain an estimate of the total barrels of oil recoverable from the tract and the number of barrels allocable to the smallest interest being registered.

A Regulation B offering sheet must incorporate two exhibits, one of which is a plat of the tract involved and the surrounding area to a distance of at least one-fourth of a mile from all sides showing lease boundaries, producing wells, dry holes, and the names of all farms and operators. The other required exhibit is a copy of the proposed instrument of conveyance. S-10 requires a similar plat in both the registration statement and the prospectus, and a number of other exhibits including all contracts

and leases, a title opinion,¹¹³ and a specimen conveyance are required in the registration statement but not in the prospectus.

A registrant under S-10 must include the following additional information in both the registration statement and prospectus none of which is specifically required by a Regulation B offering sheet.

1. Information relating to the cost to the registrant of his interest in the tract.

2. Offering price, underwriting discounts and commissions, other distribution expenses, and manner in which proceeds will be used.

3. Sales to special parties at prices varying from the offering price.

4. Material litigation affecting the interests in question and other miscellaneous information.

5. If registrant is other than a natural person information relating to the type of organization, officers and directors, business experience of principal executive officers, and the principal holders of equity securities. (Some of this information is required only in the registration statement).

Some of the information specifically required by form S-10 and not specifically required by Regulation B offering sheets is nonetheless furnished in connection with Regulation B offerings as a result of administrative suggestion. All Regulation B offering sheets require the inclusion of "any other material fact relating to or affecting the interests . . . offered."¹¹⁴ The Oil and Gas Unit as an administrative practice suggests to parties filing Regulation B offering sheets that they disclose in response to this item information relating to the cost to the promoter of the interest retained by him. Material litigation relating to the interests in question also must be disclosed in response to this item.

To the extent that oil and gas properties are developed by public financing most such financing is done pursuant to the provisions of Regulation A. In the fiscal year 1951 there were 141 letters of notification filed under Regulation A relating to companies engaged in some phase of the oil and gas business.¹¹⁵ In the same fiscal year there were 96 Regulation B offering sheets filed.¹¹⁶ To date there have been very few registered offerings made of fractional undivided interests.¹¹⁷ In fiscal year 1952 there were 93 Regulation B offering sheets filed of which number, 60 were filed by a total of seven individuals or corporations.¹¹⁸ The 93 offering sheets included 48 relating to non-producing landowner's royalties, 16

113. Under Regulation B the offeror must furnish a prospective purchaser with evidence satisfactory to him of the validity of the title which he is to receive and upon which the value of his interest depends. Rule 320(d).

114. Item 37 of Schedule D. All of the other Regulation B offering sheet schedules have a similar item.

115. 17 SEC ANN. REP. 11 (1951).

116. *Ibid.*

117. LOSS, SECURITIES REGULATION 389 (1951).

118. The statistics for fiscal 1952 are based on a compilation made by the author from fiscal 1952 Securities Act Releases.

relating to producing landowner's royalties, one relating to producing working interests, one relating to non-producing overriding royalties, 25 relating to non-producing working interests, and 2 relating to non-producing participating interests. In all probability only the 25 relating to non-producing working interests and the 2 relating to non-producing participating interests involved financing actual oil and/or gas developments. The author does not have available statistical information relating to the number of offering sheets filed in fiscal 1952 that became effective; however, it is very likely that substantially all of them did inasmuch as the expense and time involved in preparation makes it very unlikely that the offeror will not follow through with proper amendments when deficiencies are noted.

The predilection for the use of Regulation A in financing the development of oil and gas properties is readily understandable. Securities dealers by and large prefer to deal in corporate securities as the market for such securities is considerably more liquid than the market for fractional undivided interests in oil and gas rights. Further, in view of the fact that Regulation B is so much more stringent than Regulation A, it is remarkable that Regulation B is utilized at all for financing the development of oil and gas properties. All the offeror has to do to avail himself of Regulation A is to organize a corporation, transfer the oil and gas lease in question to the corporation, and finance the proposed development through an offering of corporate stock.

PROPOSED REGULATION A** AND OIL AND GAS FINANCING

The Securities and Exchange Commission now has under consideration a proposed revision to Regulation A¹¹⁹ which in view of the complete inadequacy from the standpoint of protecting investors of the present Regulation is almost certain to be adopted in some form.¹²⁰ If adopted, the new Regulation A will, to a considerable extent, eliminate the relative ease of complying with the different SEC regulations as a factor in determining the method of financing adopted.

The new Regulation A as proposed will require an issuer to use an offering circular in the sale of securities made pursuant to the regula-

** After this article went to the printers the Commission announced (on March 6, 1953) the adoption of a revised Regulation A. Securities Act Release No. 3466, 18 FED. REG. 1434. The revision, however, differs in several material respects from the proposed revision (Securities Act Release No. 3450) discussed in this article. Under revised Regulation A it will be necessary to use an offering circular but there is no requirement that the circular include any geological information. Oil and gas issuers in the promotional, exploratory or development stage, will merely have to "briefly describe the properties to be operated or developed by the issuer." Rule 219, 18 FED. REG. 1435-36. The requirements of Regulation A as revised are considerably less stringent than those of Regulation B and this factor will, therefore, continue to be relevant in determining the method of financing adopted.

119. Securities Act Release No. 3450 (August 15, 1952).

120. The Commission, however, appears to be dragging its feet with respect to this matter. The proposed revision was released on August 15, 1952, with an invitation to submit comments on or before September 15, 1952. However, to date (February 13, 1953) the Commission has not adopted the proposed revision.

tion.¹²¹ The offering circular will have to disclose the offering price, underwriting commissions and discounts, the purposes for which the proceeds from the offering will be used, and the details relating to material transactions with directors, officers, and promoters of the issuer occurring within two years preceding the filing of the offering circular.¹²² In addition, with respect to issuers engaged in the oil and gas industry the offering circular will have to describe the properties in term of location, the issuer's interest in the property and the development which has occurred to date on or near the properties held.¹²³ With respect to producing properties information must be furnished as to the production history of the wells on the tract in question reduced to terms of net production of oil and gas to the issuers interests in each of the wells.¹²⁴ In connection with proven properties an estimate of the future reserves reduced to the issuer's interest in the tract in question must be set forth.¹²⁵ No geological report is required but if statements concerning geology or engineering are made the offeror must furnish for the information of the Commission copies of the pertinent reports and other supporting data upon which such statements are based.¹²⁶

The information that will be required if the proposed revision of Regulation A is adopted is generally less specific and less detailed than the information presently required under Regulation B or S-10. However, the requirements relating to geological data are so general that it will not be surprising to find the Oil and Gas Unit insisting that offerors furnish information comparable to that presently required under Regulation B. In one particular proposed Regulation A requires information not now required under Regulation B in that the offering circular required by proposed Regulation A must, if it relates to a proven oil or gas property, disclose the estimated future reserve, whereas under Regulation B the furnishing of an estimate of this nature is optional.

LIABILITY IN CONNECTION WITH OIL AND GAS OFFERINGS

Liability must be considered from two aspects: liability incurred for failure to comply with the registration requirements of the Securities Act and liability incurred for false or misleading statements¹²⁷ made in the registration statement (or offering sheet) and in the sale of the security. As to the registration requirements, the Securities Act in addition to im-

121. Proposed Rule 224. Securities Act Release No. 3450 (August 15, 1952).

122. *Ibid.*

123. Supplemental instructions to proposed Rule 224. *Ibid.*

124. *Ibid.*

125. *Ibid.*

126. *Ibid.*

127. The terminology "misleading statements" will be used on occasion as a short hand method of stating what is spelt out in more detail in the various fraud provisions of the Securities Act and the Exchange Act. Sections 11 (a), 12 (2), and 17 (a) (2) of the Securities Act and Rules X-10B-5 and X-15C1-2 under the Exchange Act all contain a provision to the effect that it is unlawful to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading.

posing criminal sanctions for non-compliance¹²⁸ gives the purchaser of unregistered securities what is basically a rescission action subject to a one year statute of limitations for any securities sold to him in violation of the registration provisions of the Act.¹²⁹ While it is difficult to find an official pronouncement to that effect, the Commission has always insisted on an administrative level that an issuer cannot divorce himself from responsibility for compliance with the registration provisions of the Act even if the issuer sells the offering on a firm underwriting basis to the underwriter.¹³⁰ However, this construction would have no effect on the civil liability of the issuer for non-compliance if he did not in any way participate in the sale to the investor inasmuch as the civil liability provision in effect limits liability for the sale of securities sold in violation of the registration provisions to persons who sell the security.¹³¹

A registration statement can be filed only by the issuer and the issuer is a necessary signatory to the registration statement.¹³² An issuer is absolutely liable under Section 11 of the Securities Act to the purchaser of a registered security for any false or misleading statement contained in the registration statement unless the issuer can establish that the purchaser knew at the time of the purchase that the statement was false or misleading.¹³³ Section 11 (a) enumerates a number of others, including directors and officers of the issuer, and accountants and engineers who prepare reports used in the registration statement, who are liable to any purchaser for false or misleading statements in the registration statement.¹³⁴ A number of enumerated defenses are available to all parties other than an

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128. Section 24 of the Securities Act provides that any person who willfully violates any provision of the Act shall upon conviction be fined not more than \$5,000 or imprisoned not more than five years, or both. 15 U.S.C.A. 77x.
129. 15 U.S.C.A. 77i, 77m. The civil remedy actually goes beyond rescission for it provides that if the purchaser has sold the security sold him in violation of the registration provisions he can recover damages. These provisions permit a purchaser of a security sold in violation of the registration provisions to take a free ride for a year; if a dry hole is drilled he can recover the purchase price from the vendor provided he institutes his action within one year.
130. Professor Loss considers this problem in a different context—the status of a person in a control relationship selling his stock through an underwriter. LOSS, SECURITIES REGULATION 393 (1951). If the issuer affirmatively participates in the sale, for example, by discussing the likelihood of success with prospective purchasers, he is, of course, responsible on “aider and abetter” notions.
131. 15 U.S.C.A. 77i. The Commission’s position is that at least the persons who sell the security, aid and abet in the sale of the security, or control the seller of the security are liable for wrongful sales. Brief for the Securities and Exchange Commission, as *Amicus Curiae*, 71-76, *Blackwell v. Bentsen* (U.S. District Court for Southern District of Texas, Brownsville Division, Civil Action No. 728, March 31, 1952) Query whether each seller can in turn sue (or join) the party from whom he purchased so as to ultimately hold the “issuer” liable. See LOSS, SECURITIES REGULATION 991 (1951). Where the seller is the agent of the “issuer,” the issuer is, of course, liable to the vendee. If, however, the issuer has disposed of the offering to an underwriter on a firm underwriting basis it is extremely doubtful whether the underwriter could join the issuer so as to make the issuer liable. The underwriter’s assertion of a cause of action against the issuer would necessarily be based on his immediate transaction with the issuer and does not violate the registration provisions because the Act specifically defines a sales to exclude “preliminary negotiations or agreements between an issuer and any underwriter.” 15 U.S.C.A. 77b(3).
132. 15 U.S.C.A. 77f.
133. 15 U.S.C.A. 77k.
134. 15 U.S.C.A. 77k(a).

issuer subjected to liability under Section 11 for false and misleading statements in the registration statement, but they must sustain the burden of proof with respect to such defenses.¹³⁵

As we have already noted, offerings of fractional undivided interests are usually made under Regulation B rather than by the filing of a registration statement. With respect to offerings made pursuant to Regulation B, Section 11 of the Securities Act has no application inasmuch as that section is specifically limited to false or misleading statements in a registration statement. In order to determine whether a comparable liability is imposed for false or misleading statements that appear in Regulation B offering sheets it is first necessary to consider who must file or have filed on his behalf an offering sheet.

An "offeror" is defined by Regulation B to include "any issuer of, underwriter of, or dealer in" the fractional undivided interests in question.¹³⁶ An offeror of such interests is excused from liability under the registration provisions of the Securities Act only if the offeror files with the Commission or has filed on his behalf with the Commission an offering sheet meeting the requirements of the Regulation.¹³⁷ Offering sheets can be filed by some other person for and on behalf of an offeror only if the offeror on behalf of whom the offering sheet is filed is registered with the Commission as a dealer under Section 15 of the Securities Exchange Act and has signed an authorization.¹³⁸ Any other offeror must file his own offering sheet in order to avail himself of the exemption provided by Regulation B. Subject to qualification, as noted immediately below, anyone who is an issuer or underwriter with respect to the particular offering or is a dealer¹³⁹ with respect to the securities offered must file an offering sheet, although a registered dealer may have an offering sheet filed on his behalf by one of the other offerors.

An offeror who fails to file an offering sheet or to have one filed on his behalf is subjected to the same liability as would have been imposed upon him if the securities offered for sale, or sold, were unregistered.¹⁴⁰ If there would have been no liability with respect to this particular offeror in the event the securities had been sold in non-compliance with the registration provisions, there is no necessity for the particular offeror to file an offering sheet. Presumably the "liability" referred to includes both the civil and criminal liability imposed for non-compliance with the registration provisions; if it referred only to the civil liability, only those actually selling the security would have to file an offering sheet which in the case of a firm underwriting would probably exclude the issuer.¹⁴¹

135. 15 U.S.C.A. 77k (b).

136. Rule 300 (g).

137. Rule 320 (a).

138. Rule 324.

139. As to the extent that a dealer who is not an underwriter with respect to the particular offering must use and have on file an offering sheet see discussion in note 75.

140. Rule 320 (a).

141. See note 131 and related text.

Assuming that the "liability" referred to includes criminal liability, whether an offeror has to file an offering sheet will depend in part on who is criminally liable for the failure to comply with the registration requirements of the Act. Accepting the administrative construction previously noted¹⁴² that an issuer cannot avoid criminal responsibility for non-compliance with the registration provisions, it is apparent that all offerors including issuers, underwriters, and dealers must file an offering sheet although in the case of registered dealers the offering sheet may be filed by someone else on their behalf.

The question of the liability of "offerors" under Regulation B for false or misleading statements in the offering sheet has two components: (1) to whom, if anyone, is a particular offeror liable and (2) what criterion is to be applied in determining a particular offeror's liability. The answer to these questions is determined in part by Rule 332 of Regulation B which although framed in terms of "representations" clearly relates to the liability problem. To complicate matters paragraphs (a) and (b) of Rule 332 appear to be inconsistent in defining the ambit of the offeror's liability and the criterion to be applied in determining his liability although they can probably be reconciled on the basis that they apply to different "offerors."

Rule 332(a) provides that all statements contained in divisions I and II of the offering sheet and the attached exhibits shall constitute continuing representations *by the person filing the offering sheet to any person* who in reliance on a copy of the offering sheet purchases the described interest that the statements therein are substantially correct and are not misleading because of a material omission. Divisions I and II are the entire offering sheet except with respect to producing interests which may or may not include Division III relating to an estimate of recoverable reserves. Rule 332(a) is qualified by paragraph (c) of the same rule which provides that any estimate of recoverable oil or gas or a geological report made by someone other than the person filing the offering sheet shall not be regarded as a representation by the person filing the offering sheet provided the offeror had reason to believe and did believe that the author of the estimate or report had the necessary qualifications and integrity to prepare the estimate or report.

Rule 332(b) in effect provides that all statements in the offering sheet shall constitute continuing representations by any offeror to any person to whom he delivers or causes to be delivered a copy of the offering sheet and who in reliance on the offering sheet purchases interests *from him or through him* that he has reasonable grounds to believe and does believe that the statements are substantially correct and not misleading because of material omissions. Under Rule 332(b) the offeror also represents that the offering sheet is a true copy of the offering sheet filed with the Securities and Exchange Commission on his behalf.

142. See note 130 and related text.

The apparent purpose of Rule 332 (a) as qualified by Rule 332 (c) is to impose an absolute liability on anyone filing the offering sheet for the benefit of persons who purchase in reliance on the offering sheet regardless of the lack of privity of contract for any false or misleading statement set forth in the offering sheet subject to the qualification that no liability is to be imposed on the offeror filing the offering sheet in the event that he has in good faith relied on a report of an expert. Under Rule 332 (b), on the other hand, the offeror is liable only to the parties who purchased the security from or through him and the standard for determining his liability is whether he had a reasonable basis for believing the statements in the offering sheet to be correct and not misleading. The apparent reconciliation of these two provisions is to be found in the fact that the representations referred to in Rule 332 (a) apply to persons who file an offering sheet and those in Rule 332 (b) relate to persons on behalf of whom such offering sheets are filed, which, in view of the requirements previously discussed with respect to the filing of offering sheets, means that Rule 332 (a) applies to all offerors other than registered dealers and that Rule 332 (b) applies only to registered dealers who have one of the other offerors file an offering sheet on their behalf.

Rule 332 does not in itself impose any liability and in fact the word "liability" or "unlawful" does not appear in the Rule. In view of this fact, how is the liability to be imposed? One possibility is that the "representations" made by the offeror as a result of Rule 332 are to be read in connection with the provisions of Section 12 (2) of the Securities Act which imposes a civil liability for false or misleading statements made in the sale of a security.¹⁴³ With respect to Rule 332 (b) the application of Section 12 (2) poses no problem inasmuch as 12 (2) already imposes on the seller substantially the same liability indicated by Rule 332 (b). However, with respect to reading Rule 332 (a) into Section 12 (2) a real problem is presented inasmuch as 12 (2) limits liability to the seller of the security whereas Rule 332 (a) attempts to impose liability on the offeror regardless of privity of contract between the offeror and the purchaser, and Rule 332 (a) attempts to impose an absolute liability whereas 12 (2) provides that no liability is to be imposed on anyone who shall sustain the burden of proof that he did not know and in the exercise of reasonable care could not have known of such untruth or omission.

Several other possibilities suggest themselves,¹⁴⁴ including an action of common law deceit on the theory that the representation the offeror makes as a result of Rule 332 (a) is made by him directly to the purchaser so that there is privity despite the fact that the offeror does not sell the security to the purchaser. Another possible theory is that the representation imposes a contractual liability on the offeror for breach of warranty

143. 15 U.S.C.A. 771 (2).

144. No effort will be made in this article to explore these possibilities in detail inasmuch as such an effort would take us far afield of the subject matter of this article.

even though the consideration moves from the purchaser to a third party. Still another possible theory is that the Regulation itself implies a remedy which the courts will provide as they have in the case of Rule X-10B-5 under the Exchange Act¹⁴⁵ although here the Rule unlike X-10B-5 does not specifically make the false representation unlawful.¹⁴⁶ Another alternative theory and perhaps the most plausible is that the purchaser can bring an action under Rule X-10B-5 which Rule makes unlawful false or misleading statements made in connection with the sale or purchase of a security.¹⁴⁷

DEALERS IN OIL AND GAS INTERESTS

In addition to the registration requirements of the Securities Act of 1933, which apply to each separate offering of securities, an individual engaged in the sale of oil and gas securities must also give consideration to the necessity of registering with the SEC as a broker or dealer under the provisions of Section 15 of the Securities Exchange Act of 1934.¹⁴⁸ This is a particularly important matter for anyone offering securities under Regulation B inasmuch as the exemption provided by Regulation B is not available to and does not relieve from liability any offeror who is in fact a "dealer" under the Exchange Act and who is not registered with the Commission as such.¹⁴⁹ If, therefore, an offeror of securities under Regulation B is a "dealer" under the Exchange Act, although doing only a nominal business as a dealer, his failure to register as a dealer could

145. 17 Code Fed. Reg. 240.10b-5 (1949 ed.). Rule X-10b-5 in addition to making it unlawful to defraud a purchaser of a security makes it unlawful to defraud a seller. Although the Rule does not give anyone a cause of action, a series of cases under the Rule have held that where a statutory enactment is designed to protect an interest of an individual, the courts will provide a civil remedy to protected parties even if the statute fails to do so. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). Cases in which the seller seeks to recover from his vendee generally involve situations in which corporate insiders attempt to buy up outstanding stock and either misrepresent material facts relating to the transaction or withhold information available only to them. Rule X-10b-5 and cases involving the rule are discussed in LOSS, SECURITIES REGULATION 827-844, 1047-1067 (1951).
146. Note in this regard the following language of the court in *Fischman v. Raytheon Mfg. Co.*, 188 F. 2d 783, 787 (2nd Cir. 1950): "Section 10(b) to be sure, does not explicitly authorize a civil remedy. Since, however, it does make 'unlawful' the conduct it describes, it creates such a remedy."
147. See Note 145. Note, however, that Regulation B in its present form was adopted on May 21, 1937 (Securities Act Release No. 1450), whereas Rule X-10b-5 was not adopted until May 22, 1942. 7 Fed. Reg. 3804 (1942). The Second Circuit Court of Appeals has held that the fact that an action may be available to a purchaser under one or more of the provisions of the Securities Act does not prevent him from bringing his action under Rule X-10b-5 of the Exchange Act. *Fischman v. Raytheon Mfg. Co.*, *supra* note 146. One commentator has suggested that because of the language used in Rule X-10b-5 making unlawful any false representation or misleading statement made "in connection with the purchase or sale of any security" that recovery under Rule X-10b-5 does not depend upon privity of contract. Comment, 59 Yale L.J. 1120, 1131 (1950). However, a federal district court recently held that privity of contract between the purchaser and the defendant is necessary under Rule X-10b-5. *Joseph v. Farnsworth Radio and Television Corporation*, 99 F. Supp. 701 (S.D. N.Y. 1951).
148. 48 Stat. 881 (1934) 15 U.S.C. 780. To change U.S.C.A. section citations to correspond to those of the original statute disregard the 78 and convert the letter to its numerical order in the alphabet. Thus 780 is section 15 of the original act since o is the fifteenth letter of the alphabet.
149. Rule 312 of Regulation B.

result in his incurring a staggering civil liability in connection with the offering, for the entire offering would be in violation of the registration provisions of the Securities Act despite the fact that he filed an offering sheet.¹⁵⁰ The availability of Regulation B, however, is not withdrawn from a person who is a "broker" under the Exchange Act and has failed to register as such.¹⁵¹

The Exchange Act provides that all brokers or dealers whose business is not exclusively intrastate¹⁵² and who sell securities other than exempted securities must register with the Commission.¹⁵³ A broker is defined by Section 3(a)(4) of the Exchange Act as any person other than a bank engaged in the business of effecting transactions in securities for the account of others.¹⁵⁴ Section 3(a)(5) of the Exchange Act provides that any person other than a bank regularly engaged in the business of buying and selling securities for his own account is a dealer.¹⁵⁵ Both of these provisions raise a question as to the volume and nature of the transactions necessary to constitute a "business." While no clear cut line can be drawn in this respect, it is clear that the mere fact that the purchase or sale of securities is not the individual's principal business is not controlling.¹⁵⁶

Commentators and courts,¹⁵⁷ on occasion, have regarded the Securities Act and the Exchange Act as providing one integral statutory scheme of regulation. There are, nonetheless, problems that arise as a result of the fact that they are two separate statutes. The Securities Act, for example, defines a security to include "fractional undivided interest in oil, gas or other mineral rights. . .,"¹⁵⁸ whereas the comparable provision of the Exchange Act defines a security to include "certificate of interest in or participation in . . . any oil, gas, or other mineral royalty or lease."¹⁵⁹ In view of the differences in statutory language and the failure of the Exchange Act to refer to "fractional undivided interests," there might be some basis for arguing that an oil and gas lease is a security under the Exchange Act. However, the Commission would undoubtedly be reluctant to subject the ordinary oil and gas lease broker to the registration requirements of the Exchange Act. In view of this fact and in view of the fact that both Acts define a security to include an "investment contract," it is probably safe to assume that with respect to oil and gas interests the definition of a "security" has the same meaning in both acts and that a

150. See note 129 and related text.

151. Rule 312 withdraws the availability of Regulation B only from unregistered dealers as defined by the Exchange Act.

152. 15 U.S.C.A. 78o(a).

153. 15 U.S.C.A. 78o(a).

154. 15 U.S.C.A. 78c(a)(4).

155. 15 U.S.C.A. 78c(a)(5).

156. *Burley & Co.*, Securities Exchange Act Release No. 4109 (1948).

157. See, for example, *Fischman v. Raytheon Mfg. Co.*, 188 F. 2d 783 (2nd Cir. 1950) and *LOSS, SECURITIES REGULATION* vi (1951).

158. 15 U.S.C.A. 77b(1).

159. 15 U.S.C.A. 78c(a)(10).

lease is a security with respect to both Acts only when sold under circumstances involving the sale of an investment contract.¹⁶⁰

Anyone engaged in the business of buying and selling fractional undivided interests in oil and gas rights is a dealer and must register as such with the Commission. Similarly, anyone engaged in the business of purchasing and selling oil and gas lease investments contracts, must register as a dealer. Anyone engaged in the business of buying or selling oil and gas securities for the account of another on an agency basis must register with the Commission as a broker.

As we already noted, under the Exchange Act one is a dealer only if he *buys and sells* a security. If, therefore, he buys oil and gas rights under circumstances not involving the purchase of a security and then sells interests in such rights which interests are securities he is not a dealer as he has sold securities but he has not purchased securities. An individual who confines his business to the purchase of entire leasehold interests and entire royalty interests, does not ordinarily purchase a security¹⁶¹ and, therefore, is not a dealer and does not have to register under the Exchange Act even if he creates and sells fractional undivided interests in the lease or royalty. He may, of course, be an issuer under the Securities Act with respect to the sale of such interests and each such offering may have to comply with the registration requirements of the Securities Act.¹⁶²

Another problem arising from the fact that two separate statutes impose a single regulatory scheme relates to the fact that "exempted securities" under one Act are not necessarily "exempted securities" under the other. A person may, therefore, be a broker or dealer under the Exchange Act despite the fact that his business is confined to securities exempted or excepted from registration under the Securities Act. An individual who confines his business to securities exempted from registration under the Securities Act because no public offering is involved¹⁶³ or excepted from registration under the provisions of Rule 322 of Regulation B¹⁶⁴ would, nonetheless, have to register as a broker or dealer under the Exchange Act inasmuch as such securities are not "exempted securities" under the latter Act.¹⁶⁵ On the other hand, a dealer confining his business to offerings exempt under the "intrastate" exemption of the Securities Act¹⁶⁶ would ordinarily be exempt from registration under the Exchange Act because of the exclusion from registration of brokers or dealers "whose business is exclusively intra-state."¹⁶⁷

160. See pages 53-56 *supra* for discussion of the circumstances, under which the sale of an oil and gas lease involves the sale of a security.

161. *Supra* pages 53-56.

162. *Supra* pages 58-60.

163. *Supra* pages 61-63.

164. *Supra* pages 63-65.

165. 15 U.S.C.A. 78c(a) (12).

166. *Supra* pages 60-61.

167. 15 U.S.C.A. 78o(a).

A registered broker or dealer must maintain certain prescribed books and records and must file annual financial reports with the Commission.¹⁶⁸ He must at or before the completion of each transaction furnish his customer with a written confirmation setting forth certain specified information.¹⁶⁹ He is subject to a number of other Commission regulations which relate to the manner in which his business is conducted.¹⁷⁰ Registered brokers or dealers are inspected at periodic intervals by one of the Commission's trading inspectors for the purpose of determining whether they are in compliance with the applicable statutory and regulatory provisions.

The Commission has the power to deny and to revoke broker-dealer registrations for specified statutory reasons including the violation of any provision of the Securities Act or the Exchange Act and the rules and regulations adopted pursuant thereto.¹⁷¹ In exercising this power the Commission has interpreted the anti-fraud provisions of the Acts to preclude a broker-dealer when acting as an agent or a fiduciary from taking secret profits¹⁷² and when acting as a principal from changing prices not reasonably related to the market price.¹⁷³ These doctrines represent no departure from the common law insofar as they relate to the duty of fiduciaries not to take secret profits¹⁷⁴ although the Commission's determination of when a fiduciary relationship exists is broader than commonly applied in the past. In the latter regard the Commission has held that the cultivation of the customers' trust and confidence by a securities dealer and the customary reliance thereon by his customers imposes the duties of a fiduciary on the dealer despite the fact the dealer has purported to act as a principal.¹⁷⁵

The doctrine that a broker-dealer when acting as a principal must charge prices reasonably related to the market price is, however, a novel one. The Commission has read into the relationship between the dealer and his customer an implied representation to deal with the customer

168. 15 U.S.C.A. 78q and rules thereunder.

169. Rule X-15C1-4. 17 Code Fed. Reg. 240.15c1-4. (1949 ed.).

170. See particularly Rules X-15C1-1 through X-15C3-1. 17 Code Fed. Reg. 240.15c1-1 through 240.15c3-1 (1949 ed.).

171. 15 U.S.C.A. 78o (b).

172. Arleen W. Hughes, Securities Exchange Act Release No. 4048 (1948) *aff'd in Hughes v. S.E.C.*, 174 F. 2d 969 (D.C. Cir. 1949); Oxford Company, Inc., Securities Exchange Release No. 3769 (1946); Trost & Co., 12 S.E.C. 531 (1942); William J. Stelmack Corp., 11 S.E.C. 442 (1942); Allender Co., Inc., 9 S.E.C. 1043 (1941). For excellent discussions see LOSS, SECURITIES REGULATION 862-866 (1951); Lesh, *Federal Regulation of Over-the-Counter Brokers and Dealers in Securities*, 59 Harv. L. Rev. 1237 (1946).

173. Charles Hughes & Co., Inc., 13 S.E.C. 676 *aff'd in Hughes & Co. v. S.E.C.*, 139 F. 2d 434 (2d Cir. 1943); W. K. Archer & Co., 11 S.E.C. 635 (1942) *aff'd in Archer v. S.E.C.*, 133 F. 2d 795 (8th Cir. 1943); E. H. Rollins & Sons, 18 S.E.C. 347 (1945); Duker & Duker, 6 S.E.C. (1939); LOSS, SECURITIES REGULATION 850-862 (1951); Lesh, *supra* note 172 *passim*.

174. Lesh, *supra* note 172 at 1259-1262.

175. Arleen W. Hughes, Securities Exchange Act Release No. 4048 (1948) *aff'd in Hughes v. S.E.C.*, 174 F. 2d 969 (D.C. Cir. 1949); Norris and Hirshberg, Securities Act Release No. 3776 (1946) *aff'd in Norris and Hirshberg v. S.E.C.*, 177 F. 2d 228 (D.C. Cir. 1949); Behel, Johnson & Co., Securities Exchange Act Release No. 3967 (1947); William J. Stelmack Corp., 11 S.E.C. 601 (1942); Allender Co., Inc., 9 S.E.C. 1043 (1941); LOSS, SECURITIES REGULATION 862-869 (1951).

fairly which in turn involves an implied representation that the price charged by the dealer is reasonably related to the prevailing market price.¹⁷⁶ This doctrine was applied in the *Leeby* case¹⁷⁷ to oil royalty dealers despite the protest of Mr. Leeby that the markups regarded by the Commission as excessive are "indulged in by practically every broker, dealer, salesman, or securities representative of any character in the country dealing or investing in oil royalty interests."¹⁷⁸

The Commission has not adopted any hard and fast rules as to what is an excessive markup.¹⁷⁹ In one oil and gas royalty dealer case markups ranging from 30 per cent to 150 per cent were regarded as "grossly excessive"¹⁸⁰ and in another markups ranging as high as 89.2 per cent were regarded as excessive.¹⁸¹ The markup is computed on the basis of the relationship of the price charged to the current wholesale price¹⁸² and whether or not excessive depends on the individual sale rather than the average markup for all sales.¹⁸³ In determining the current wholesale price of oil royalties the Commission has regarded as "a good prima facie indication" the wholesale prices actually paid by the dealer contemporaneously with his retail sales.¹⁸⁴

The foregoing principles must be considered in the context in which they were developed. The proceedings before the Commission in the principal oil royalty dealer case¹⁸⁵ in which these principles were applied involved a retail dealer who could and did obtain the royalties in question with little difficulty from wholesale dealers. The dealer after procuring the order from his customers had to do little more than telephone a wholesale dealer to obtain the royalty and the transactions were essentially riskless.¹⁸⁶ However, in many instances dealers obtain the royalties from landowners and others only after considerable investment of money, time, and effort. The determination of the market price and excessive markups in the latter situation is obviously a more complex matter; particularly, if any substantial period of time elapses between the acquisition of the royalties by the dealer and the sale to the customers. The Commission intimated in the *Leeby* case that if, as Mr. Leeby, contended excessive markups are widespread in the royalty business that appropriate steps would be taken to rectify this situation.¹⁸⁷ There have, however, been few broker-dealer revocation proceedings involving oil royalty dealers

176. See cases cited in note 173.

177. *Lawrence R. Leeby & Co.*, 13 S.E.C. 499 (1943).

178. *Id.* at 506.

179. *Charles Hughes & Co. Inc.*, 13 S.E.C. 676 (1946); *Duker v. Duker*, 6 S.E.C. 396 (1939).

180. *Lawrence R. Leeby & Co.*, 13 S.E.C. 499 (1943).

181. *Patrick A. Trapp*, 15 S.E.C. 349 (1944).

182. *Lawrence R. Leeby & Co.*, 13 S.E.C. 499, 506 (1943).

183. *Id.* at 506.

184. *Id.* at 506.

185. *Ibid.*

186. The Commission did not make an express finding to this effect but that this was true is apparent from the recital of the facts. *Id.* at 508.

187. *Id.* at 506.

since the *Leeby* case and this may in part be due to the problems involved in determining the market price of oil and gas royalties.

CONCLUSION

In focusing our attention on shortcomings in certain areas of the securities laws as administered by the SEC, we should not lose sight of the fact that where the securities laws apply they generally result in making available to investors in oil and gas securities the basic information necessary to make informed investment decisions.¹⁸⁸ When and if the Commission adopts the proposed revision to Regulation A, one of the principal means of avoiding the disclosure requirements will have been eliminated.¹⁸⁹ However, much of the geological information presently required in Regulation B offering sheets and Form S-10 registration and which will be required under Regulation A if the proposed revision is adopted, is of such a nature that the investor must make his own appraisal of its significance, a task that is frequently beyond his competence. A report prepared by a petroleum geologist setting forth his qualifications and his conclusions would be considerably more useful to the average investor.¹⁹⁰

The sale of fractional undivided interests is seldom made pursuant to full registration and Regulation B which provides a conditional exemption from registration for the sale of fractional undivided interests is used only to a limited extent and by a relatively few people. In fiscal 1951 the sales made pursuant to Regulation B did not exceed \$1,127,226.¹⁹¹ While there are no reliable statistics, the amount of financing accomplished through the sale of fractional undivided interests of oil and gas rights probably is considerably in excess of this amount. There are undoubtedly many offerings of fractional undivided interests made under the private offering exemption, some of which are probably borderline situations with respect to the availability of the exemption. There are also undoubtedly offerings of fractional undivided interest made in violation of the Securities Act, sometimes without any appreciation by the offeror or his attorney that it is unlawful to sell such interests without registration. Offerings made in violation of the registration provisions subject the offeror to criminal penalties and civil liabilities which can make non-compliance an expensive proposition. However, the non-complying offeror frequently avoids prosecution because the matter does not come to the attention of the Commission and the Commission seldom, if ever, prosecutes

188. Investors do not, however, necessarily make informed investment decisions. The inadequacy of full disclosure in appraising value is implicit in the Commission's decision in the *Leeby* case, *supra* note 182. In that case customers were furnished with Regulation B offering sheets, but nonetheless the Commission held that the dealer was under a duty to charge prices reasonably related to the market price.

189. See discussion *supra* pages 70-71, 76-77. Even under the present Regulation A if the offeror uses sales literature the Commission's staff on an administrative level does a fairly effective job of compelling disclosure.

190. All such reports should be supported by data submitted to the Commission for its use in determining the validity of the conclusions reached by the geologist.

191. 17 SEC ANN. REP. 12 (1951).

inadvertent violators. He is frequently protected from the civil liabilities provisions by the short one year statute of limitations¹⁹² and the fact that the purchasers and their attorneys are often unaware of the fact that they have an action under the Federal Securities Act. The present private offering exemption, as previously noted,¹⁹³ raises a difficult factual issue which tends to discourage both prosecution and private litigation.

While compliance with Regulation B is a formidable task it is not one beyond the competence of most attorneys. Full registration pursuant to S-10 is only a slightly more formidable task with respect to non-producing interests and even with respect to producing interests, which in the case of registration require an estimate of recoverable reserves, there are situations in which because of the restrictions of Regulation B registration is the only or preferable route. While the complexities of the Securities Act have been considerably exaggerated, they are nonetheless real; it is, therefore, particularly unfortunate that Regulation B is so poorly drafted. So much is provided by indirection that could have been provided directly and with considerable more clarity. The so-called conditional exceptions are provided by indirection,¹⁹⁴ the parties who must file offering sheets is provided by indirection,¹⁹⁵ the liability of various types of offerors is provided by indirection,¹⁹⁶ and the extent to which dealers in securities must use offering sheets is provided by indirection.¹⁹⁷ In almost every enumerated instance it is necessary to consider at least three provisions of the Regulation itself in conjunction with various provisions of the statute. This type of indirection does not add to clarity or compliance.

192. See note 129 and related text.

193. *Supra* pages 61-63.

194. *Supra* pages 63-65.

195. *Supra* pages 79-80.

196. *Supra* pages 79-82.

197. See note 75 and related text.