Land & Water Law Review

Volume 11 | Issue 1 Article 6

1976

Exemptions from Securities Registration for Small Issuers: Shifting from Full Disclosure - Part II: The Intrastate Offering Exemption and Rule 147

William J. Carney

University of Wyoming

College of Law

LAND AND WATER

LAW REVIEW

VOLUME XI 1976 NUMBER 1

In this, Part II of a multi-part article on exemptions from registration requirements for issuers of securities, Professor Carney examines the *intrastate offering exemption under Rule 147 and contrasts its* requirements with those of the private offering exemption under Rule 146.

EXEMPTIONS FROM SECURITIES REGISTRATION FOR SMALL ISSUERS: SHIFTING FROM FULL DISCLOSURE -- PART II: THE INTRASTATE OFFERING EXEMPTION AND RULE 147

*William J. Carney**

INTRODUCTION

THE first part of this article[1] examined the availability of the private offering exemption of the Securities Act of 1933[2] in the light of the SEC's adoption of Rule 146,[3] and concluded that for small new issuers the conditions of the rule were both too burdensome and too uncertain to be of much use. This portion will examine the intrastate offering exemption provided by Section 3(a)(11) of the Act.[4] This exemp-

*Associate Professor of Law, University of Wyoming, College of Law; B.A., 1959, Yale University; LL.B., 1962, Yale University; Member of the Wyoming and Colorado Bars.

1. Carney, *Exemptions From Securities Registration for Small Issuers: Shifting From Full Disclosure—Part I: The Private Offering Exemption, Rule 146 and an End to Access for Small Issuers*, 10 LAND & WATER L. REV. 507 (1975).
2. 15 U.S.C. §§ 77a-77aa (1970). All references to the "Securities Act" will be to the Securities Act of 1933.
3. 17 C.F.R. § 230.146 (1975).
4. 15 U.S.C. § 77c(a)(11) (1970).

tion is of renewed interest to small issuers not only because of the adoption of Rule 147[5] to implement it, but also because of the difficulties which now inhere in the private offering exemption. The difficulties small issuers face in complying with Rule 146's requirements relating to disclosure and investor qualification are in sharp contrast with the requirements of Rule 147 in these areas. Rule 147 may fairly be characterized as a nondisclosure transactional exemption from registration. It should be precisely this feature, coupled with the greater certainty available for small issuers, which will make it relatively more attractive to them, at least in comparison with Rule 146.

Rule 147 will not provide assistance for issuers attempting financings of any size, since the problems which made public financings so perilous prior to Rule 147 have in large measure not been cured by it. Furthermore, while the conditions to be met for exemption from registration under Rule 147 require no disclosure to investors, the exemption is from registration only, and not from the antifraud provisions of the Act.[6]

While some authors have criticized the Commission's treatment of the intrastate offering exemption in Rule 147,[7] this examination of the rule will show that while the Commission has not solved the problems of many larger issuers attempting to utilize the exemption to raise substantial amounts of capital from a multitude of investors, it may well have solved many of the serious problems which have plagued

5. Securities Act Rule 147, 17 C.F.R. § 230.147 (1975).
6. SEC Securities Act Release No. 5450 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶ 2340, adopting Rule 147, stated:

> Neither Section 3(a)(11) nor Rule 147 provides an exemption from the civil liability provisions of the Section 12(2) of the Act, the antifraud provisions of the Act or of the Securities Exchange Act of 1934 ("Exchange Act"), the registration and periodic reporting provisions of Section 12(g) and 13 of the Exchange Act, or any applicable state laws.

7. Articles critical of Rule 147 which suggest that the SEC has either narrowed the availability of the intrastate offering exemption or done little to improve the degree of certainty associated with its use include: Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147*, 69 NW. U.L. REV. 167 (1974); Gardiner, *Intrastate Offering Exemption: Rule 147—Progress or Stalemate?* 35 OHIO ST. L. J. 340 (1974); Kant, *SEC Rule 147—A Further Narrowing of the Intrastate Offering Exemption*, 30 BUS. LAW. 73 (1974); Kessler, *Private Placement Rules 146 and 240—Safe Harbor?* 44 FORD. L. REV. 37 (1975); and Sowards, *The Twilight of the Intrastate Exemption*, 25 MERCER L. REV. 437 (1974).

smaller issuers and their attorneys. If this is true, it represents both a clarification of a confusing area of the law for small new issuers and a recognition by the Commission that there are some areas where its regulatory muscle need not be exercised to protect investors.

THE INTRASTATE OFFERING EXEMPTION

The intrastate offering exemption is grounded on Section 3(a)(11) of the Act, which provides an exemption for:

> Any security which is part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such State or Territory.[8]

The purpose of the exemption was apparently two-fold: Congress apparently felt that where an offering was sufficiently local in character, prospective investors would be enabled by their proximity to know the issuer, its promoters and its business, and would also be sufficiently protected by state regulation.[9] Obviously where the issuer was located in the state where the offers were to be made, the state securities officials would have adequate jurisdiction to enforce their orders effectively. The exemption developed on a case-by-case basis, with the Commission cautiously explaining in releases what transactions would not qualify for the exemption, much as it did in the case of the private offering exemption.[10]

---

8. Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970).
9. SEC Securities Act Release No. 5450 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶ 2340, at 2611-612, states:

> Section 3(a)(11) was intended to allow issuers with localized operations to sell securities as part of a plan of local financing. Congress apparently believed that a company whose operations are restricted to one area should be able to raise money from investors in the immediate vicinity without having to register the securities with a federal agency. In theory, the investors would be protected both by their proximity to the issuer and by state regulation.

10. Major releases by the Comission in this area include: SEC Securities Act Release No. 1459 (May 29, 1937), CCH FED. SEC. L. REP. ¶ 2260; SEC Securities Act Release No. 2029 (Aug. 8, 1939), CCH FED. SEC. L. REP. ¶ 2140; SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270; and SEC Securities Act Release No. 5450 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶ 2340. Securities Act Release No. 201 (July 30, 1934), CCH FED. SEC. L. REP. ¶ 2255, issued by the Federal Trade Commission during its administration of the Act also interpreted the exemption in the context of secondary distributions.

A. Difficulties with the Exemption

Much has been written of the difficulties with the intrastate exemption and it would add nothing to repeat all of those criticisms here.[11] Nevertheless, some of the most difficult problems have not been solved entirely by Rule 147. In any event the rule is not exclusive, so that some issuers may find themselves forced to rely on the existing interpretations of Section 3(a)(11) should they find themselves in court.[12] Furthermore, a summary of the problems will serve to illustrate why so many practitioners and observers felt the exemption had become so uncertain in its application that it was virtually useless.

1. Part of An Issue

Section 3 of the Act generally contains exemptions for classes of securities. The sale of these securities is exempt regardless of the identity of the seller or the manner in which

11. Over the years numerous authors have pointed out the pitfalls of the intrastate offering exemption. *See* Bloomenthal, *The Federal Securities Act Intra-State Exemption—Fact or Fiction?* 15 WYO. L. J. 121 (1961); Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933, in 1971*, 40 U. CIN. L. REV. 799 (1971); Gadsby, *The Securities and Exchange Commission and the Financing of Small Businesses*, 14 BUS. LAW. 144 (1958); Hertz, *Federal Securities Act of 1933—The Intrastate Exemption of Section 3(a)(11)—Fact or Fiction?* 34 DICTA 289 (1957); McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959); Mulford, *Private Placements and Intrastate Offerings of Securities*, 13 BUS. LAW. 297 (1958). One of the more recent summaries of the state of the law in this area is by Cummings, *supra* note 7. The proposed Federal Securities Code does not provide an intrastate offering exemption at all, and in the comments to Section 301, Tentative Draft No. 1, discussing the existing exemption, states at 75, after reviewing all of the current requirements:

> If all these strictures were strenuously enforced, the exemption would be virtually a dead letter. It is of little if any use at best (because of the domicil problem) in metropolitan areas that border on other states. And, although it has seen significant use in some of the larger states, particularly away from metropolitan areas bordering on other states, careful lawyers seldom advise reliance on it in advance except when the number of offerees is so small that the nonpublic offering exemption in §4(2) might well be available in any event.

After the adoption of Rule 146, it seems doubtful that the comment would suggest that the Section 4(2) exemption would generally be available to offerors relying on Section 3(a)(11).

12. Preliminary Note 1 to Rule 147 states:

> This rule shall not raise any presumption that the exemption provided by Section 3(a)(11) of the Act is not available for transactions by an issuer which do not satisfy all of the provisions of the rule.

Alberg & Lybecker, *New SEC Rules 146 and 147: The Non-Public and Intrastate Offering Exemptions from Registration for the Sale of Securities*, 74 COLUM. L. REV. 622, 653 (1974), believe the Rule 147 standards will "spill over" into interpretations of the statutory exemption.

they are issued or sold. But Section 3(a)(11) is more transactional in nature, since it specifies that securities will be exempt only if they are "part of an issue" which is offered and sold in the prescribed manner. Observers have characterized the exemption as transactional in nature,[13] but it might be more accurate to view it as a combination of an exemption for transactions with an exemption of a class of securities, since buyers may resell immediately to other residents of the same state as the issuer.[14] Thus none of the difficult questions concerning which purchasers may be underwriters appear in determining whether the exemption is available.[15]

The exemption applies only to an issue which is both offered and sold only to persons resident within a single state or territory.[16] Some attempts to market securities constitute continuing offers to sell securities of the issuer, and thus the offering, and the issue, is not complete until such offers are either accepted or withdrawn. Examples include warrants, convertible securities, and subscription agreements where the buyer has not completed his payments, and thus does not yet have the right of ownership of all of the securities which are the subject of the agreement.[17]

13. *See* SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, and Kant, *supra* note 7, at 76, text at n.16 (1974).
14. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2275.
15. *But see* BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 4.14[4] (1975) [hereinafter cited as BLOOMENTHAL], who describes the requirement of resale only to residents as "another way of saying that those who purchase the securities must not be underwriters except for the limited purpose of reselling to other residents of the single appropriate state." This article does not attempt to deal with the problem of so-called "presumptive underwriters" who purchase large blocks of securities in the course of a distribution. *See* Nathan, *Presumptive Underwriters,* 8 REV. SEC. REG. 881 (1975).
16. SEC Securities Act Release No. 1459 (May 29, 1937), CCH FED. SEC. L. REP. ¶ 2260. Until the 1954 amendments the exemption referred only to an issue "sold" to residents of the state or territory. It was originally thought that the reference to "sale" was sufficient to cover offers as well. *See* LOSS, SECURITIES REGULATION 375 n.249 (1951). The amendment which added "offered and" to the statute was thought necessary " 'to preserve existing law' in view of the distinction being made between offers and sales in section 2(3) of the act." 1 LOSS, SECURITIES REGULATION 592 (2d ed. 1961), *citing* S. REP. No. 1036, 83rd Cong., 2d Sess. 13 (1954), and H.R. REP. No. 1542, 83rd Cong., 2d Sess. 22 (1954).
17. The problem of the continuing offer is one that pervades the securities regulation field. SEC Securities Act Release No. 3210 (April 9, 1947), CCH FED. SEC. L. REP. ¶ 1127, noted that warrants to purchase common stock are offers to sell the stock, and concluded that "both the warrants and the stock subject thereto should be registered." The House Report recognized

It has always been difficult to determine which offers and sales must be combined, or "integrated" in a single issue, a problem common to all transactional exemptions. Initially, the Commission appeared to take a stand which was so stringent that it was theoretically possible to integrate nearly all offers and sales. In Release No. 4434, the Commission set out criteria for determining when integration of isolated transactions would result in their inclusion in a single "issue":

> *Any one* or more of the following factors may be determinative of the question of integration: (1) Are the offerings part of a single plan of financing; (2) do the offerings involve issuance of the same class of security; (3) are the offerings made at or about the same time; (4) is the same type of consideration to be received, and (5) are the offerings made for the same general purpose. (emphasis added).[18]

If the language of Release No. 4434 were taken literally, it would have been possible to integrate almost any transactions into a single issue, since at least one of the tests is nearly always met.[19] Some of the interpretations of the courts and the Commission will serve to illustrate the uncertainty which has existed.

---

that convertible securities constitute an offer to sell the security into which they are convertible, and concluded that such underlying securities did not have to be registered until the conversion right became effective. H.R. REP. No. 85, 73rd Cong., 1st Sess. 11 (1933). SEC v. American Founders Life Ins. Co., [Transfer Binder 1957-61 Decisions] CCH FED. SEC. L. REP. ¶ 90, 861 (D. Colo. 1958), held that a subscription agreement which did not obligate a subscriber to complete his subscription was a continuing offer, not a completed sale. In an unusual ruling, the staff allowed an issuer with preferred stock presently convertible into common outstanding under a previous registration statement to sell additional common stock pursuant to Regulation A, where the market price for the common stock was well below the conversion price, and there seemed little likelihood that any preferred stockholders would elect to convert during the course of the Regulation A offering. Systems Associates, Inc., [Transfer Binder 1970-71 Decisions] CCH FED. SEC. L. REP. ¶ 78,103 (SEC Div. Corp. Fin. April 16, 1971). For a discussion of the problems of large-scale financings using subscription agreements *see* BLOOMENTHAL, at § 4.04[6]. *Cf.* Collins Securities Corp., CCH FED. SEC. L. REP. ¶ 80,327, at 85,792—85,793, n.2 (S.E.C., 1975).

18. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2272.
19. Some observers believe that a subsequent release discussing the private offering exemption indicated a softening of the Commission's formal stance on integration when it eliminated the phrase "any one" introducing the criteria, and stated instead: "The following factors are relevant to such question of integration." SEC Securities Act Release No. 4552 (Nov. 6, 1962), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2781.

a. *Single plan of financing.* In *Unity Gold Corporation*,[20] the Commission integrated several contracts to sell stock and several options to purchase the issuer's stock which were executed at the same time, and extended over a four year period, concluding that where common stock was issued in each transaction, and sales and options were covered in the same agreements, "it is clear that these contracts involve a single integrated plan for the distribution of these 600,000 shares."[21] The Commission has held that shares issued to promoters and for acquisition of mining properties were part of the same "plan" of financnig as shares later issued purportedly under the private offering exemption, and other shares sold later in a registered offering.[22] In that case the public offering was financed in part by the preceding private offering for cash, and the proceeds of the public offering were to be used to complete the purchase of the mining properties for which stock had previously been issued. These cases would suggest that whenever the transactions are part of a continuous course of business, integration would apply, regardless of the time elapsed between the offerings. Since any growing business can reasonably anticipate that at some time growth will require additional financing, such an approach could require integration indefinitely. Recent rulings and cases seem to have taken a more liberal attitude toward this problem. One such case refused to integrate a series of "private" offerings, all of which were used to pay bills and provide working capital, where the issuer hoped the first and each succeeding offering would be sufficient.[23] A no-action ruling suggests that

20. 3 SEC 618 (1938).
21. *Id.* at 625.
22. Cameron Indus., Inc., 39 SEC 540 (1959).
23. Livens v. William D. Witter, Inc., 374 F. Supp. 1104 (D. Mass. 1974), involved an attempt to use the integration doctrine to avoid the one-year statute of limitations of Section 13 of the Act, since the sales which the plaintiff attempted to rescind took place more than one year prior to bringing the action. The decision may have been influenced by the fact that the defendants had lost over one million dollars of their own funds in the enterprise, but the opinion was based on the factors listed in SEC Securities Act Release No. 4552 (Nov. 6, 1962), CCH FED. SEC. L. REP. ¶2270. The plaintiff purchased his securities in four separate financings over fourteen months, but did not participate in the two later financings which took place over the next fourteen or fifteen months, which would have brought the alleged "issue" within the statute of limitations. Plaintiff urged that all of the sales were part of a single plan of financing to pay old bills and provide working capital for the issuer. The court noted

where one offering for cash is made to fund an acquisition and to retire some debt, another offering to exchange shares of the same class for outstanding debt and a small amount of cash will not be considered part of the same plan.[24]

b. *Issuance of same class of security.* The most restrictive reading of this requirement is reflected in *Shaw v. United States*,[25] which held that an "issue" meant all shares of the same class, whenever sold by the issuer. The case has never been followed by any court, although it is cited for another purpose in Release No. 4434.[26] Later cases have rejected this approach, although it has not been overruled.[27] Sales of convertible securities will be integrated with sales of the securities into which they are convertible if they are presently convertible.[28] The difficult questions relate to when the terms of securities are sufficiently distinct to constitute separate classes rather than series of the same class.[29] The only safe course has been to issue securities of distinctly different classes such as preferred and common stock, or bonds and debentures, even though this approach limits an issuer's flexibility in financial planning.

---

that some factors which would militate for integration of the offerings as a single "issue" were present, since "(a) for the most part the offerings were made for the same general purpose, and (b) the parties recognized that the first financing in October, 1967 might be inadequate and additional financing might be required." 374 F. Supp. at 1107. But the court noted the hopes that the first financing might be sufficient, and that new circumstances developed later which required more financing which could not have been foreseen. The court concluded: "Moreover, the several offerings were not made at or about the same time, different classes of securities were issued and the prices of the securities varied. On balance, the integrated offering doctrine is clearly inapplicable." *Id.* at 1107.

24. Remote Computing Corp., [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶ 79,182 (SEC Div. Corp. Fin. Dec. 28, 1972).
25. 131 F.2d 476 (9th Cir. 1942). And *see* Texas Glass Mfg. Corp., 38 SEC 630, 634 (1958), *infra* note 40.
26. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2272.
27. *See* Livens v. William D. Witter, Inc., *supra* note 23, involving the issue of common stock at various times, and Value Line Fund, Inc. v. Marcus, [Transfer Binder 1964-66 Decisions] CCH FED. SEC. L. REP. ¶ 91,523 (S.D. N.Y. 1965), involving issuance of common stock by the issuer in acquisitions and sales of the issuer's stock by a controlling person.
28. *Cf.* H.R. REP. NO. 85, 73d Cong., 1st Sess. 11 (1933), which points out that when the conversion rights are exercisable, the securities into which they are convertible must be registered. This requirement exists because conversion rights are treated as a continuing offer of the securities into which the first class of securities are convertible. *See* note 17, *supra*, discussing conversion rights.
29. *See* SEC Securities Act Release No. 2029 (Aug. 8, 1939) CCH FED. SEC. L. REP. ¶ 2140, ruling that two series of bonds are not the same class of securities where they "differ substantially from each other in respect of

c. *Offerings at or about the same time.* In a sense, this test is related to whether the offerings are part of the same plan of financing, and proximity in time tends to lead to that conclusion. No clear guidelines have been provided by the SEC or the courts, but offerings made within a year of each other have been held suspect.[30] Closer offerings, such as those within a few months of each other, are generally integrated by the SEC staff, such as an intrastate offering of promissory notes followed by a registered offering of common stock, which would begin not sooner than six months after the start of the note offering.[31] Recently the staff has exhibited a more liberal approach to the time problem under Rules 146 and 147, indicating that it would not integrate offerings of subordinated sinking fund debentures and first mortgage bonds made within six months of each other.[32] These rulings exhibit no consistent theory which would enable an attorney to predict staff rulings in advance. They may suggest a weighing of the various factors

maturity date, interest rate, redemption prices and default provisions." To the same effect is SEC v. Dunfee, [Transfer Binder 1966-67 Decisions] CCH FED. SEC. L. REP. ¶ 91,970 (W.D. Mo. 1966), holding that six percent bonds payable in twenty monthly installments were a different issue of securities from seven percent notes payable in thirty-six months where there was a gap of nine months between the end of the first offering and the commencement of the second. *But see* Hillsborough Inv. Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960), holding that seven percent notes were merely substitutes for an earlier issue of securities, and thus part of the same issue.

30. *Cf.* Crowell-Collier Publishing Co., SEC Securities Act Release No. 3825 (Aug. 12, 1957), [Transfer Binder 1957-61 Decisions] CCH FED. SEC. L. REP. ¶ 76,539, a case involving the private offering exemption of Section 4(2) of the Securities Act.

31. Property Inv., Inc., [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶79,123 (SEC Div. Corp. Fin. Nov. 17, 1972). The staff ruling also noted that proceeds would be used for similar purposes, and the same type of consideration (cash) was to be received in both offerings. To the same effect is Presidential Realty Corp., [Transfer Binder 1970-71 Decisions] CCH FED. SEC. L. REP. ¶ 78,066 (SEC Div. Corp. Fin. Feb. 19, 1971). And *see* Hynes & Howes Real Estate, Inc., [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶ 78,603 (SEC Div. Corp. Fin. Jan 5, 1972), where an interstate offering was proposed to be followed within five or six months by an intrastate offering. To the same effect is Founders Preferred Life Ins. Co., 106 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. June 16, 1971).

32. Eastern Ill. Tel. Corp., 299 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. April 23, 1975). And *see* Stratford Employees' Cattle Program, Ltd., [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,761 (SEC Div. Corp. Fin. April 8, 1974), involving an intrastate offering of pre-organization subscriptions in a limited partnership while the sponsor was simultaneously engaged in public interstate offerings of pre-organization subscriptions in other cattle feeding limited partnerships. The interpretations focused on the fact that different classes of securities were involved, indicating that in such cases timing may be less important in the future.

rather than the rigid approach of Release No. 4434 that meeting "any one" of the tests is determinative.

d. *Receipt of same type of consideration.* Since issuers are normally attempting to raise cash, this test could integrate nearly all offerings if applied harshly. For new issuers, the only offerings which would not be integrated would be those with promoters for assets or services, or with existing securities holders for conversion of an outstanding class of securities.[33] With such a test the SEC staff has the ability, in no-action correspondence, to integrate nearly any offerings,[34] or to ignore this factor and hold that the offerings are separate.[35] Court cases provide little guidance in this area, except for *Livens v. William D. Witter, Inc.*,[36] holding cash offerings separate, and *Value Line Fund, Inc. v. Marcus*,[37] which declined to integrate stock issued in acquisitions with a controlling person's sale for cash.

e. *Offerings made for the same general purpose.* In the broadest sense, all offerings are made for the purpose of capitalizing a business, either with cash or assets. Obviously such an approach would render this test meaningless. Something more limited and specific must have been intended, but it is difficult to discern what the staff has in mind from no-action correspondence. The test is best illustrated by a no-action request involving offerings by two separate coopera-

33. In Smith v. Jackson Tool & Die, Inc., 419 F.2d 152 (5th Cir. 1969), the court declined to integrate an intrastate offering of common stock for cash with an issue of common stock as a conversion of a corporate note. SEC Securities Act Release No. 2029 (Aug. 8, 1939), CCH FED. SEC. L. REP. ¶ 2140, involved an issue of series B bonds in exchange for outstanding series A bonds, and the sale of series C bonds for cash, where the bonds also differed from each other in maturity date, interest rate, redemption prices and default provisions. The Commission concluded the offerings were separate. And *see* Remote Computing Corp., *supra* note 24.

34. In Property Inv., Inc., *supra* note 31, one of the factors mentioned as justifying integration was receipt of cash for the sale of both promissory notes and common stock.

35. *See* Eastern Ill. Tel. Corp., *supra* note 32; and SEC Securities Act Release No. 2029 (Aug. 8, 1939), CCH FED. SEC. L. REP. ¶ 2140, all taking the position that offerings for cash were separate.

36. Livens v. William D. Witter, Inc., *supra* note 23. The court refused to consider any one factor as determinative, but looked at all the factors.

37. Value Line Fund, Inc. v. Marcus, *supra* note 27. The court considered all the factors listed in SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, plus the fact that not all the securities were sold by the same person. *But see* SEC v. Los Angeles Trust, Deed & Mortgage Exch., 186 F. Supp. 830 (S.D. Cal.) *aff'd*, 285 F.2d 162 (9th Cir. 1960), integrating sales of identical securities by a parent and its subsidiary.

tive apartment companies, one of which was intrastate, which were integrated by the staff because the proceeds of both offerings were to be used to pay debts due to the same developer.[38] In another case where proceeds of two offerings were cash, and no difference in the use of proceeds was indicated, the staff ignored this factor and treated the offerings as separate.[39] The risk is that all offerings made during the promotional stage of a company, no matter how long the period, may be treated as being made for the same purpose. In one such case where initial production had not yet begun, offerings made seventeen months apart were integrated.[40]

The most articulate judicial approach to integration is contained in the district court opinion in *Livens v. William D. Witter, Inc.*[41] A series of six separate private offerings were made by the issuer in a little under three years, each to raise working capital. The court noted that in each case officers of the issuer had hoped the proceeds would be sufficient to enable it to operate profitably, although this did not turn out to be the case. The court noted that for the most part the offerings were made for the same general purpose and that the participants recognized that additional financing might be required—factors which militated for integration. However, the court also noted that different classes of securities were issued, both stock and debentures, and that the offerings were not made at the same time, although some of them were as little as two or three months apart—close enough to find a factor which would lead to integration in other cases. Rather than treat any one as determinative, the court reviewed all factors, and concluded that on balance the integrated offering doctrine was inapplicable.[42] The only

38. Presidential Realty Corp., *supra* note 31.
39. Eastern Ill. Tel. Corp., *supra* note 32.
40. Texas Glass Mfg. Corp., 38 SEC 630, 634 (1958). The Commission's decision was influenced by the fact that the company had attempted a public intrastate offering which was abandoned because of its lack of success, and its later registered offering was regarded as an offer of "the rest of the issue." *Id.* at 634. It is possible that if an issuer had successfully completed one offering, had used the proceeds for the planned purpose, and later made another offering for a subsequent expansion of its business, the result might have been different.
41. 374 F. Supp. 1104 (D. Mass. 1974).
42. *Id.* at 1107.

case cited by the court was *Value Line Fund, Inc. v. Marcus*, which also appeared to consider and weigh all of these factors in reaching a decision not to integrate.[43] These cases appear to stand alone in articulating a conceptual approach to the problem.

The most exhaustive article on the integration doctrine, written prior to *Livens* and the 140 series, fails, understandably, to articulate a rational theory of integration based on court and administrative decisions.[44] The suggestions of the authors, short of reform of the law, suggest the extreme difficulties facing practitioners in the area. The first suggestion for the issuer faced with integration and destruction of prior exemptions if it continues to offer securities is a registered public offering coupled with a rescission offer to prior purchasers. The second suggestion is to plan a second "exempt" offering "with a plan and a prayer."[45] The plan is to go ahead with the offering, disclosing the possibility of integration and the loss of the exemption, and pray that the issuer's stock remains in favor with investors so no one rescinds. That attorneys skilled in the area should ever have to resort to such an approach suggests the absurdity of the existing state of the integration doctrine.

43. [Transfer Binder 1964-66 Decisions] CCH FED. SEC. L. REP. ¶ 91,523 (S.D. N.Y. 1965). The *Value Line* decision added one more factor, that the offerings were made by a controlling person as well as by the issuer. The court weighed that fact against integration.

44. Shapiro & Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always . . .*, 31 MD. L. REV. 3 (1971). Other extended discussions of integration problems can be found in BLOOMENTHAL, at § 4.14[5]; Gardiner, *supra* note 7; Kant, *supra* note 7; and Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 WEST RES. L. REV. 110 (1964). Sosin articulates a conceptual approach to the integration problem which seems to have been adopted in Livens v. William D. Witter, Inc., *supra* note 41.

45. Shapiro & Sachs, *supra* note 44, at 24-25. The integration problem was much more severe for intrastate offerings than for private offerings, where the supposedly exempt offering was followed by a registered public offering, for the reason that the later registered public offering would be integrated with the earlier intrastate offering where the SEC thought it appropriate, as in Texas Glass Mfg. Corp., *supra* note 40. For private offerings followed by a registered public offering issuers have available SEC Securities Act Rule 152, 17 C.F.R. § 230.152 (1975), quoted below:

> The phrase "transactions by an issuer not involving any public offering" in Section 4(2) shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement.

Another option was to wait for the one year statute of limitations of Section 13 to expire. The latter is the only option with intrastate offerings.

Sosin suggests that the ultimate test is whether the transactions were part of a single plan of financing, and that all of the other tests stated in Release No. 4434 were subsidiary tests which provided evidence of whether such a plan existed.[46] Release No. 4434[47] certainly did not suggest that view when it introduced the tests with the statement that any one of them might be determinative, nor did Release No. 4552,[48] or recent staff no-action correspondence. The result is that thirty years of judicial and administrative interpretation still leaves the practitioner with feelings of great uncertainty, leading to a large number of requests for no-action letters. In view of these problems, it is no small wonder that one experienced practitioner recommends that counsel avoid no-action requests on integration problems, on the theory

> [T]hat you would not get a helpful answer most of the time. You would get either a "no" or a very guarded "maybe". I think this is a good area in which the lawyer should make his own judgment, and not expect any real help from the Commission on a no-action basis.[49]

2. The Nature of the Issuer

a. *Residence.* The exemption is available only for offers

46. Sosin, *supra* note 44.
47. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270.
48. SEC Securities Act Release No. 4552 (Nov. 6, 1962), CCH FED. SEC. L. REP. ¶ 2770, at ¶ 2781. *See* the discussion of this release, *supra* note 19.
49. Schneider, *The Intrastate Offering Exemption*, PLI SECOND ANNUAL INST. ON SEC. REG. 22, 25-26 (Mundheim & Fleischer, eds. 1971). It is possible that the view of the Commission itself may not be as restrictive as that of the staff, and may be more in accord with that of the district court in Livens v. William D. Witter, Inc., *supra* note 41, that all of the factors must be weighed. Unfortunately the risk of reaching either the Commission or the courts for such a determination is generally too high. Since it appears the recommendation is that counsel not disclose the details of their clients' integration problems to the staff (except in the context of a registration statement) where counsel anticipate that the staff might integrate several transactions, the practitioner may risk disciplinary action under developing standards of ethical behavior, which effectively require attorneys to act as policemen for the SEC. Recent articles discussing this trend include: Freedman, *A Civil Libertarian Looks at Securities Regulation*, 34 OHIO ST. L. J. 280 (1974); Goldberg, *Ethical Dilemma: Attorney-Client Privilege vs. the National Student Marketing Doctrine*, 1 SEC. REG. L. J. 297 (1974); Lowenfels, *Expanding Public Responsibilities of Securities Lawyers: An Analysis of the New Trend in Standard of Care and Priorities of Duties*, 74 COLUM. L. REV. 412 (1974); and *Proceedings of ABA National Institute, Advisors to Management—Responsibilities of Lawyers and Accountants*, 30 BUS. LAW. Special Issue (1975).

and sales within a single state or territory "where the issuer of such security is a person resident and doing business within or, if a corporation, incorporated by and doing business within, such state or territory."[50] Obviously determining the state of incorporation creates no serious problems. Determining the residence of individual issuers is a matter of determining domicile, which may be difficult in some cases and relatively simple in many others.[51]

Given the statutory language, which refers to issuers resident in the state, or where corporations are involved, incorporated in the state, one might assume that for unincorporated issuers the term "resident" was functionally equivalent to the term "incorporated". This has not been the Commission's attitude in the partnership area.

General partnerships can be formed with no formalities under the Uniform Partnership Act, although trade and fictitious name statutes may require filings under some circumstances.[52] The Commission has not looked to these formalities, where they exist, as evidence of residence of general partnerships. For most partnerships the question of residence is easily solved, since all of the evidence points to only one state. For the typical small partnership, and most professional partnerships, all the partners reside in the one state, and all of the offices are in that state. Other partnerships raise the old and unanswered question whether a partnership is an entity or an aggregate. The typical New York City law partnership may well have partners who reside in Connecticut and New Jersey, although they may be licensed to practice law only in the state of New York. The position of the SEC staff has been that such partnerships reside in each state where any member of the partnership resides, a

50. Securities Act of 1933, § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970).

51. *See* SEC Securities Act Release No. 4434, at 3 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, which discusses residence of issuers and purchasers in the same terms and observes that "Mere presence in the state is not sufficient to constitute residence, as in the case of military personnel at a military post."

52. *See, e.g.*, COLO. REV. STAT. § 7-71-101 (1973), requiring any partnership doing business in the state under any other name than the personal name of its constituent members to file an affidavit with the county clerk and recorder in the county where the business is carried on. Wyoming has no comparable requirement.

view which hardly accords with reality in the example of the law partnership just mentioned. Nevertheless the view persisted, and the result was that the intrastate exemption was denied to such partnerships.[53] It was not until 1975 that a judicial ruling appeared on the question, and took the opposite view. The opinion reviewed the SEC staff position, took note of the opposite position of Rule 147[54] and the assertion of a recent article that the existing law is otherwise, and concluded that "the better view is that the residence of a general partnership is that of its principal place of business."[55]

While it is generally agreed that limited partnerships reside in the state where they are organized, the difficult problem with limited partnerships has been determining who is the issuer.[56] It has been common practice to offer pre-

53. In 1959 an Associate General Counsel of the Commission wrote:

> In either a general or limited partnership it is a real possibility that some of the partners will not be residents of the same state as the issuer. The question then presented is whether the partnership, as a business entity, has a residence separate and distinct from its members. Since a general partner retains his personal identity in a partnership, to a degree, and has property rights with respect to the partnership property, it would seem that nonresidence of such a general partner would seriously affect the issuer's intrastate exemption. On the other hand, in view of the restricted rights of limited partners with respect to partnership property and their interests in the entity, a stronger argument could be made that a purchase or sale by a limited partnership having non-resident limited partners would not necessarily defeat the exemption.

McCauley, *supra* note 11, at 948. While the article contains the usual disclaimer that it does not necessarily reflect the views of the Commission or the rest of the staff, evidence that this view prevailed over a period of time can be seen from the initial version of proposed Rule 147, which contained the same approach in 147(c)(1). *See* SEC Securities Act Release No. 5349, at 10 (Jan. 8, 1973), [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶ 79,168, at 82,548.

54. Rule 147(c)(1)(ii), discussed *infra*, provides that a general partnership shall be deemed resident in the state where its principal office is located.

55. Grendaer v. Spitz, [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 95,008, at 97,499 (S.D. N.Y. 1975) *reh. denied, question certified for interlocutory appeal*, CCH FED. SEC. L. REP. ¶ 95,300 (Sept. 29, 1975), citing Alberg & Lybecker, *New SEC Rules 146 and 147: The Nonpublic and Intrastate Offering Exemptions From Registration for the Sale of Securities*, 74 COLUM. L. REV. 622, 650 (1974). The authors of the article, one of whom is a member of the SEC staff, simply state that "Rule 147 adopts the prior law as to the residence of an issuer." *Id.* The footnote supporting that statement cites 1 LOSS, SECURITIES REGULATION 600 (2d ed. 1961), who states only that "in the case of a partnership or association or business trust, presumably its principal place of business [is its state of residence], under the entity theory followed in defining the term 'issuer'." Neither source cites any case law or SEC interpretations.

56. *See* the discussion of this issue by McCauley, *supra* note 53. And *see* Louisiana Motor Inns, [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶ 78,902 (SEC Div. Corp. Fin. May 23, 1972).

organization subscriptions in a limited partnership which will be formed after receipt of sufficient subscriptions, and some organizations have engaged in repeated formation of limited partnerships in the real estate, oil and gas, and cattle feeding areas. Promoters of such offerings frequently have a corporation which is the sponsor of a series of such offerings, with a number of subsidiaries which serve as corporate general partners of the limited partnerships.[57] In such cases the question of who is the issuer may be answered in three separate ways—the program sponsor, the corporate general partner, or the limited partnership. The answer may vary depending on whether the corporate general partner or the limited partnership have been formed at the time of the offering.

Not all of the staff correspondence dealing with this problem discuss it expressly. Where raised, the staff position seems to have been that where the limited partnership has not yet been formed, and a corporation is offering the pre-organization interests, the corporation is the issuer, and the intrastate exemption is available only in the state where the corporation is incorporated and doing substantially all of its business.[58] But where the limited partnership has first been organized, the limited partnership itself has been treated as the issuer, and the state of its organization controls, so that it becomes possible to have a foreign corporation serving as a general partner.[59] A number of rulings are silent on the

57. Formation of the limited partnership after subscriptions are received reduces the number of amendments, if any, which must be made to the certificate of limited partnership under the Uniform Limited Partnership Act.

58. American Plan Inv. Corp., [Transfer Binder 1970-71 Decisions] CCH FED. SEC. L. REP. ¶ 78,044 (SEC Div. Corp. Fin. Feb. 9, 1971). The staff took the position that the corporate general partner was the issuer of the subscriptions.

59. Louisiana Motor Inns, *supra* note 56. It is interesting that the staff agreed, sub silentio, with the opinion of issuer's counsel, that the general partnership interest was not a security, and thus no problem of integration existed. A recent staff interpretation of Rule 146 articulates this distinction clearly. Helmut Petroleum Corp., 317 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Aug. 18, 1975), reports that "The staff said it is the Division's position that separate existing partnerships [with a common general partner, both formed for oil and gas exploration] may be deemed to be separate issuers. When the partnerships are unformed at the time of offerings . . . the general partner may be considered the issuer of pre-formation interests." And *see* Dogwood Farm, Inc., 318 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Sept. 1, 1975), which appears to take the same position, although the report of the correspondence is unclear.

question of timing.[60] But where the limited partnership is regarded as the issuer, if a corporate sponsor forms a series of limited partnerships and markets the limited partnership interests, the staff at present will not integrate the offerings.

In some rulings the staff seemed to indicate some ambivalence about whether the general partner or the limited partnerships should be considered the issuer, where a question of integration arose,[61] but generally the rulings have been consistent. The staff's approach on the continuous formation of limited partnerships does not seem consistent with the approach of the SEC to related corporations, where it has held the exemption is not available if the corporations are organized in separate states but are part of a "single business enterprise."[62] In one case the staff questioned whether a

60. In Landura Corp., 290 BNA SEC. REG. & L. REP. C-2 (SEC Div. Corp. Fin. Feb. 9, 1975), the staff took the position that the limited partnership would be the issuer of the securities, and the report of the correspondence contains no discussion of whether pre-organization subscriptions or interests in an existing limited partnership were being offered. In Guardian Oil Co., 309 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. July 2, 1975), the staff took the same position. To the same effect is the staff ruling in Stratford Employee's Cattle Program, Ltd., *supra* note 32, involving a Delaware corporation as program sponsor and a Texas corporate general partner and Texas limited partnership, offering pre-organization subscriptions to Texas employees.

61. After stating that the limited partnership would be considered as the issuer of its securities, in considering the problem of whether to integrate two separate offerings in separate limited partnerships under Rule 146 where the same corporate general partner was involved, the staff was reported as taking the following position:

> Generally speaking, the staff said, it is the Divisions's position that each limited partnership would be considered to be a separate issuer of limited partnership interests. The staff suggested, however, that while Guardian limited its inquiry to whether the two partnerships would be considered to have the same issuer, it would be a useful inquiry as well to assume that the same issuer was involved and then consider whether that issuer was issuing the "same class of security."

Guardian Oil Co., *supra* note 60. And *see* JEG Partners, 325 BNA SEC. REG. & L. REP. C-2 (SEC Div. Corp. Fin. Oct. 15, 1975), where the staff declined to rule on the same question.

62. SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2273, stated:

> [A] Section 3(a)(11) exemption should not be relied upon for each of a series of corporations organized in different States where there is in fact and purpose a single business enterprise or financial venture whether or not it is planned to merge or consilidate the various corporations at a later date. *SEC v. Los Angeles Trust Deed & Mortgage Exchange et al.*, 186 F. Supp. 830 871 (S.D. Cal. 1960), *aff'd* 285 F.2d 162 (C.A.9 1960).

To the same effect is the staff's position in Commercial Credit Co., [Transfer Binder 1971-72 Decisions] CCH FED. SEC. L. REP. ¶ 78,544 (SEC Div. Corp. Fin. Nov. 5, 1971), concluding the exemption was not available to industrial bank subsidiaries of a larger credit corporation, doing business in various states.

corporate general partner continuously engaged in forming and marketing interests in limited partnerships was engaged in the brokerage business, thus requiring registration under the Exchange Act.[63]

The intrastate offering exemption is not limited to issuers, and in theory a nonresident underwriter can be utilized,[64] but for a selling shareholder to utilize the exemption the Commission staff has taken the position that the selling shareholder must also be a resident of the state where the offer is made, because the staff considers that the receipt of proceeds by the out-of-state shareholder, and their use outside of the state, destroys the purely "local" nature of the offering.[65] While an attempt to sell by a nonresident shareholder may destroy the purely local nature of the transaction, it would not defeat the purpose of the exemption, which is to restrict it to a locality where investors can personally investigate the business and receive the protection of local securities regulation.[66] Nothing in Section 3(a)(11) requires such a restrictive reading.

b. *Doing business.* Section 3(a)(11) also requires that the issuer be "doing business" within the state or territory

63. Boetel & Co., 117 BNA SEC. REG. & L. REP. C-1 (SEC Div .Corp. Fin. Sept. 1, 1971).

64. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, states: "the non-residence of the underwriter or dealer is not pertinent so long as the ultimate distribution is to residents of the state."

65. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270. In Continental Investors Life Ins. Co., [Transfer Binder 1970-71 Decisions] CCH FED. SEC L. REP. ¶ 78,084 (SEC Div. Corp. Fin. March 4, 1971), the Commission staff took the position that a secondary offering would not qualify under Section 3(a)(11), even though the issuer was incorporated in and doing business in the state where the offering was proposed, where the selling shareholder, a parent of the issuer, was incorporated in another state, and proposed to utilize a nonresident bank as trustee of an employee's stock purchase plan, so the proceeds from the sale would flow out of state. Obviously, any time a nonresident attempts a secondary offering, the proceeds may wind up outside the issuer's state. The staff's position is contrary to the position previously taken in Release No. 4434:

> A secondary offering by a controlling person in the issuer's state of incorporation may be made in reliance on a Section 3(a) (11) exemption provided the exemption would be available to the issuer for a primary offering in that State. It is not essential that the controlling person be a resident of the issuer's state of incorporation.

66. Jurisdictional concepts have expanded since the adoption of the Securities Act. *See, e.g.*, International Shoe Co. v. Washington, 326 U.S. 310 (1945). Similarly, state long-arm statutes have expanded service of process, as in WYO. STAT. §§ 5-4.1 to -4.3 (Supp. 1975).

in question.[67] This test has focused on the location of the issuer's existing assets, the source of its revenues and the proposed use of the proceeds of the offering. Failure to meet any of these tests denies the availability of the exemption.

The test has not been interpreted to involve mere "doing business" for purposes of jurisdiction in a state, but the case law to date does not go beyond this point.[68] In 1961 Professor Loss was of the view that "Perhaps—although this is far less clear—the issuer may even be doing the major part of its business elsewhere."[69] The cases to date involve holdings which go no further than the proposition that an issuer may not have nearly all of its business in a state other than the state of its organization, either before or after the completion of the offering. The Commission prevailed in the case of an issuer owning a wholesale drug business in California with assets of less than $13,000 which proposed to raise over $4 million to acquire and operate a hotel in Nevada.[70] Similarly, the Commission ruled that a Pennsylvania corporation could not utilize the exemption for sales to Pennsylvania residents where its only business was operation of a hotel in the Bahamas.[71]

A more troublesome and interesting case is *Chapman v. Dunn*,[72] which involved sales of fractional undivided interests in Ohio oil and gas leases to Michigan residents by a Michigan resident who maintained an office and staff in Michigan. The court reviewed the legislative history of Section 3(a)(11), which began life as a transactional exemption in Section 5(c) of the Securities Act, only to be changed to an

67. 15 U.S.C. § 77c(a)(11) (1970).

68. For what constitutes "doing business" for jurisdictional purposes, *see* International Shoe Co. v. Washington, 326 U.S. 310 (1945). This is not the Section 3(a)(11) test. Cases establishing a requirement of a higher quantity of local activity involve home offices in the state of issue, but most of the "business" in other states, such as SEC v. McDonald Inv. Co., 343 F. Sup. 343 (D. Minn. 1972), *infra* note 86; Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969), *infra* note 72; and SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957).

69. 1 LOSS, SECURITIES REGULATION 601 (2d ed. 1961).

70. SEC v. Truckee Showboat, Inc., *supra* note 68.

71. Mark E. O'Leary, SEC Exchange Act Release No. 8361, 43 SEC 842 (1968). The Commission's opinion went no further than to reject the claim to exemption on the ground that the corporation "did not perform 'substantial operational activities' in the state of its incorporation." *Id.* at 847.

72. 414 F.2d 153 (6th Cir. 1969).

exemption for a class of securities in Section 3(a)(11) in the 1934 amendments, apparently to allow over-the-counter trading intrastate for small companies.[73] In reviewing the purpose of the legislation, the court noted the difficulties state securities administrators had with jurisdiction over issues sold interstate,[74] and concluded that in order to qualify for the exemption, the issuer must meet a "doing business" requirement which meant "something substantially more than has been held sufficient to subject one to service of process in civil suits."[75] The court did not explain why a jurisdictional problem required a doing business test far more "substantial" than minimum due process requirements.

The SEC has consistently taken the position that the doing business test is met only when virtually all of the issuer's business is intrastate. This insistence has created considerable difficulties for issuers. In one of the earliest discussions of the test, a then Associate General Counsel of the SEC took the position that "the issuer must conduct its principal business in the state."[76] In its 1961 release the SEC described this test as being one that "can only be satisfied by the performance of substantial operational activities in the State."[77]

Unfortunately for issuers, no specific guidelines were given, and as in the case of releases dealing with the private offering exemption, the release did no more than describe what would *not* satisfy the test—merely keeping records in the state, or keeping an office in the state while investing

73. The court cited the exchange between Representatives Sam Rayburn and Everett Dirksen:

> Mr. DIRKSEN: The gentleman will remember that in the discussion when the bill was under consideration in the House I voiced some apprehension about the small corporate entities whose securities were unregistered, that they might be placed under undue restrictions with respect to over-the-counter markets. I understand the bill has been amended and an exception has been made in their favor.
>
> Mr. RAYBURN: An exception is made in unregistered securities of companies predominantly intrastate in character.

Id. at 156, *citing* 78 CONG. REC. 10,269 (1934).

74. 414 F.2d at 157.

75. *Id.* at 158-59. *See* International Shoe Co. v. Washington, *supra*, note 66.

76. McCauley, *supra* note 11, at 950. This article was the sole authority cited by the court for this proposition in Chapman v. Dunn, *supra* note 72, at 157.

77. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2273.

in real property interests in other states.[78] Indeed, until Rule 147 the SEC avoided adopting any percentage tests which would allow issuers to readily determine whether they qualified for the exemption.

Obviously where all of the issuer's business is conducted and located within a single state, the Commission has been willing to concede that the intrastate exemption is available if all other conditions are met.[79] But where the issuer was doing only ninety-seven percent of its business in the state of the offering, the staff has commented that the question of whether this met the doing business test was "not free from doubt."[80] Such a position obviously goes well beyond the holdings in *Truckee Showboat, Chapman v. Dunn,* and *McDonald Investment Co.,* all of which involved doing most if not all business outside the state of incorporation.[81] One author states that the SEC staff has "regularly insisted that at least eighty percent of the issuer's business exist in and continue within the state,"[82] but cites a response to a no-action letter request where the staff refused to issue the letter because the issuer planned to conduct approximately twenty percent of its operations in another state, stating that the exemption was not available because "a significant portion of the issuer's operations will be conducted outside of California."[83] Other staff rulings seem consistent with an eighty percent test.[84] Whenever an issuer

---

78. *Id.* For the SEC's treatment of the tests of a private offering, *see* Carney, *supra* note 1, at 516 *et seq.*
79. *See, e.g.,* Stratford Employees' Cattle Program, Ltd., *supra* note 32, involving cattle feeding operations entirely within state of Texas. And *see* Pawgan v. Silverstein, 265 F. Supp. 898 (S.D. N.Y. 1967), involving purchase and operation of a hotel in New York.
80. Katz & Besthoff, Inc., 199 BNA SEC. REG. & L. REP. C-2, C-3 (SEC Div. Corp. Fin. April 25, 1973). The staff did state that under these circumstances it would recommend that the Commission take no action if the transaction took place.
81. SEC v. Truckee Showboat, Inc., 157 F. Supp. 824 (S.D. Cal. 1957); Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969); and SEC v. McDonald Inv. Co., 343 F. Supp. 343 (D. Minn. 1972).
82. Hicks, *Intrastate Offerings Under Rule 147,* 72 MICH. L. REV. 463, 480 (1974).
83. *Id.* at 480 n.71, *citing* Pan Agra Cattle Fund, CCH FED. SEC. MICROFILM, roll 2, frame 01621 (SEC Div. Corp. Fin. Jan. 19, 1972).
84. *See* Insurance Fin. Co., 275 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Oct. 30, 1974), permitting the offering where sixteen percent of the issuer's assets were foreign receivables, and SEC no-action correspondence, 93 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Mar. 17, 1971),

has been doing a substantial business in several states, the staff's consistent position appears to have been that the exemption is not available.[85]

Perhaps the most interesting and difficult situations arise when the issuer's only offices are located in the state of the proposed issue, but its assets consist of claims against assets in another state, either in the form of notes or receivables from out-of-state debtors, or securities in foreign corporations. The leading case in this area is *SEC v. McDonald Investment Co.*,[86] which involved a Minnesota corporation offering its own installment notes to Minnesota residents. Its only business office was in Minnesota, but the purpose of the offering was to make loans secured by real estate mortgages to land developers, located mainly outside Minnesota. The court noted that the issuer retained no control over the developer's business, that the loan agreements would be construed according to the law of Minnesota, that interest would be earned in Minnesota, and that Minnesota registration provided investors with all information they might desire.[87] But the court felt itself bound by the results in *SEC v. Truckee Showboat*,[88] and *Chapman v. Dunn*.[89] Since the success or failure of the issuer's business, real estate lending, depended to a large degree on the success or failure of land developments in other states, the court held that the exemption was not available.[90] Since many issuers have interstate receivables or contracts, the ruling was designed to discourage use of the exemption by issuers whose operations were purely local, but who dealt with nonresidents.

SEC staff opinions dealing with issuers holding all the stock of a subsidiary doing business in another state are consistent with the *McDonald* holding, and reasonably take the position that the issuer is doing business in another state

concluding an issuer failed to meet the doing business test where seventy-five percent of its assets and sixty-five percent of its revenues were located in the state of the offering.

85. Hynes & Howes Real Estate, Inc., *supra* note 31, involving a real estate broker with offices in two states.
86. 343 F. Supp. 343 (D. Minn. 1972).
87. *Id.* at 346-47.
88. 157 F. Supp. 824 (S.D. Cal. 1957).
89. 414 F.2d 153 (6th Cir. 1969).
90. 343 F. Supp. at 345.

through its subsidiary.[91] But recent cases involving issuers engaged in commodity trading which deal with Rule 147 take a different approach. One dealing in commodities is dealing in contracts for future delivery of the particular commodity, and where the contracts are traded on a national exchange, it is obvious that the other party to the contract may well be a nonresident of the issuer's state, and in that sense, at least, the success or failure of the issuer's enterprise, to use the test of *McDonald*, is dependent on events outside the state. Certainly the profits which the trader may earn are dependent on events outside the trader's state, such as the weather in various parts of the country, when dealing with grains, or world economic conditions, when dealing with precious metals. But the staff has recently taken the position that a corporation proposing to invest in commodities through a local broker would meet the doing business test under Rule 147, even though more than twenty percent of the trades would be effected on exchanges located outside the state.[92] However, where a commodities trader, doing business through a local branch office of a brokerage firm proposed to maintain over fifty percent of its funds in a segregated account with the broker's Chicago office, the staff concluded that the company was not doing business within the state.[93] Since in both cases what the issuer had was a contract right or a claim presumably enforceable in its home state, it is difficult to see why the physical location of cash should make such a drastic difference in result.

91. The issuer in General Motel Corp., [Transfer Binder 1971-72 Decisions] CCH FED. SEC. L. REP. ¶ 78,332 (SEC Div. Corp. Fin. June 24, 1971), attempted to distinguish its situation from *Truckee Showboat* by showing that while the issuer, an Oregon corporation, owned all of the outstanding stock of a Texas corporation owning a motel in Texas, the issuer proposed to do business solely in Oregon, and to utilize the proceeds solely in Oregon. The staff rejected the claim of an intrastate exemption, apparently concluding the issuer was doing business through its subsidiary in Texas. In Commercial Credit Co., *supra* note 62, the staff took the "single enterprise" approach to the doing business problem, and stated the exemption would not be available to a series of locally organized industrial banks in various states which were owned by a foreign holding company. Since an issuer has total control over the business of a wholly-owned subsidiary, the facts are readily distinguishable from *McDonald*.

92. Robert Enright, [Transfer Binder 1973-74 Decisions] CCH FED. SEC. L. REP. ¶ 79,714 (SEC Div. Corp. Fin. Feb. 11, 1974). *But see* The Consartiom Fund No. 1, 319 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Sept. 5, 1975).

93. National Commodity Traders, Inc., 297 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Apr. 9, 1975).

In summary, the doing business test has always been interpreted in a restrictive manner, not always with logical consistency, to preclude issuers with even slight interstate contacts in their business from making use of the exemption, even when it was clear that all of the issuer's operations were within the state, and the local securities authorities would have full jurisdiction over the issuer.

3. Residence of Offerees and Purchasers

Perhaps the greatest peril to the intrastate exemption is found in the statutory requirement that the entire issue be both offered and sold only to persons resident within the state. The SEC's interpretation of this requirement has been restrictive in the extreme, and has resulted in many observers advising that the exemption should be used not for public offerings within the state, but only for small, relatively "private" offerings.[94] The primary reason for the great caution in using the exemption is that even one offer to a nonresident will destroy the exemption for the entire issue, even though the issuer has proceeded in utmost good faith in attempting to comply with the requirements of the Act.[95]

The difficulty in convincing issuers, their officers and even broker-dealers of the strictness with which this require-

94. Gadsby, *supra* note 11, at 146, states:

> The exemption provided by this section, due to practical considerations, is primarily an exemption for small issues for the simple reason that the offering and sale of a large issue is very apt to fail to meet all of the terms and conditions of the exemption.

And *see* Schneider, *supra* note 49, at 33, and the discussion of the perils of large-scale intrastate offerings in BLOOMENTHAL, at § 4.04[6].

95. Belhumeur v. Dawson, 229 F. Supp. 78 (D. Mont. 1964), and Petersen Engine Co., 2 SEC 893 (1937), involved loss of exemption for a sale to a single nonresident. *See* SEC Securities Act Release No. 5439 (Jan. 8, 1973), [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,168. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2272, pointed out:

> A basic condition of the exemption is that the entire issue of securities be offered and sold exclusively to residents of the state in question. Consequently, an offer to a nonresident which is considered a part of the intrastate issue will render the exemption unavailable to the entire offering.

Cases holding the exemption unavailable because of sales to nonresidents include: Capital Funds, Inc. v. SEC, 348 F.2d 582 (8th Cir. 1965); SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86 (D. N.H. 1958), *modified and aff'd*, 276 F.2d 665 (1st Cir. 1960); SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830 (S.D. Cal. 1960), *aff'd*, 285 F.2d 162 (9th Cir. 1960); Armstrong, Jones & Co. v. SEC, 421 F.2d 359 (6th Cir. 1970), *cert. denied*, 398 U.S. 958 (1970); and Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269 (10th Cir. 1957). None of these cases appear to have involved good faith attempts to comply with the exemption.

ment is enforced is illustrated by repeated and unsuccessful attempts to make offers and sales to nonresidents through resident straw men.[96] Even assuming that sales are carefully policed to assure that purchasers are buying for their own account, that is only the beginning of the issuer's problems with the residence requirement. The SEC staff has taken the position that for individual offerees and purchasers the term "resident" was synonymous with "domiciliary", using the example of military personnel presently residing in the state as persons not qualifying as purchasers.[97] Under this approach it was possible, at least in theory, to sell part of an issue to military personnel who retained domicile in the issuer's state and were stationed elsewhere. Obviously such buyers would have far less opportunity to know the issuer's reputation and business than service personnel presently stationed in the state. The jurisdiction of state securities officials over such transactions seems dubious.

In any event, the determination of a person's domicile can be such a difficult question that it is an issue with which courts and attorneys have been grappling for generations without finding a simple formula.[98] To entrust such determinations to officers of an issuer in urgent need of cash for survival, or to securities salesmen dependent on sales commissions for their livelihood almost assures some mistakes in judgment which will be fatal to the entire offering. These problems alone have made it extremely difficult to police an

96. Belhumeur v. Dawson, *supra* note 95; Stadia Oil & Uranium Co. v. Wheelis, *supra* note 95; Capital Funds, Inc. v. SEC, *supra* note 95.
97. McCauley, *supra* note 11, at 946. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2274, states in part: "Section 3(a)(11) requires that the entire issue be confined to a single state in which the issuer, the offerees and the purchasers are residents. Mere presence in the State is not sufficient to constitute residence as in the case of military personnel at a military post." SEC Securities Act Release No. 5349 (Jan. 8, 1973), [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶79,168, at 82,547, proposing Rule 147, stated the SEC's past position: "The residence of individuals has usually been considered to mean their domicile rather than a temporary residence."
98. The intricacy of the domicile question is obvious from the extensive treatment given it by authors in the conflicts of law area: RESTATEMENT (SECOND) OF CONFLICTS OF LAWS §§ 10-24 (1971); WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS ch. 2, at 8-38 (1971); LEFLAR, AMERICAN CONFLICTS LAW ch. 2, at 15-32 (student ed. 1968); REESE & ROSENBERG, CONFLICT OF LAWS, CASES AND MATERIALS ch. 2, at 8-64 (6th ed. 1971); SCOLES & WEINTRAUB, CASES AND MATERIALS ON CONFLICT OF LAWS ch. 2, at 13-57 (2d ed. 1972); CHEATHAM, GRISWOLD, REESE & ROSENBERG, CASES AND MATERIALS ON CONFLICT OF LAWS ch. 2, at 10-91 (5th ed. 1964).

intrastate offering of any size, and when large-scale financings have been attempted on an intrastate basis, the results have frequently been disastrous.[99]

Where the offerees or purchasers are corporations, partnerships or trusts, the Commission has taken the position that such organizations are resident in the state where they are organized, which is a simpler approach than was taken for issuers.[100] As in the case of private offerings, the Commission has taken the position that sales may be made to bona fide trusts and partnerships with nonresident beneficiaries or partners, but sales may not be made to such entities when they are formed solely for the purpose of providing a conduit to nonresident investors.[101] These rules are relatively simple to comply with, especially when they are compared with the domicile requirement for individuals, and should cause careful issuers little trouble.

The Commission has taken the position that an underwriter of an intrastate offering need not be a resident of the state, provided all of the securities ultimately are distributed to residents.[102] Use of a nonresident underwriter does involve the risk that part of the issue may remain unsold and in the hands of the underwriter, if a firm underwriting

---

99. Large-scale financings are discussed in BLOOMENTHAL, at § 4.04[6]. The principal problem discussed there is with subscription agreements which extend over time, and give the buyer the right, but not the obligation, to purchase additional securities at dates in the future. Even if the seller's agent has been careful in investigating the domicile of the purchaser at the time the initial sale is made, there is the likelihood that some of the buyers will move before they have completed all of their purchases, and the subscription, or "plan" will be treated as a continuing offer, which now extends to a nonresident. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2274, warned that "An offering may be so large that its success as a local offering appears doubtful from the outset."

100. SEC Securities Act Release No. 5349 (Jan. 8, 1973), [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶ 79,168. Thus a corporate offeree organized in the issuer's state will apparently qualify even though most of its business is done in some other state.

101. An example of an unsuccessful attempt to create a trust to serve as an investment vehicle for a group of investors including some non-residents is ContROLL Awnings, Inc., [Transfer Binder 1973 Decisions] CCH FED. SEC. L. REP. ¶ 79,333 (SEC Div. Corp. Fin. April 11, 1973).

102. SEC Securities Act Release No. 4434, (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270, at ¶ 2275. Bloomenthal suggests this is because the Section 2(3) definition of a sale "excludes *preliminary negotiations or agreements between an issuer . . . and any underwriter*." BLOOMENTHAL, at § 6.07. He further suggests that "preliminary" modifies only the word "negotiations" and not the word "agreements", so that all underwriting agreements would be excluded from the definition of sale.

is involved. If the underwriter is attempting a placement to a small group of investors in the issuer's state, it is likely that only a best efforts underwriting will be involved, and the risk of such a violation is eliminated.

Finally, the distribution must be completed in the hands of resident investors, which means that no reoffers or resales to nonresidents can take place until the entire issue has "come to rest" within the state. This requirement creates the most difficulty with larger issues, and the frequency with which resales to nonresidents have been found to destroy the exemption illustrates the difficulty with policing reoffers and resales. Resales have taken place from a few days[103] to a few months[104] after the initial sales, and have in all cases been found to destroy the exemption.

The question of when an issue has "come to rest" is a subjective one, depending on the intent of the initial purchasers. Nevertheless, since its earliest ruling the Commission has taken the position that the securities must stay in the hands of resident investors for a period of one year after completion of the initial sales. This was based on the statutory distinction first drawn in the Securities Act beween distributions and trading transactions, which exempt-

103. The earliest case under the exemption was Brooklyn Manhattan Transit Corp., 1 SEC 147 (1935), where four local underwriters purchased the entire issue, but within two trading days some of the bonds had found their way into the hands of nonresidents, and within a few months fifteen percent of the issue was held by nonresidents, and it was proposed to begin unrestricted trading on the New York Stock Exchange. The same issue prompted the FTC to issue a warning in Securities Act Release No. 201 (July 20, 1934), CCH FED. SEC. L. REP. ¶2255, which stated that the exemption would be tested on the basis of the ultimate distribution after completion of any secondary distribution by the underwriters. In SEC v. Hillsborough Inv. Corp., *supra* note 95, resales were made to nonresidents after a thirty day waiting period, while in Stadia Oil & Uranium Co. v. Wheelis, *supra* note 95, a broker took shares in his own name without paying for them, and began resales about a month later, retaining part of the proceeds as his commission. To a claim of intrastate exemption, the court responded, "This naive argument could not appeal even to the most credulous." *Id.* at 274. In Capital Funds, Inc. v. SEC, *supra* note 95, some sales to nonresidents were asserted to be resales by a securities salesman who discovered that he could not pay for the securities, although the evidence, including the numbers of the certificates issued to the salesman and to the nonresidents, suggested a direct sale rather than a resale.

104. Armstrong, Jones & Co., v. SEC, *supra* note 95, involved a securities salesman who solicited orders for a stock from nonresidents immediately after the commencement of trading in the stock, although the statement of facts in the case does not state how long that was after completion of the initial sales. Ned J. Bowman Co., 39 SEC 879 (1960), involved resales to nonresidents the following month.

ed dealer transactions after one year from the first sale of the security.[105] Dealer transactions are now exempt forty days after the offering of an issue by an issuer having previously registered under the Act, and ninety days after the offering of a first registered offering by an issuer. Based on this it has been suggested that since Congress has shortened the periods during which securities are deemed to be in distribution, the waiting period for resales of an intrastate issue should be shortened accordingly. The SEC, however, has not accepted the suggestion.[106]

From the standpoint of a small new issuer, the one year restriction on resales to nonresidents did not present a serious problem, since a small local issuer is hardly likely to generate widespread interest in the first year after an intrastate offering. The requirement that resales be limited for one year to local residents was preferable to the restrictions on purchasers encountered under the alternative private offering exemption. As a result, at least one author took the view that the intrastate exemption, with resales available to residents, was preferable to the private offering exemption.[107] Where the offering was a small one and could

105. In Brooklyn Manhattan Transit Corp., *supra* note 103, at 162-63, the Commission noted that the question of when a distribution is completed is a question of fact in each case, but then stated:

> As already noted, the Securities Act incorporates in Section 4(1) [now § 4(3)] a presumption that sales by dealers within a period of one year from the first date upon which the security was bona fide offered to the public by the issuer or by or through an underwriter are a part of the distribution of the issue. That presumption which Congress adopted should be applied here, not, however, as a conclusive presumption of law, as in the third clause of Section 4(1) of the Act, but as a presumption of fact subject to refutation upon a showing of fact that distribution was completed within less than one year.

106. Securities Act of 1933, § 4(3), 15 U.S.C. § 77d(3) (1970). For a discussion of the possibility of urging a forty or ninety day waiting period before resales to nonresidents, *see* Schneider, *supra* note 49, at 31. Despite the SEC's early suggestion that the one-year waiting period was only a rebuttable presumption, and SEC releases which did not suggest a rigid approach, *see* SEC Securities Act Release No. 1459 (May 29, 1937), CCH FED. SEC. L. REP. ¶2260, at ¶2262, and SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶2270, at ¶2275, Schneider reports that a one year waiting period was the SEC staff position in 1970. At 29 n.19. The one year waiting period was assumed to be a safe waiting period by a state court hearing a fraud suit in Myer v. E. M. Adams & Co., 268 Ore. 91, 511 P.2d 841, 843 (1973). It would have been more accurate to say a rebuttable presumption was created which had wide currency, but there was always a risk, particularly with a slow and only partially successful distribution, that the distribution had not yet been completed.

107. Mandel, *Intrastate vs. Private Offering: The Advantages of Focusing on an Often Blurred Distinction*, 46 L. A. BAR BULL. 101 (1971).

be policed properly, that view now seems clearly correct. But for offerings of substantial size, the difficulties in policing resales could be insuperable, especially in view of the fact that even one reoffer to a nonresident would destroy the exemption, and the fact that the Commission would look to domicile, rather than the layman's view of residence, as the test.

By the 1970's the general view was that the intrastate exemption had become so dangerous that it was virtually useless for issues of any size, and most authors were beginning to regard it as a dead letter. This view was summarized in comments to the First Tentative Draft of the American Law Insitute's Federal Securities Code:

> (4) *Intrastate issues:* Sec. Act § 3(a)(11) exempts "Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory." The Commission, with help from the courts, has taken a very hard view of this exemption: (a) The word "resident" has been construed to mean "domiciled" in the conflict-of-laws sense. (b) If a single unit of the issue is *offered* (let alone sold) to a non-resident, the exemption is destroyed for the entire issue. (c) The issuer must not only be incorporated in and doing business *in the same state* but also be doing a *predominant part* of its business in that state. (d) No matter how carefully the issuer checks on the residence (i.e., domicile) of each offeree, the exemption is lost if the issuer makes one mistake, and absolute civil liability results under § 12(1). (e) Even though all the offerees and buyers are domiciled in the State, the securities cannot be resold immediately to nonresidents; there is no fixed holding period, but the securities must "come to rest" in the hands of residents.[108]

Indeed, the Code seemed to presage the death of the intrastate exemption, since it was omitted entirely from the

108. ALI FED. SEC. CODE § 301 at 74-75 (Tent. Draft No. 1, 1972).

Code drafts.[109] The proposal of Rule 147 within a few months of the first draft of the Code at least gave pause to those who predicted the death of the exemption, although many felt the rule did little to revive it.[110]

B. *Rule 147*

On January 8, 1973, the Commission invited public comment on proposed Rule 147. In the accompanying release, the Commission explained the purpose of the proposed rule:

> The Commission is aware that there are many public offerings of securities made in reliance on the exemption from registration provided by Section 3(a)(11). However, some issuers may not be familiar with the the administrative and judicial interpretations of that Section, and therefore, may be relying on it mistakenly. Moreover, the Commission believes that local businesses seeking financing solely from local sources should have objective standards to facilitate compliance with Section 3(a)(11) and the registration provisions of the Act.[111]

The final version of the new rule codified and to that extent clarified some of the administrative interpretations of the rule.[112] To the disappointment of many, the Commission adhered to a large extent to what many thought were overly restrictive interpretations, and it did not eliminate the requirement that failure to comply strictly with all of the conditions of the rule made it unavailable.

While the rule did not liberalize the previous requirements for the exemption, it did not substantially tighten them, as did Rule 146 and a series of recent cases involving the private offering exemption,[113] and, at least by comparison with the private offering exemption, Rule 147 now looks

109. *Id.* at §§ 301-02. But the Code gives the Commission the power to promulgate additional exemptions. *See* ALI FED. SEC. CODE § 302 (Tent. Draft No. 4, 1975).

110. *See, e.g.,* Coles, *Has Securities Law Regulation in the Private Capital Markets Become a Deterrent to Capital Growth: A Critical Review*, 58 MARQ. L. REV. 395 (1975); Cummings, *supra* note 7; Gardnier, *supra* note 7; Kant, *supra* note 7; Kessler, *supra* note 7; and Sowards, *supra* note 7.

111. SEC Securities Act Release No. 5349 (Jan. 8, 1973), [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶ 79,168, at 82,546.

112. *See* SEC Securities Act Release No. 5450 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶2340, adopting Rule 147, 17 C.F.R. § 230.147 (1975).

113. *See* cases discused in Carney, *supra* note 1, at 526-40.

relatively more attractive to small promotional issuers than it did a few years earlier. In this regard, it may be safe to say that the reports of the death of the intrastate offering exemption have been greatly exaggerated.[114]

Like Rule 146, Rule 147 is designed to provide a "safe harbor" under Section 19(a) of the Act, protecting issuers from liabilities under the Act if they have fully complied with all conditions of the rule.[115] The introductory notes to Rule 147, as well as Subsection (a) of the rule, make it clear that the exemption will only be available if all of the conditions of the rule are met with respect to each and every transaction (both offers and sales) which will be integrated as a part of the same "issue".[116] Thus the rule carries the same kind of trap which is present to a lesser extent in Rule 146; one mistake will destroy the exemption for an entire series of transactions, and expose the issuer to liability for all of the sales which have taken place as part of the issue, even though, with respect to the other sales, the issuer is entirely free from fraud and has complied fully with the rule. This, coupled with a lack of any excuse for good faith substantial compliance, has led many commentators to conclude that the rule does little to assist issuers who might wish to rely on the intrastate exemption for transactions of any size. With this the author agrees; it is dangerous, to say the least, to attempt to rely on Rule 147 for large intrastate

114. *Cf.*, Clemens, Cable from Europe to the Associated Press, *reprinted in* II PAINE, MARK TWAIN: A BIOGRAPHY 1039 (1912).

115. Securities Act of 1933, § 19(a), 15 U.S.C. § 77s(a) (1970), provides in part:

> No provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason.

116. Preliminary Note 3 to Rule 147 states in part:

> All offers, offers to sell, offers for sale, and sales which are part of the same issue must meet all of the conditions of Rule 147 for the rule to be available.

The note then quotes the criteria from Release No. 4434 which will be applied in determining which transactions are part of the issue, noting that "*any one or more of the . . . factors may be determinative.*" Paragraph (a) of the rule provides that transactions made in accordance with all of the terms of the rule shall be deemed to be a part of an issue exempt under Section 3(a)(11). And see Preliminary Note 3: "All of the terms and conditions of the rule must be satisfied in order for the rule to be available."

offerings, such as real estate syndications of the type for which the intrastate exemption has been used in the past. But the rule, like the administrative and judicial interpretations of Section 3(a)(11), may still have utility for the smaller offering in a small community to persons previously known to the issuer. If this is so, it may be that Rule 147 represents a considered attempt by the SEC to limit the use of the intrastate exemption to very small financings, an area where the private offering exemption once predominated.

Rule 147, like Rule 146, is available to issuers only. The Section 3(a)(11) exemption is not limited to issuers, but has been available to shareholders for secondary offerings, where the issuer meets the requirements of the statute.[117] The Commission's failure to make Rule 147 available for secondary offerings represents a further step in the effort to restrict the exemptions to issuers, and to discourage secondary distributions under this or any other exemption, except Rule 144.[118]

The major difference between Rules 146 and 147, in terms of risk of liability, is that while Rule 146 allows some of its conditions to be satisfied by good faith belief and good faith investigation, Rule 147 makes the issuer the insurer that all conditions have been fulfilled. The recent amendments to Rule 146,[119] which provide that the issuer must only have reasonable grounds to believe and, after making reasonable inquiry, shall believe that there are no more than thirty-five purchasers, evidence an attempt to make Rule 146 more useful to issuers and to respond to some of the criticisms of the rule. No such amendments have been proposed for Rule 147, which retains its absolute requirements. For many issuers contemplating offerings to persons presently unknown to them, the absolute nature of these requirements

117. See discussion *supra*, text at note 64.

118. Securities Act Rule 144, 17 C.F.R. § 230.144 (1975).

119. Securities Act Rule 146, 17 C.F.R. § 230.146 (effective June 10, 1974), *as amended*, SEC Securities Act Release No. 5585 (May 7, 1975), [1974-75 Transfer Binder] CCH FED. SEC. L. REP. ¶80,168. The amendment requiring only a reasonable belief concerning the number of purchasers was to Rule 146(g). Rule 146(a)(1) only requires issuers to have a reasonable belief in the qualifications of offeree representatives and Rule 146(d) requires only reasonable belief concerning qualifications of offerees.

will discourage them from utilizing Rule 147, just as they are discouraged from using the intrastate exemption.[120]

1. Part of an Issue

Major progress has been made in delineating which offerings will be integrated into a single "issue". From an initial proposal to integrate automatically all offerings and sales of any kind made by an issuer within six consecutive months,[121] the Commission backed off to a recital of the factors mentioned in Release No. 4434[122] as determinative of when various offers and sales should be integrated and to a six-month "safe harbor" from integration.[123] Rule 147, like Rule 146, adopts a six-month waiting period between offerings as a safe harbor—a definite time limit which will protect against integration, even if all of the previous integration tests other than proximity in time are met.[124] Second, the rule, like Rule 146, adopts the approach of the ALI Federal Securities Code that offerings of different classes of securities will not be integrated even if other traditional integration tests are satisfied.[125]

---

120. Again the contrast with Rule 146 in this area is dramatic. Under Rule 146(d)(1) no investigation is required before an initial offer can be made, and if an issuer later determines, after making the reasonable inquiry required by Rule 146(d)(2), that an offeree is not in fact qualified under the rule, negotiations can be terminated without destroying the exemption. It is difficult to see why a similar approach would not be appropriate under Rule 147, since only sales, not mere offers, can cause investors harm.

121. As initially proposed in SEC Securities Act Release No. 5349 (Jan. 8, 1971), Rule 147(b) read in part:

> For purposes of the Rule, all securities, other than those exempt pursuant to Section 3(a) of the Act, of the issuer, its affiliates, and predecessors, offered, offered for sale or sold by the issuer, its affiliates and predecessors within any consecutive six-month period shall be deemed to be part of the same issue; . . .

184 BNA SEC. REG. & L. REP. F-3-4 (Jan. 10, 1973).

122. Preliminary Note 3 to Rule 147 states in part:

> The determination whether offers, offers to sell, offers for sale and sales of securities are part of the same issue (*i.e.*, are deemed to be "integrated") will continue to be a question of fact and will depend on the particular circumstances.

See SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶ 2270.

123. 17 C.F.R. § 230.147(b)(2) (1975).

124. Rule 147(b)(2) and Rule 146(b)(1) contain substantially identical provisions concerning integration.

125. ALI FED. SEC. CODE § 267 (Tent. Draft No. 1, April 25, 1972), defines an "offering" (the substitute for "issue" in the present law) as follows:

> (a) "Offering" is used in the sense that (1) offers of securities of different classes are separate offerings, and (2) offers of securities of the same class (whether by or for the account or benefit of the issuer or any other person) are separate offerings only if they are substantially distinct on the basis of such factors as

The approach taken by Rule 147 to integration, limiting the offerings which may be integrated to those of the same or similar classes of securities, means that an issuer may more freely offer notes pursuant to a private placement to institutions and equity securities in an intrastate offering.[126] This represents a significant advance in flexibility for issuers under the exemption. The only serious risk is that a single plan of financing involving several classes of stock may be regarded as a plan or scheme to make interstate offers or sales, which finding would render the rule unavailable.[127] Such treatment would frustrate the stated policy of providing greater certainty for issuers, however.

Rule 147 also takes a significant step toward greater certainty in eliminating the possibility that an issuer's offers will be integrated with a secondary offering. The six-month safe harbor provision of Section (b)(2) of the rule states that securities of the issuer sold or offered more than six months prior to or after any transactions under the rule shall be deemed not to be "part of an issue" sold under the rule, provided that during each of the six-month periods there are no offers or sales of securities "by or for the issuer of the same or similar class as those offered . . . ."[128] The reference to sales by or for the issuer presumably excludes secondary offerings made by stockholders who may be statutory underwriters, as long as they are not selling for the

---

> the manner, time, or purpose of the offerings, the offering price, or the kind of consideration.

The second portion of the definition substantially reflected existing law as stated in Release No. 4434, with the addition of a test of whether the offering price of the securities was substantially distinct.

126. Contrast the staff position in Eastern Ill. Tel. Corp., *supra* note 32, which did not integrate offerings of subordinated sinking fund debentures and first mortgage bonds made within six months of each other, with Property Inv. Inc., *supra* note 31, where the staff integrated offerings of promissory notes and common stock made about the same length of time apart. Some observers have felt that such offerings of distinctively different classes of securities were separate "issues" even before the adoption of Rule 147. *See* BLOOMENTHAL, § 4.14[6].

127. Preliminary Note 3 to Rule 147 provides in part:

> Finally, in view of the objectives of the rule and the purposes and policies underlying the Act, the rule shall not be available to any person with respect to any offering which, although in technical compliance with the rule, is part of a plan or scheme by such person to make interstate offers or sales of securities. In such cases registration pursuant to the Act is required.

128. Securities Act Rule 147(b)(2), 17 C.F.R. § 230.147(b)(2) (1975).

issuer. Under some circumstances such secondary offerings may be integrated to destroy an exemption for an issuer,[129] which raises the insoluble problem of how an issuer can know that offers are not being made by a stockholder at a time when the issuer begins what it believes is an exempt offering.

2. The Nature of the Issuer

a. *Residence.* With respect to corporations, residence is determined under Rule 147(c) on the basis of the state of incorporation. This approach reflects existing law. The rule also provides that limited partnerships and trusts shall be deemed residents of the state in which they are organized. This provision also appears to reflect existing Commission interpretation of the law. The rule does not deal with the problem of residence of the issuer where a nonresident promoter who will be the general partner is selling interests in a limited partnership which will be organized after the interests have been sold, and leaves unchanged the existing law that in such cases the promoter is the issuer of preorganization subscriptions.[130] The rule does resolve the problem of general partnerships in a manner favorable to issuers by treating such partnerships as resident in the state where the principal office of the partnership is located, regardless of the residence of the individual partners.[131] Whether this represents a concession to issuers depends on whether this means that in the future the SEC will regard partnership interests in general partnerships as securities, a question which has been the subject of considerable doubt.[132]

---

129. *Cf.*, Value Line Fund, Inc. v. Marcus, *supra* note 27. Note that under Section 2(11) of the Act, controlling shareholders are included in the definition of an issuer for purposes of determining who is an underwriter.
130. The staff recently confirmed this in interpretative correspondence. Helmut Petroleum Corp., *supra* note 59.
131. Grenader v. Spitz, *supra* note 59, after reviewing the Rule 147 approach to a general partnership, reached the same conclusion.
132. Professor Loss takes the position that while limited partnership interests are securities, a bona fide interest as a general partner is not. 1 LOSS, SECURITIES REGULATION 503-06 (2d ed. 1961). Bloomenthal notes the question seems to turn on whether a bona fide general partnership is contemplated where the investor will have an active part in management. BLOOMENTHAL at § 2.12[1]. An extended discussion of the problem can be found in Long, *Partnership, Limited Partnership, and Joint Venture Interests as Securities*, 37 MO. L. REV. 581 (1972). The analysis in that article suggests whether a security is involved in a general partnership interest depends on whether the partnership interest will carry with it participation in the active management of the business. In no-action correspondence previously referred to, the staff apparently agreed with

Land & Water Law Review, Vol. 11 [1976], Iss. 1, Art. 6

b. *Doing business.* The doing business test of Rule 147 (c)(2) has codified the eighty percent test which the SEC staff had previously developed in interpreting Section 3(a) (11). This interpretation represents a requirement well beyond that of prior case law.[133] The eighty percent test applies to revenues, assets and use of proceeds.[134] As initially proposed, the rule received considerable criticism because it was thought few issuers would have so little interstate business that they would be able to qualify under the rule.[135] In adopting the eighty percent revenue test in the final version of the rule, the Commission went to considerable lengths to make it clear that an issuer with operational headquarters within the state can do substantial interstate business and still meet the revenue test.[136] Thus a company, with its only warehouse, manufacturing plant and office in its state of incorporation, doing a mail order business throughout the United States, will be treated as meeting the eighty percent test provided all orders are filled at and shipped from its warehouse within the state.[137] Another example suggests

the position of the issuer's counsel that a general partnership interest was not a security, even though the letter from the issuer's counsel did not discuss the question of whether a proposed partner would have management control, or actual participation in management. Louisiana Motor Inns, *supra* note 56. *But see* Pawgan v. Silverstein, *supra* note 79, holding general partnership interests to be securities, apparently agreeing with the thesis of Bloomenthal that where general partners in a real estate syndicate have no real management control, the "venture was not a general partnership in the accepted sense," 265 F. Supp. at 900, and the interests were thus securities.

133. In support of an eighty percent "doing business" test, both SEC Securities Act Release No. 5349 (Jan. 9, 1975), [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶ 79,168, at 82,548, introducing the proposed rule, and SEC Securities Act Release No. 5450 (Jan 7, 1974), CCH FED SEC. L. REP. ¶ 2340, at 2611-3, adopting Rule 147, cite Chapman v. Dunn, *supra* note 81, where all of the fractional undivided oil and gas interests were outside the issuer's state, and in support of an eighty percent use of proceeds test, SEC v. Truckee Showboat, Inc., *supra* note 81, where all proceeds were to be used outside the state.

134. Securities Act Rule 147(c)(2), 17 C.F.R. § 230.147(c)(2) (1975). The staff is applying a strict construction of this requirement. Having only 79.8% of the issuer's assets located within the state is not enough. No rounding off to 80% was permitted in Berkley & Co., Inc., 325 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Oct. 16, 1975).

135. *See* Cummings, *supra* note 7, at 191-92; Kant, *supra* note 7, at 83-87; and Sowards, *supra* note 7, at 444. *But see* Gardiner, *supra* note 7, at 361-66; and Hicks, *supra* note 82, at 479-83.

136. SEC Securities Act Release No. 5450 (Jan. 7, 1974), CCH FED. SEC L. REP. ¶2340.

137. *Id.* at ¶2611-5. *But see* The Consartium Fund No. 1, *supra* note 92, where the staff concluded a limited partnership investing in art would not be "doing business" in Michigan if it bought its art at major auction houses in London and New York, even though the art would be stored in Michigan, where all the partnership activities would take place.

that businesses involved in rendering personal services, such as engineering consultants, will meet the eighty percent test where employees of the company spend twenty-five percent of the total man hours outside of the home office, and the company derives fifty percent of its gross revenues from clients located outside the issuer's home state.

These examples and others in the release suggest that the crucial test is not the source of the revenues or assets, but the operational headquarters.[138] Thus the staff suggested that even where twenty-five percent of an issuer's assets represent accounts receivable from clients in another state, the issuer will still satisfy the eighty percent of assets test, reasoning that accounts receivable arising from a business conducted in the state would be considered to be located at the principal office of the issuer.[139] This appears to represent a departure from *SEC v. McDonald Investment Co.*,[140] where the district court held the exemption unavailable for an issue of corporate notes where the issuer's business was making loans to out-of-state land developers. *McDonald* noted that the success of the issuer's business depended on the success of out-of-state real estate developments, but whenever an issuer has substantial receivables its success depends to a certain extent on the success and continuing solvency of its debtors. Under these Rule 147 interpretations the defendant in *McDonald* could meet the gross assets test, since receivables and notes are virtually indistinguishable in terms of their location, and since the notes in *McDonald* were payable in and governed by the law of Minnesota, the issuer's home state.[141] To the extent *McDonald* had operations, pre-

138. A recent staff interpretation confirms that a coin dealer engaging in "substantial" purchases and sales of coins outside the state of incorporation meets the "doing business" test provided the inventory is kept at its home office. CoinVest, Inc., [Transfer Binder 1973-74 Decisions] ¶ 79,823 (SEC Div. Inv. Mgmt. Reg. June 10, 1974). And *see* HR-10 Master Plan & Group Trust of Md. Nat'l Bank, [Transfer Binder 1974-75 Decisions] CCH FED. SEC. L. REP. ¶ 80,087 (SEC Div. Corp. Fin. Dec. 6, 1974), approving purchase of NYSE listed securities. *But see* The Consartium Fund No. 1, *supra* note 92.

139. CoinVest, Inc., *supra* note 138. And *see* Provident Credit Corp., 328 BNA SEC. REG. & L. REP. C-1-2 (SEC Div. Corp. Fin. Nov. 6, 1975), where half of lender's loans were to nonresident consumers for the purchase of automobiles. Presumably the lender's security interest would be recorded in the foreign state, but the staff looked to the issuer's operational headquarters.

140. 343 F. Supp. 343 (D. Minn. 1972).

141. *Id.* at 346-47. And *see* Provident Credit Corp., *supra* note 139.

sumably conducted at its home office, the interpretations of Rule 147 suggest that interest earned on the notes was revenue from operations conducted at the home office. This operational approach represents a significant broadening of the SEC's previous position on the question of the source of revenues.

Rule 147 provides specific guidelines concerning the accounting periods to be used in calculating whether gross revenues and assets meet the tests imposed, thereby providing certainty where little existed before. Certainty appears to require precise compliance.[142] For the issuer with poor accounting records, this may present a problem. If the question is a close one, the issuer might well have found itself in difficulty in any event, and would have been ill-advised to proceed without sufficient documentation to meet the standards which had previously been suggested by staff interpretations.

A question which formerly troubled issuers involves what happens if, during the course of the offering, the issuer discovers from its latest financial reports that it no longer meets the eighty percent test, either on revenues or assets? Previously Commission interpretations of the statute gave no indication whether an issuer must continue to meet the doing business test at all times during the course of an issue, which might include resales deemed part of the "distribution." In the only case on this question prior to the adoption of the rule, the SEC staff was reported to have taken the position that acquisition of a corporation doing a substantial business in another state made the exemption unavailable for future sales, although at the time sales of the issue began the issuer did no business in any other state.[143]

142. Rule 147(c)(2) requires an issuer to meet the eighty percent doing business test for its most recent fiscal year if the first offer under the rule is made during the first six months of its fiscal year, and where the offering is made in the last six months, allows the issuer to choose either the first six months of that fiscal year or the twelve month period ending with the first half of the present fiscal year, in recognition of the seasonal character of some businesses. SEC Securities Act Release No. 5450, at 6 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶ 2340, at 2611-5.

143. Tait v. North America Equitable Life Assur. Co., 92 Ohio L. Ab. 551, 25 Ohio Op. 2d 451, 194 N.E.2d 456 (C.P. 1963), *aff'd per curiam*, 195 N.E.2d 128 (Ohio App. 1963), *appeal dismissed*, 176 Ohio St. 240, 199 N.E.2d 3 (1964). The action was brought as a breach of contract by an Ohio under-

Using integration, if a single sale or offer were made after the change in circumstances, presumably the exemption for previous sales was lost. Under the rule it may not be necessary to stop sales in such circumstancs, since the measuring dates are keyed to the date of "the first offer of any part of the issue."[144] In light of the restrictive view taken of the exemption in the past by the staff, it would be wise to obtain a staff interpretative ruling before relying on the literal language of the rule for subsequent sales. At the present time this provision appears to add a greater element of certainty for issuers contemplating an offering which may extend over more than one accounting period. They will be able to complete the offering under the rule, regardless of what changes may occur in the nature of their business, provided they can meet the use of proceeds test of the rule.

In addition to a helpful clarification of the place of interstate business in the test, the Commission added to the final version of the rule an exemption from the doing business requirement for issuers which have not had gross revenues in excess of $5,000 from the sale of products or services or other conduct of the business during the most recent twelve month fiscal period. While it might have been possible for the Commission to suggest that the exemption of such issuers from this test threw them back on the uncertain rules which had been developed prior to the adoption of the rule, the Commission again took the opposite approach and liberalized the application of the rule:

> Finally, subparagraph (c) (2) of the rule provides that an issuer which has not had gross revenues from the operation of its business in excess of

writer of a proposed intrastate offering of an insurance company organized under the laws of Ohio. The offering was to take place over a three year period, and during that time the issuer acquired an insurance company doing business in Maryland. The SEC staff warned officials of the issuer that the intrastate exemption would no longer be available, and that further sales would be regarded as a willful, and thus criminal, violation of the securities laws. As a result the issuer stopped sales of its securities.

144. Rule 147(c)(2) keys the gross revenue tests to this date in subparagraph (i), while the assets test of subparagraph (ii) is keyed to the same date. A detailed treatment of the time periods when revenues and assets are to be tested under the rule can be found in Hicks, *supra* note 82, at 482-83.

> $5,000 during its most recent twelve month period need not satisfy the revenue test of subsection (c) (2) (i).[145]

Thus the rule will be available to newly organized issuers which may have made isolated sales outside the state constituting more than twenty percent of total sales to date, but which really represent a de minimis portion of contemplated business, if the offering is successful. This exemption applies only to past revenues, and not to the location of assets or the use of proceeds. While the revenue test may continue to present complex problems of interpretation for larger and more established issuers, for the small, truly local business the test should be a manageable one.[146]

The use of proceeds test imposed by the rule differs little from existing Commission interpretations of Section 3(a)(11), requiring that

> (iii) the issuer intends to use and uses at least 80% of the net proceeds to the issuer from sales made pursuant to this rule in connection with the operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory; . . .[147]

145. SEC Securities Act Release No. 5450, at 6 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶ 2340, at 2611-5.

146. Some of the problems raised by the test are well treated in Hicks, *supra* note 82, at 479-83, 492-94; Gardiner, *supra* note 7, at 361-66; and Comment, *A New Approach to the Intrastate Exemption: Rule 147 vs. Section 3(a) (11)*, 62 CALIF. L. REV. 195, 208-11 (1974). Since the focus of this article is on the small, often new issuer, it would unduly extend its length to discuss in detail problems fully discussed by other authors.

147. Securities Act Rule 147(c)(2)(iii), 17 C.F.R. § 230.147(c)(2)(iii) (1975). It was noted earlier that an eighty percent requirement for use of proceeds goes well beyond the holding in SEC v. Truckee Showboat, Inc., *supra* note 81. A further indication of liberalization of Commission attitudes is evident in staff approval of use of the proceeds to pay past due mortgage indebtedness and past due equipment lease indebtedness to an out-of-state bank, where the issuer's sole business was operation of a motel within the state where the Rule 147 sale was proposed. Pilgrim Inns, Inc., 296 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. April 2, 1975). But where the bulk of the proceeds of a limited partnership offering to make a movie within the state of Alabama were to be paid to a Florida corporation serving as producer, and some of the final editing, cutting and printing of the film would take place in Florida, the staff took the position that filming a substantial portion, but not all, of the film in Alabama was not enough to meet the "doing business" test of Rule 147. Thornton, Farish & Gauntt, Inc., 299 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. April 23, 1975). Such a result is consistent with an operational approach to the doing business test.

The use of the term "net proceeds" makes it clear that payments to out-of-state underwriters, accountants and attorneys will not be counted against the twenty percent which can be spent outside the issuer's home state. For a small issuer at an early stage in its existence, it is likely that expansion will not yet be contemplated much beyond the home state's borders, at least in terms of plant and facilities. While the issuer may contemplate making more than twenty percent of its sales in interstate commerce, it is unlikely that use of proceeds for plant and facilities at an early stage will require a substantial investment in property which will be located outside the home state. Provided sales orders are filled at the principal office in the state, the rule should allow an issuer to spend part of the proceeds on an advertising and promotional campaign which will be interstate in nature. Such expenditures should be treated as being made in connection with the operation of a business within such state or territory, even where proceeds are paid to media located outside the issuer's home state. This is an area where staff interpretation would be beneficial.

Rule 147 takes a restrictive view towards use of proceeds in requiring eighty percent to be used "in connection with the operation of a business" within the state, since the issuer may be contemplating a small expansion in another state and currently have all its assets located in the state of the offering.[148] The result may be a requirement that in such cases the issuer will have far more than eighty percent of its assets located in the state of the offering after the issue. One author has suggested that a test more consistent with the spirit of the exemption would be a requirement that eighty percent of the issuer's assets be located in the state of the offering both before and after the issue.[149] The Commission's choice of the more restrictive approach demonstrates its intention to restrict the exemption to relatively small issuers as well as to small offerings.

148. Securities Act Rule 147(c)(2)(iii), 17 C.F.R. § 230.147(c)(2)(iii) (1975). This requirement is curiously phrased, and could be read to require the issuer to continue to meet the 80% revenue test after the offering, or at least until its completion, which would erode the certainty of the rule. *But see* HR-10 Master Plan & Group Trust of Md. Nat'l Bank, *supra* note 138.
149. Gardiner, *supra* note 7, at 364-65.

3. Residence of Offerees and Purchasers

Section 3(a)(11) limits the exemption to issues both offered and sold to persons resident within the state. The Commission took the position that general advertising was permitted so long as it was limited by its terms to persons resident within the state.[150] Apparently this was based on the reasoning that such an offer creates no power of acceptance in a nonresident, and thus is not an offer to such a person.[151] Rule 147 is silent on the question, simply providing that all offers and sales must be made to persons resident within the state.[152] The rule does not indicate any intent to depart from previous practice in this respect, nor did the releases accompanying the proposed and final versions.[153] The release proposing the rule stated that the rule would codify only certain of the Commission's interpretations of the exemption, presumably leaving others unchanged.[154]

The rule requires, in paragraph (f), that the issuer take precautions both against initial sales and resales to nonresidents, but full compliance with these requirements does not assure satisfaction of the conditions of the rule relating to sales to nonresidents in paragraph (d) or to resales in paragraph (e). Thus full compliance by the issuer with the conditions of the rule is no assurance that the exemption will be available, since it can be destroyed by a purchaser at any time up to nine months after the last sale by the issuer.

150. SEC Securities Act Release No. 4434 (Dec. 6, 1961), CCH FED. SEC. L. REP. ¶2270, at ¶2276, *noted:*

> Securities issued in a transaction properly exempt under this provision may be offered and sold without registration through the mails or by use of any instruments of transportation or communication in interstate commerce, may be made the subject of general newspaper advertisement (provided the advertisement is appropriately limited to indicate that offers to purchase are solicited only from, and sales will be made only to, residents of the particular State involved), and may even be delivered by means of transportation and communication used in interstate commerce, to the purchasers.

151. *See* BLOOMENTHAL, at § 4.04[8].
152. Securities Act Rule 147(d), 17 C.F.R. § 230.147(d) (1975).
153. SEC Securities Act Release No. 5349 (Jan. 8, 1973), [Transfer Binder 1972-73 Decisions] CCH FED. SEC. L. REP. ¶79,168, and SEC Securities Act Release No. 5450 (Jan. 7, 1974), CCH FED. SEC. L. REP. ¶2340. The staff recently confirmed that Rule 147 would not be violated if written offers addressed only to residents reach nonresidents. Palmer & Dodge, 320 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Sept. 11, 1975).
154. SEC Securities Act Release No. 5349, *supra* note 153, at 82,546.

The most dramatic change under Rule 147 is the elimination of the domicile test for the residence of purchasers; this change came after criticism of the initial proposal to retain the domicile test.[155] Rule 147 (d) (2) now provides:

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

While eliminating the domicile test, the rule still places the issuer in peril if an initial misjudgment is made about the principal residence of an offeree, since all of the terms and conditions of the rule must be met before it is available.[156] Unless the offerees are personally known to representatives of the issuer in advance of any offer, it will be extremely difficult for issuers to make the full and thorough investigation of facts necessary to determine a person's principal residence before beginning at least preliminary discussions about the offering, which will probably constitute an "offer".[157]

155. Proposed Rule 147(d)(2) provided: "An individual shall be deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale, his principal residence in the state or territory *and has no present intention of moving his principal residence to a different state or territory.*" (Emphasis added). SEC Securities Act Release No. 5349 (Jan. 4, 1973), 184 BNA SEC. REG. & L. REP. F-4. Release 5349 noted the previous existence of the domicile test, and stated that the proposed rule "does abandon the domicile test and attempts to provide more objective standards for determining when a person is considered a resident." *Id.* at F-2. Not all commentators agreed. *See, e.g.*, Sowards, *supra* note 7, at 447; and Gilchrist, *New Methods of Intrastate Financing—Proposed Rule 147*, FIFTH ANNUAL INST. ON SEC. REG. 305, 318-19 (1974). The final version of the rule squares with the Commision's stated purpose. But the transition from domicile to residence has been accompanied by some hedging by the Commission. In Release No. 5450, *supra* note 153, at 8, the Commission stated: "Temporary residence such as that of many persons in the military service, would not satisfy the provisions of paragraph (d)."

156. Securities Act Rule 147, Preliminary Note 3, 17 C.F.R. § 230.147 (1975). In states with resorts which attract persons from other states to reside for major parts of a year, determining "principal residence" may be more difficult than determining domicile. Colorado, for example, in an attempt to attract affluent persons from other states to reside in Colorado without subjecting themselves to ad valorem taxes on intangible personal property, Colorado death taxes and the like, allows persons "temporarily" residing in Colorado for more than six months of a year to file a certificate of nonresidence, thus retaining domicile elsewhere, despite numerous indicia of domicile in Colorado, such as real property ownership, driver's license, etc. COLO. REV. STAT. § 39-22-612 *et seq.* (1973). What, then, will be the "principal residence" of a Texas citizen who spends more than six months of each year in Colorado?

157. For a definition of what constitutes an "offer," *see* In The Matter of Carl M. Loeb, Rhoades & Co. and Dominick & Dominick, 38 SEC 843 (1959),

The Commission could have chosen an approach more congenial to offers made within the state to a broader segment of the public. One approach would be that used in Rule 146, which allows the issuer to make offers, but not sales, to persons the issuer has reasonable grounds to believe, and actually believes, are qualified offerees.[158] The important restriction in Rule 146 is that an issuer must undertake an investigation and believe offerees are qualified before selling to them. This is consistent with Rule 147's requirement that the issuer obtain a written representation from each purchaser as to residence.[159]

In such a case no violence is done to the statutory purpose of protecting investors, as long as the issuer, upon learning of the true facts, does not sell to the persons who are not qualified buyers under Rule 146. No harm would be done by a similar approach to Rule 147. But Rule 147 does not allow the issuer a good faith defense where an offer is mistakenly made to a nonresident, thus effectively limiting the use of the intrastate offering to persons previously known to the issuer. The issuer remains, as before, an insurer of the residence of each offeree and purchaser. The result of this approach to residence clearly is to discourage the use of the intrastate exemption for larger offerings which must be offered to persons beyond the circle of acquaintances of officers and promoters of the issuer, while making the exemption relatively more attractive to small issuers raising modest amounts of capital in the local community, probably without assistance of a broker-dealer.

Rule 147 codifies existing interpretations of the residence requirements with respect to corporations and partnerships which purchase under the rule, so that the presence of nonresident investors in these entities will not disqualify them as purchasers if they maintain their principal offices

holding a press release about a planned offering to be an "offer;" and SEC Securities Act Release No. 3844 (Oct. 8, 1957), CCH FED. SEC. L. REP. ¶ 3250; and *see* SEC Securities Act Release No. 5009 (Oct. 7, 1969), [Transfer Binder 1969-70 Decisions] CCH FED. SEC. L. REP. ¶ 77,744.

158. Securities Act Rule 146 (d)(1), 17 C.F.R. § 230.146(d)(1) (1975).

159. Securities Act Rule 147(f), 17 C.F.R. § 230.147(f) (1975).

within the state of the issuer's residence.[160] The exemption is unavailable, however, where the purchasing entity has been organized for the specific purpose of purchasing this security, and thus is a mere conduit.[161] These problems are not likely to prove insuperable for most small issuers utilizing the rule in good faith.

The provisions relating to resale of securities solve some problems for issuers and leave others unsolved. Like the previous interpretations, the rule allows immediate resales to residents, but changes the rules with respect to the dates for resales to nonresidents. Under the rule such resales are prohibited for a period of nine months from the date of the last sale by the issuer.[162] The rule does not deal with a definition of a "sale" for purposes of resales, thereby leaving open the possibility that a sale can take place without a transfer of the record ownership of the shares, by delivery of the security. Rule 147(f) requires the issuer to take precautions against resale, including a disclosure to purchasers of the restrictions on resale, stop transfer orders or a notation on the issuer's own transfer records, and a legend on the certificate setting forth the limitations on resale contained in the rule,[163] but is silent on the treatment of sales of which the issuer has no notice.

The rule's preservation of the right of purchasers to resell immediately intrastate should be an important consideration in choosing between the intrastate and private offerings, since the private offering exemption effectively precludes resale for a period of two to five years, depending on the nature of the issuer. Of course security owners may

160. Rule 147(d)(1) provides that "A corporation, partnership, trust or other form of business organization shall be deemed a resident of a state or territory if, at the time of the offer and sale to it, it has its principal office within such state or territory." A corporate purchaser buying for its pension or profit-sharing plan may even utilize a nonresident trustee provided the actual purchasers are residents. Pacific West Investors, 327 BNA SEC. REG. & L. REP. C-1 (SEC Div. Corp. Fin. Oct. 30, 1975).

161. Rule 147(d)(3) provides that "A corporation partnership, trust or other form of business organization which is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule shall be deemed not to be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory." *See* ContROLL Awnings, Inc., *supra* note 101.

162. Securities Act Rule 147(e), 17 C.F.R. § 230.147(e) (1975).

163. Securities Act Rule 147(f), 17 C.F.R. § 230.147(f) (1975).

resell in private offerings of their own, subject to all of the difficulties with such sales.[164] In the absence of such sales, for reporting issuers the securities may be resold in limited amounts after a two year holding period under Rule 144,[165] while for non-reporting issuers the holding period may be as long as five years under Rule 237, assuming the seller is not a controlling person.[166] In contrast, securities purchased in a Rule 147 transaction can be resold immediately, provided only that the purchaser is also a resident of the same state as the selling shareholder.[167]

Rule 147 makes an important contribution toward certainty by establishing an arbitrary date on which securities sold in a Rule 147 transaction by an issuer will be deemed to have "come to rest"—nine months after the last sale by the issuer.[168] This eliminates all of the difficult and subjective questions about who is an underwriter, and further eliminates the possibility that offers as well as sales by shareholders might be considered in determining whether the issue was restricted to the issuer's state. While an active trading market can be developed in an intrastate issue prior to the expiration of the nine-month period, for most small issuers the prospects of a trading market are remote. Even if development of such a market were possible, active trading

---

164. The difficulties with this exemption are discussed in Carney, *supra* note 1. Selling shareholders may not use Rule 146.

165. Securities Act Rule 144(d)(1), 17 C.F.R. § 230.144(d)(1) (1975). Rule 144 (c) further provides that the rule is available only to companies reporting under Sections 13 or 15 of the 1934 Act, or making equivalent information available.

166. For a shareholder in a small issue, not qualifying under Rule 144, Rule 237 requires a five year holding period before securities can be resold, where an initial private offering was involved. 17 C.F.R. § 230.237 (1975). Of course the stockholder can attempt to take advantage of the private offering exemption by restricting the resale of the stock he is selling, if he sells prior to the end of the required holding period, but use of the private offering exemption materially lowers the price at which the shareholder can sell his shares. The advantages with respect to resale under the intrastate offering exemption prior to the adoption of the 140 series of rules are discussed in Mandel, *supra* note 101.

167. Securities Act Rule 147(e), 17 C.F.R. § 230.147(e) (1975).

168. Rule 147(e) provides:

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

increases the risk that policing of resales will break down, and that a resale to a nonresident will inadvertently be allowed.

The provisions of the Rule limiting resale are cumbersome for issuers since the limitation is tied not to a date related to the sale of each share, but to a date related to the last sale which is part of the "issue"—a date which may be unknown at the time of most individual sales. Mechanically, from the issuer's standpoint, there appear to be at least two ways to deal with this problem—neither entirely satisfactory. An issuer can determine in advance that it will cease efforts to sell after a given period of time, regardless of whether it has raised the funds it requires or not, or it can simply place an indefinite restriction on interstate resale of all shares, and subsequently inform shareholders when they can resell outside the state. The latter approach may impair the marketability of the shares, although it may be that buyers will find restriction to sales to residents less unattractive than the restrictions required for sales under Rules 146 and 240.

It is unfortunate that Rule 147 does not define "resale." The rule provides no hint whether the prohibition is against transfers of record ownership of shares, which an issuer can control, or transfers of equitable and economic ownership, such as pledges and contracts of sale, over which the issuer has no control. An issuer may take all the required precautions against resale to nonresidents during the nine month period, including a legend on the certificate, and still be unable to prevent a nonresident from becoming a purchaser of the security.[169] At best, the issuer can prevent such a nonresident from becoming a bona fide purchaser without notice of the restrictions on resale, and thus can prevent registra-

169. *See* ISRAELS & GUTTMAN, MODERN SECURITIES TRANSFERS ch. IV *Transfer* (rev. ed. 1971), for a discussion of the distinction between a "purchase" and registration of the transfer on the books of the issuer after a transfer. Any person, despite the existence of a legend, may become a "purchaser" under the Uniform Commercial Code's Stock Transfer Article, and may have rights in the security, even though he may not qualify as a bona fide purchaser for value without notice, and thus may not be entitled to registration of the transfer on the issuer's books.

tion of the securities in the name of the nonresident buyer.[170] Lack of registration of shares purchased by a nonresident may make problems of proof of a breach of the rule's conditions more difficult for a dissatisfied stockholder attempting to bring suit, but it provides little comfort for a careful issuer attempting to comply with the rule. The Commission could have defined sale for purposes of the rule as a transfer recorded on the issuer's books in the case of resales, which would have given issuers control over resales. In the last analysis the availability of the exemption is out of the control of the issuer—a factor which is likely to make it too dangerous for any but the smallest and most "private" of offerings, where the buyers each have a significant economic interest in the issuer's success, and an interest in the success of an exempt offering.

CONCLUSION

It has been pointed out by many observers that the effect of the rule is to grant greater certainty and objectivity at the expense of a more restrictive interpretation of many of the previous requirements which the Commission and the courts have imposed on the use of the exemption.[171] The rule has taken previous staff interpretations of these requirements and given them the authority of a Commission rule. While the rule is expressly nonexclusive, in murky areas such as this where courts are far less familiar with the Act than the Commission, there will be a strong tendency for the requirements of the rule to become exclusive, or nearly so.

Greater clarity and certainty have been achieved in the areas of integration of sales, residence of purchasers and issuers, the "doing business" test, and on the time during

170. UNIFORM COMMERCIAL CODE § 8-204 (1972), states that "Unless noted conspicuously on the security a restriction on transfer imposed by the issuer even though otherwise lawful is ineffective except against a person with actual knowledge of it." Restrictions designed to help an issuer comply with requirements for exemption from Securities Act registration have generally been upheld, according to ISRAELS & GUTTMAN, *supra* note 169, at § 4.06.

171. Alberg & Lybecker, *supra* note 55, at 653; Coles, *supra* note 110, at 420; Gardiner, *supra* note 7, at 391; Kant, *supra* note 7, at 98; Sowards, *supra* note 7, at 450; and Comment, *SEC Rule 147—Distilling Substance from the Spirit of the Intrastate Exemption,* 79 DICK. L. REV. 18, 49 (1974).

which securities may not be resold interstate. At the same time, the requirements imposed in the doing business area confirmed the fears of some observers that the exemption was being destroyed by the rule.[172] The conditions of the rule require careful technical compliance, and its worst feature is that even such compliance will not assure the exemption, since the issuer is made the insurer of matters beyond its control—the residence of offerees and purchasers, and that resales will take place only within the state for a specified period.[173] Under these conditions it can fairly be stated that for many issuers, the exemption is in fact still loaded with dynamite.[174]

If the exemption is viewed along with Rule 146, it might first seem that the thrust of the rules is to force more offerings into formal disclosure, of the type required by registration, without forcing the Commission to bear the burden of review of the new disclosure documents. This may in fact be the result for larger offerings. Where an issuer wishes to raise a substantial sum which is beyond the capabilities of persons within the acquaintance of the responsible officers of the issuer, the intrastate exemption should be avoided. It is no longer a suitable exemption for "an issuer to offer an unlimited amount of securities without the heavy expense involved in preparing and filing a registration statement,"[175] if indeed, it ever was. For such issuers, another exemption must now be found, and it may well be that Regulation A will provide a more viable approach for offerings under $500,000 than Rule 146, but in any event elaborate formal disclosures appear to be required for any exemption for offerings of substantial size.

The lack of availability of Rule 147 for issuers raising substantial amounts of capital does not mean that the intrastate offering exemption is dead. For issuers capable of raising needed capital from immediate acquaintances, the exemption may still be quite useful, especially where such in-

172. *See, e.g.*, Kant, *supra* note 7, at 98, and Sowards, *supra* note 7, at 451.
173. *See* Rule 147(d) and (e), and Comment, *SEC Rule 147—Distilling Substance from the Spirit of the Intrastate Exemption*, *supra* note 171, at 50.
174. Gadsby, *supra* note 11, at 148.
175. Cummings, *supra* note 7, at 216.

vestors do not meet the sophistication standards which have been developing under the private offering exemption and Rule 146. This author believes that many small offerings to relatively unsophisticated investors may now be made under Rule 147, since it lacks any requirements of investor sophistication or ability to bear the risk. If the offering is restricted to persons known to the issuer's officers and directors, the risk of misrepresentation of residence or that an offer will inadvertently be made to a nonresident is reduced to a tolerable level. Further, if the group of investors interested in the issuer is kept sufficiently small, each investor will have sufficient interest in the issuer's success and in the availability of the intrastate offering exemption to consciously avoid reoffers or resales interstate for the required period, especially in view of his probable status as an underwriter. A trading market should not develop for the securities of small issuers, due to the limited size of the issuer, the small number of shareholders, and the relatively small number of shares outstanding. An issuer would be well advised to use the smallest number of shares and certificates possible to complete the financing required in order to minimize the possibilities of a trading market.

It is obvious that the Commission could have approached the intrastate exemption quite differently if it had wished to make the exemption available to larger issuers. A more liberal "doing business" test was certainly not precluded by existing judicial interpretations; the rule, like Rule 146, could have looked more to sales than to offers; and complete compliance in good faith by the issuer with the technical requirements could have been deemed to satisfy the requirements that all offers and sales be made within the state and that resales be restricted to the state for a period of time. An exception could have been made for isolated sales outside of the state, just as Rule 240 does not destroy the exempt nature of prior sales when a subsequent sale is made which violates its terms.[176] The Commission declined to take any

176. One or more of these approaches were suggested in the articles cited in note 171, *supra*.

of these steps, thus denying for all practical purposes the exemption to larger offerings.

What is left, then, is an exemption for very small offerings made within the state to groups of persons previously known to the issuer's officers and directors—offerings which most observers once thought qualified for the private offering exemption. While the private offering exemption of Section 4(2) has been denied by Rule 146 to small issuers unable to attract sufficiently sophisticated and affluent investors, the Commission has partially resurrected it under Section 3(a)(11), a most unlikely place.

Like Rule 146, Rule 147 will require careful documentation of compliance with its conditions, since the burden of proving the availability of the exemption will fall on the issuer, which will have to establish that all offerees qualified under the rule. A careful issuer will adopt a board resolution authorizing only specified persons to make offers on its behalf, and then only in writing. The written offering document should be receipted for by every offeree, who should provide evidence or at least a detailed statement of residence. The offering document should contain a legend that the offer is made only by means of the offering document, and then only to residents of the issuer's home state. The document should solicit offers to buy the issuer's stock, so no power of acceptance is created in offerees. Offers to buy should be accepted only by specified officials of the issuer in writing and only after such officials have had an opportunity to review the residence of the prospective purchaser. While these precautions do not guarantee success, without them the issuer runs a considerable risk of liability under Section 12(1).[177]

Something thus appears to be left of the intrastate exemption. If the guidelines suggested here are followed, it may be that state securities officials will not become involved

177. 15 U.S.C. § 77*e*(1) (1970), provides that

> Any person who—
> (1) offers or sells a security in violation of section 5 . . . shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon . . . or for damages if he no longer owns the security.

in the offering, since limited or private offering exemptions of state laws may be available. The state regulation contemplated by Congress and the SEC in such exempt offerings will thus be minimal. In such cases the only constraint upon issuers will be the antifraud provisions of federal and state securities laws. This is appropriate, since such offerings are generally too small to justify the social cost of detailed administrative supervision.