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James A. Askew

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Comments

A NEW APPROACH TO THE INTRASTATE EXEMPTION: RULE 147 VS. SECTION 3(a)(11)†

Before the federal government began to regulate securities in 1933, the states alone controlled securities issues through local "blue sky laws"¹ which differed markedly from state to state. Although some states provided a fairly sophisticated degree of regulation, in many instances state legislatures failed to create adequate machinery to enforce the laws.² In any event, the states could not cope adequately with multi-state public offerings of securities because of constitutional and other limitations on the application of state statutes to interstate transactions.³

Many years of debate on the need for federal regulation produced little result until the stock market collapse of 1929. In the decade preceding the Securities Act of 1933, tremendous prosperity and a free flow of money seriously damaged the securities markets' integrity: securities were issued by corporations when cash was not needed, investors speculated excessively, and swindles were not uncommon.⁴ Between 1920 and 1933, fifty billion dollars worth of securities were sold in the United States; by 1933, half were worthless.⁵ Similarly, on September 1, 1929, the aggregate value of all securities on the New York Stock Exchange was eighty-nine billion dollars;⁶ by 1932, that figure had declined to only fifteen billion dollars.⁷

† On January 7, 1974, while this Comment was in page proofs, proposed Rule 147 was adopted by the Commission. SEC Securities Act Release No. 5450 (effective March 1, 1974). Only a few changes were made in adopting the Rule, a number of which were only numerical; e.g., 80 percent instead of 90 percent. The criticisms made by this Comment are still valid as to the tests not changed by the Commission and as to most of the few which were changed. For further discussion, see note 92 *infra*.

1. 1 L. LOSS, *SECURITIES REGULATION*, 30 (2d ed. 1961) [hereinafter cited as Loss].

State Securities laws are called "blue sky laws" because they regulate, in one judge's phrase, "speculative schemes which have no more basis than so many feet of 'blue sky.'" *Hall v. Geiger-Jones Co.*, 242 U.S. 539, 550 (1917). These statutes generally provide for a State Securities Commission to determine the merits of securities proposed to be offered, and to deny the issuers the right of sale for securities deemed to be unsound.

2. 1 Loss, *supra* note 1, at 105-106.

3. *Id.* at 105.

4. E. McCORMICK, *UNDERSTANDING THE SECURITIES ACT AND THE S.E.C.* 18-19 (1948) [hereinafter cited as McCORMICK].

5. 1 Loss, *supra* note 1, at 120.

6. *Id.* at 120.

7. *Id.* at 120.

Congress, seeing the need for federal regulation, enacted the Securities Act of 1933 (hereinafter the Act),⁸ the first of five acts regulating securities.⁹ The Act governs the issuance of securities offered to the public through the mails or other channels of interstate commerce by requiring the registration of such securities. Its registration and prospectus requirements seek to give the investor enough information to reach an investment decision concerning the securities, thus protecting investors from fraud and misrepresentation, and "legitimate" enterprises from competition by fraudulent or deceptive offerings.¹⁰ The registration statement filed with the Securities and Exchange Commission must contain specific information regarding the issuer, the security, and the underwriter. To ensure compliance, the Act provides criminal and civil penalties for material misstatements or omissions in the registration statement and prospectus. The Act contains three sanctions: (1) for false or untrue material statements or failure to furnish material information, the Commission has authority to issue a stop order suspending the effectiveness of a registration statement;¹¹ (2) those persons responsible for flotation of the issue are subject to civil liability for untrue, false, or inadequate material representations;¹² and (3) the willful use of a fraudulent scheme or device or the willful misstatement or omission of a material fact gives rise to criminal liability.¹³

Certain types of securities and transactions, however, are exempted from the prospectus and registration requirements of the Act.¹⁴ This

8. 15 U.S.C. § 77a (1970).

9. The five acts regulating securities are: the Securities Act of 1933, 15 U.S.C. § 77a (1970) which regulates the initial distribution of securities rather than subsequent trading; the Securities Exchange Act of 1934, 15 U.S.C. § 78a (1970) which regulates post-distribution trading; the Public Utility Holding Company Act of 1935, 15 U.S.C. § 79 (1970), which regulates holding companies whose subsidiaries are engaged in the retail distribution of natural or manufactured gas or engaged in the electric utility business; the Trust Indenture Act of 1939, 15 U.S.C. § 77aaa (1970) which creates independent trustees under indentures who will enforce and protect the rights of holders of securities issued thereunder; and the Investment Company Act of 1940, 15 U.S.C. § 80a-1, 11 U.S.C. §§ 72, 107 (1970) which regulates investment companies or "investment trusts" to a greater extent than does the disclosure treatment of the Securities Act of 1933.

10. McCORMICK, *supra* note 4, at 24.

11. Securities Act of 1933 § 8, 15 U.S.C. § 77h (1970).

12. Securities Act of 1933 §§ 11-12, 15 U.S.C. § 77k, 1 (1970).

13. Securities Act of 1933 §§ 17, 24, 15 U.S.C. § 77q, x (1970).

14. It should be noted that all securities and transactions exempted by section 3 (except 3(a)(2), relating primarily to government and bank securities) and section 4 are nevertheless subject to the anti-fraud provisions in section 17 and the provisions in section 12(2). The pertinent part of section 17 creates three separate offenses, and provides:

It shall be unlawful for any person in the sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly . . .

(1) to employ any device, scheme, or artifice to defraud, or

Comment examines one such exemption, the "intrastate exemption," embodied in section 3(a)(11) of the Act. Section 3(a)(11) exempts from the registration and prospectus requirements of the Act:

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.¹⁵

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Section 12(2) provides:

Any person who sells a security . . . by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading . . . and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, 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, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

In addition, liability under section 12(1) may result if the requirements of the intrastate exemption are not in fact met. Section 12(1) provides:

Any person who 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, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

In short, the issuer may subject himself to a serious risk of civil liability for selling a security not entitled to the exemption from registration.

15. 15 U.S.C. § 77c(11) (1970).

Many transactions which could come within the intrastate exemption also fall within the purview of other exemptions. An issuer may wish to comply with one of the other available exemptions rather than the ambiguous requirements of the section 3(a)(11) exemption. The most prominent of these other exemptions are the "small issue" exemption of section 3(b), and the private offering exemptions of section 4(1) and section 4(2). The prospective issuer should note that these exemptions are not as hazardous or as difficult to comply with as is section 3(a)(11).

'[A]s a practical matter the intrastate exemption is loaded with dynamite and must be handled with very great care.' (Citation omitted.) Its limited usefulness is all the more apparent in the light of two other exemptions. If the offering is not over \$300,000, [now \$500,000] an exemption will be available in most cases pursuant to § 3(b), with none of the risk inherent in § 3(a)(11). And, if the offering is larger, it is difficult to see how the very restrictive conditions of § 3(a)(11) can be satisfied unless the entire issue is placed with a relatively few persons for investment, in which event the exemption for private offerings under the first clause of § 4(1) will be available without regard to the residence of the issuer or the purchasers.

Nevertheless, the exemption is there. It was presumably intended to be used. And it is in fact used.

The exemption for local financing consummated entirely within the state or territory in which the issuer is incorporated and doing business was premised¹⁶ on the theory that investors in such securities will be protected by state regulation and their proximity to the issuer.¹⁷ Local transactions and sales of securities that meet the conditions of section 3(a)(11) are left to state regulation, which continues to vary from state to state.

Currently, many transactions which might qualify for the intrastate exemption also qualify for other exemptions, such as the private-offering exemption under section 4(1) and section 4(2), and the small-issue exemption in section 3(b) of the Act. Issuers often choose to comply with one of these other exemptions rather than the intrastate exemption because of the ambiguities in section 3(a)(11). Despite the ambiguities of the intrastate exemption, however, it is still an important exemption, particularly when used for offerings to the public exceeding \$500,000, the current limit on offerings by an issuer under the Regulation A exemption. The intrastate exemption's importance may well be enhanced as a result of the "140 Series"—a series of rules proposed by the SEC—some of which have already been adopted.¹⁸ The "140 Series" restricts some exemptions, possibly curtailing their use, while increasing the attractiveness of the intrastate exemption by making it more objective and nonambiguous.

Obtaining an exemption is relatively easy for a small businessman offering a limited number of securities to his relatives and acquaintances. Problems arise, however, when a more substantial offer is made

1 Loss, *supra* note 1, at 603.

As Loss admits, the intrastate exemption, despite its dangers, is still used. It is particularly useful in situations where the securities issued exceed the value of \$500,000 and where the transactions involve the "public." Furthermore, use of the intrastate exemption is likely to increase. Letter from the Committee on Federal Regulations of Securities of the American Bar Association to Securities and Exchange Commission (first draft) Feb. 27, 1973.

16. SEC Securities Act Release No. 1459 (May 29, 1937). See also *Hillsborough Inv. Corp. v. SEC*, 276 F.2d 665 (1st Cir. 1960), *aff'g* 176 F. Supp. 789 (D.N.H. 1959); *SEC v. Los Angeles Trust Deed & Mortgage Exch.*, 186 F. Supp. 830, 871-72 (S.D. Cal. 1960), *modified on other grounds*, 285 F.2d 162 (9th Cir. 1961), *cert. denied*, 366 U.S. 919 (1961). See generally SEC Securities Act Release No. 4434 (Dec. 6, 1961).

17. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

The intrastate exemption, other exemptions in section 3 and section 4, and various other provisions of the Act reflect the congressional decision to refrain from preempting the field of securities regulation or supplanting state control. The congressional policy was to "fill the gap in those areas where State regulation cannot adequately meet a national need." SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess. pt. 1 571 (1963). In addition, the Commission has said: "Small local offerings of this character are not a matter of Federal concern, and can be adequately supervised by State authority to the extent that regulation is deemed necessary." *Id.* at 571.

18. See n.23 *infra*.

to the general public, especially when the securities are offered and sold through the organized securities markets.¹⁹ The private-offering and the small issue exemptions are then not available and, unless the securities are themselves exempted by another subsection of section 3(a), the issuer must comply with the requirements of section 3(a)(11) to avoid the registration requirements of the Act.

Whether an issuer has complied with section 3(a)(11) depends on resolving certain questions of statutory interpretation. The questions are: (1) what transactions are covered by the exemption; (2) when are securities considered "part of an issue"; (3) when is an issuer "resident within a state"; (4) when is an issuer "doing business within a state"; (5) when is an offeree or purchaser "resident within a state"; and (6) what limitations exist on reoffers and resales. In response to these questions, Commission opinions and judicial interpretations of section 3(a)(11) have developed some general guidelines. The Commission, however, believing that some issuers may not be familiar with these guidelines and attempting to curtail abuse and evasion and create a safe harbor for complying issuers, proposed Rule 147,²⁰ an alternative method of obtaining the section 3(a)(11) exemption. The Commission seeks to attain these purposes by making proposed Rule 147 more objective and stringent than section 3(a)(11). The proposed Rule's objectivity may also make it quicker and cheaper for the small business to determine whether it can qualify for the exemption.

19. There are problems for the issuer—the requirements of the exemption make compliance difficult; there are also problems for the Commission—since the exemption is not conditioned on prior notification to, clearance by, or filing with the Commission, the Commission does not have the kind of notice of these transactions which would enable it fully to protect investors from fraud.

20. SEC Securities Act Release No. 5349 (Jan. 8, 1973). The sections of Proposed Rule 147 considered by this Comment are:

Introductory Note

. . . Persons may claim a Section 3(a)(11) exemption without complying with the proposed rule if they satisfy the standards set forth in relevant administrative and judicial interpretations in effect at the time of the transaction, but they have the burden of proving its availability.

. . . (b) *Part of an Issue*

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; provided, however, that securities offered, offered for sale or sold by a person which is a business enterprise separate and distinct from the issuer and which is affiliated with the issuer solely by reason of the existence of a common general partner, shall be deemed not to be part of such issue.

(c) *Nature of the Issuer*

. . . (1) *Person Resident*. The issuer shall be deemed to be a resident of such state or territory if:

A. a corporation, trust or other forms of business organization, other than a partnership, it is incorporated in or organized under the laws of such state or territory;

B. a partnership, it is organized under the laws of such state or terri-

The proposed Rule does not purport to provide the exclusive method of complying with the statute.²¹ Compliance with judicial decisions and administrative interpretations [hereinafter, "the section," as distinct from "the Rule," both of which are means of complying with

tory and all of its general partners are residents of such state or territory.

(2) *Doing Business Within.* The issuer shall be deemed to be doing business within a state or territory if:

A. the issuer derived at least 80 percent of its gross revenues on a consolidated basis during its most recent fiscal year and subsequent three, six, or nine month period, from the operation of property located in or from the manufacture of products or rendering of services within such state or territory, and has, as at the end of its most recent fiscal quarter, at least 80 percent of its assets within such state or territory; and

B. the issuer intends to use and uses at least 90 percent of the proceeds from sales made pursuant to this Rule in connection with the operation of a business or purchase of real property located in, or rendering of services within, such state or territory.

C. the principal office of such organization is located within such state or territory.

(d) *Offerees and Purchasers: Person Resident*

Offers, offers to sell, offers for sale and sales shall be made only to persons resident within the state or territory of which the issuer is a resident.

(1) A corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state or territory if it meets the residence conditions set forth in Paragraph (c)(1) as to issuers.

(2) An individual shall be deemed to be a resident of a state or territory if such individual has, at the time of the offer and sale, his principal residence in the state or territory and has no present intention of moving his principal residence to a different state or territory.

(3) In any case in which a corporation, partnership, trust or other form of business organization is organized for the specific purpose of acquiring part of an issue offered pursuant to Section 3(a)(11), the residence of such organization shall be deemed to be the residence of each of the beneficial owners of any interest in such organization.

(e) *Limitation on Reoffers and Resales*

During the distribution of any part of the issue and for a period of twelve months from the date of the last sale of securities which are any part of that issue, all reoffers, reoffers for sale and resales of any part of the issue, by any person, shall be made only to persons resident within such state or territory.

(f) *Precautions Against Interstate Distributions*

The issuer shall, in connection with any securities offered or sold pursuant to this Rule,

(1) place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the restrictions on transferability of the securities;

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

(3) disclose the restrictions on reoffer and resale in writing to the person to whom the issue is offered or sold;

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

21. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

If proposed Rule 147 were "exclusive," then an issuer could obtain the intrastate exemption only in compliance with the rule. Proposed Rule 147 being "nonexclusive," however, provides an issuer with an alternate method of complying with the section 3(a)(11) exemption.

“the statute”] in effect at the time of the transaction will also satisfy the requirements for an intrastate exemption.²² The statutory requirements of the exemption are the same whether the issuer complies with the Rule or the section. The tests used to measure such compliance, however, differ substantially. It is important to understand the different tests, because the problems of compliance with the exemption requirements may vary, depending on which method is used to comply. This Comment explores proposed Rule 147 in the context of existing interpretations of section 3(a)(11). It concentrates on the Rule’s purported nonexclusivity and compares the Rule to the section in an attempt to show how compliance with each should be measured.

The availability of the intrastate exemption for future transactions will depend upon the exclusivity of proposed Rule 147. If the Rule is treated as being exclusive, the exemption may no longer be obtained by complying with the section. If it is not exclusive, however, the exemption will be available by satisfying existing administrative interpretations and judicial decisions in effect at the time of the transaction.

I

EXCLUSIVITY OF PROPOSED RULE 147 AND THE RULE’S APPLICATION

A. Is Proposed Rule 147 Really Nonexclusive?

In proposing and adopting each rule in the “140 Series,” the Commission has taken a different approach with regard to that rule’s exclusivity as a means of complying with the Act.²³ The Commission, however, had a uniform goal throughout the series: to make the Securities Act of 1933 more effective.²⁴ It has sought to “provide full and fair disclosure of the character of the securities sold in interstate commerce and through the mails and to prevent fraud in the sale

22. *Id.*

23. The Commission in proposing and adopting Rules within the “140 Series” has stated that some are intended to be the exclusive method for complying with the various exemptions. Rule 144, the section 4(4) brokerage exemption [SEC Securities Act Release No. 5223 (Jan. 11, 1972)] was adopted on January 11, 1972 and made effective as of April 15, 1972, and is to be applied exclusively. Similarly, Rule 145, relating to business combinations [SEC Securities Act Release No. 5316 (Oct. 6, 1972)] is also to be applied exclusively. However, there is a limited exemption to Rule 144. See note 28 *infra*. On the other hand, proposed Rule 146, the private-offering exemption [SEC Securities Act Release No. 5336 (Nov. 28, 1972)] and proposed Rule 147, the intrastate exemption [SEC Securities Act Release No. 5349 (Jan. 8, 1973)] are stated to be nonexclusive.

24. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

thereof,"²⁵ and to "create greater certainty and predictability in the application of the registration provisions of the Act by replacing subjective standards with more objective ones."²⁶ In some instances, these objectives have been attained by making the Rule the exclusive standard for compliance with the Act. A comparison between Rule 144 and proposed Rule 147 is useful as indicating the Commission's different approaches to the relative exclusivity of the Rules.

At the time of its promulgation, Rule 144 was described as being nonexclusive by the Commission,²⁷ but in adopting the Rule, the Commission made it exclusive in most situations and remained antagonistic to its nonexclusive application in the area left open to such an interpretation.²⁸ Like Rule 144, proposed Rule 147 was announced as a non-exclusive means of complying with the Act. The strong qualifying language of Rule 144, however, is absent from the Commission's announcement of Rule 147:

[R]ule [147] does not establish exclusive standards for complying with Section 3(a)(11). Persons may claim a Section 3(a)(11) exemption without complying with the rule if they satisfy the standards set forth in relevant administrative and judicial interpretations in effect at the time of the transaction, but they have the burden of proving its availability.²⁹

Clearly, the Commission intended different degrees of exclusivity for Rules 144 and 147.³⁰ Rule 147 differs substantially from Rule

25. SEC Securities Act Release No. 5223 (Jan. 11, 1972).

26. *Id.*

27. SEC Securities Act Release No. 5186 (Sept. 10, 1971).

28. SEC Securities Act Release No. 5223 (Jan. 11, 1972).

All securities acquired after April 15, 1972, the effective date of Rule 144, must comply with the rule. Securities acquired by a noncontrolling person prior to that date, however, may be sold in compliance with the rule or existing administrative interpretations of section 4(4) in effect at the time of resale. Securities acquired by a controlling person prior to April 15, 1972 may be sold without registration only in compliance with the rule on the same basis as that applicable to all persons who acquired securities after the effective date of the rule. The Commission, in effect, declared Rule 144 exclusive since the Rule flatly states that the only exception to it is with respect to sales by noncontrolling persons who acquired their securities prior to April 15 1972. The Commission has indicated it will not look with favor on noncontrolling persons who acquire securities prior to the rule and then choose to comply with the section rather than the rule:

[P]ersons who offer or sell restricted securities without complying with Rule 144 are hereby put on notice . . . that . . . they will have a substantial burden of proof in establishing that an exemption from registration is available . . . and that such persons . . . and other persons who participate in the transactions do so at their risk.

The result is that although technically the Commission interprets the rule as nonexclusive, in reality, the section 4(4) brokerage exemption is virtually unavailable except by complying with the rule.

29. SEC Securities Act Release No. 5349 (Jan. 8, 1972).

30. The Commission did not intend for proposed Rule 147 to be the only non-

144 in the manner in which the Commission made and interpreted the Rule. And proposed Rule 147 is to apply prospectively only, whereas Rule 144 applies prospectively in some situations and retroactively in others. The Commission failed to qualify the nonexclusivity of proposed Rule 147, while it qualified it so much in Rule 144 that the rule is virtually exclusive. Finally, in the case of proposed Rule 147, unlike that of Rule 144, the Commission has not warned issuers who chose not to comply with the rule that they face a "substantial burden" of showing the availability of an exemption, and that they engage in such transactions "at their risk."³¹ One can only conclude that Rule 147 is intended to be nonexclusive in practice and is to be interpreted differently than Rule 144.

B. May the Requirements of Proposed Rule 147 Be Used as Guidelines for Section 3(a)(11)?

Deciding that proposed Rule 147 is nonexclusive does not end the matter. When a difficult question of interpreting the statute is presented, the Commission and the courts may be inclined to look to the easily ascertainable requirements of proposed Rule 147 for guidance. Most administrative interpretations of the statute after the effective date of the Rule will probably be geared to Rule 147, and judicial decisions deviating from existing Commission interpretations are not likely to occur, for courts have been inclined to defer to administrative expertise in matters of statutory interpretation.

If the courts look to administrative interpretations that follow the standards of proposed Rule 147 or look directly to the Rule for guidance, the nonexclusivity of the Rule will eventually be eroded and compliance with the Rule will become the exclusive means of obtaining the intrastate exemption. Since this would run directly counter to its

exclusive Rule. For example, examination of the Commission's statement accompanying proposed Rule 146, relating to the private offering exemption under section 4(2), makes it obvious that Rule 146, like proposed Rule 147, is intended to be nonexclusive. Absent in proposed Rule 146 are any qualifications regarding its nonexclusivity like those found in Rule 144. Also absent is the antagonistic language present in Rule 144. See note 28 *supra*. In the release accompanying proposed Rule 146, the Commission discusses exclusivity four times and clearly states that the Rule is to be nonexclusive. SEC Securities Act Release No. 5336 (Nov. 28, 1972). The strongest statement is contained in the section entitled "Proposed Operation of Proposed Rule 146":

It is to be emphasized that the rule would not provide the exclusive means for offering and selling securities in reliance on Section 4(2). Issuers who are able to meet the criteria set forth in relevant judicial and administrative interpretation of Section 4(2) in effect at the time of a proposed transaction may offer and sell without compliance with the proposed rule.

Id. A comparison of the language of proposed Rule 146 and Rule 144 makes it quite clear that the exclusivity of each rule is to be interpreted differently.

31. See note 28 *supra*.

announced intent,³² the Commission should keep the nonexclusivity of the Rule in mind when interpreting it and should clearly state that Commission decisions based on the Rule do not devitalize existing administrative and judicial interpretations of the statute.

II

COMPARISON OF THE PROPOSED RULE AND THE SECTION

Once it has been established that compliance with proposed Rule 147 is not the only way to obtain the intrastate exemption, it is important to compare the Rule and the section. They are similar in their allocation of the burden of proof on the exemption's availability and their characterization of the exemption as applying to specific transactions rather than particular securities. They differ in their definitions of the terms used in Section 3(a)(11): *e.g.*, when is a security "part of an issue"; what is an "issuer"; and what are "offerees" and "purchasers." Further differences are found in the limitation imposed on reoffers and resales and the requirement that an issuer take precautions against interstate distribution.

A. Similarities of the Rule and the Section

Many of the tests of compliance with proposed Rule 147 and the section are substantially identical.³³ When complying with the Rule, the issuer has the burden of proving satisfaction of all the conditions of the Rule. Once these conditions are satisfied, the exemption is available.³⁴ When complying with the section the issuer must satisfy the requirements of relevant judicial and administrative interpretations, and has the burden of proving the availability of the exemption.³⁵ Although there appears to be a difference between the two regarding the availability of the exemption, no real difference exists. The burden of proving satisfaction of all conditions under proposed Rule 147, and satisfying the conditions and proving the availability of the exemption under the section are the same: proving the availability of the exemption implicitly includes carrying the burden of proof on satisfaction of the requirements.

32. See text accompanying note 29 *supra*.

33. Absent from both proposed Rule 147 and the section is any reporting requirement. The nonreporting character of the intrastate exemption is sensible, for if the Commission were to require issuers to report, it would, in fact, be regulating what it had exempted from regulation. The exemption is automatic once the conditions of the exemption are satisfied, notwithstanding the differences between the requirements of the rule and the section. The exemption does not require approval by the Commission. McCORMICK, *supra* note 4, at 413.

34. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

35. *Id.*

Whether obtained under proposed Rule 147 or the section, the intrastate exemption is a "transaction exemption,"³⁶ notwithstanding its location in section 3 (exempted securities), rather than section 4 (exempted transactions).³⁷ The exemption was originally located in section 5(c) of the 1933 Act. In 1934, it was relocated because it restricted trading activity by exempting transactions only from the provisions precluding use of the mails and not from the provisions precluding the use of interstate commerce.³⁸ Proposed Rule 147 does not modify the transaction character of the exemption, but objectively defines "transaction" to mean "offers, offers to sell, offers for sale and sales."³⁹

B. Differences Between the Rule and the Section

While the requirements of proposed Rule 147 and the section are the same, the tests used to determine compliance differ substantially. The proposed Rule was purposely made more objective than existing interpretations of Section 3(a)(11) to give clarity and certainty to the exemption. The Rule is therefore likely to be given a rigid construction, as is the case with the other Rules in the "140 Series."

1. "Part of an Issue": When Does Integration Occur?

The section and the Rule both require integration of separate but related issues of securities. Under the section, if any part of an issue is offered or sold to nonresidents the intrastate exemption is destroyed, even though that part of the issue would be entitled to exemption if considered alone.⁴⁰ In applying the section, integration is determined on a case-by-case basis and one or more of the following may be determinative: (1) whether the offerings are made for the same general purpose; (2) whether the offerings are part of a single plan of financing; (3) whether the same type of consideration is to be received; (4) whether the offerings are made at or about the same time; and (5) whether the offerings involve issuance of the same class of secur-

36. A "transaction" exemption applies only to a particular transaction or series of transactions meeting the exemption's requirements; it does not permanently exempt the securities themselves. A "security" exemption applies to all transactions in the particular security, and is granted because the security's nature is such that no registration is required to further the Act's objectives.

37. SECURITIES & EXCHANGE COMMISSION, PROPOSAL FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934, 24 (1941).

38. H.R. REP. No. 1838, 73rd Cong., 2d Sess. 40 (1934).

39. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

40. 1 Loss, *supra* note 1, at 593. Similarly, the exemption is not available when part of an issue is sold to nonresidents even though the balance is registered. Texas Glass Mfg. Corp., 38 S.E.C. 630, 634 (1958) (*dictum*). See SEC Securities Act Release No. 3984 (Oct. 31, 1958) at 6; *cf.* Unity Gold Corp., 3 S.E.C. 618, 625-26 (1938).

ity.⁴¹ Under the Rule, however, the test is simpler. Abandoning the case-by-case analysis, the rule provides: "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 . . . *within any consecutive six-month period* shall be deemed to be part of the same issue."⁴²

The six-month period set by the Commission has been criticized as being arbitrary and too lengthy,⁴³ but any time limit which might have been adopted would be subject to such criticisms. One of the purposes of Rule 147 is to provide objective standards rather than subjective ones. The cost of such objectivity, in many instances, is the setting of arbitrary standards. The need for such objective standards, however, outweighs their arbitrariness. With a strict six-month integration period, an issuer will know in advance whether a separate but related issue of securities will be integrated, and the issuer will not have to run the risk that the securities may be integrated. In addition, most businesses can project their financial needs for six months and therefore can plan future issuances so as to avoid integration; if a business miscalculates its needs, it may still be able to obtain additional funds without losing its exemption by complying with the section under its case-by-case approach.

The American Bar Association Committee on Federal Regulations of Securities has suggested that the Commission take a different approach towards integration under proposed Rule 147. The Committee recommends that issuers be allowed to issue securities under a Rule 147 exemption in close proximity to the issuance of nonexempt securities without integrating the transactions, as long as the Rule 147 securities are not reoffered or resold to nonresidents within one year after the offer or sale of nonexempt securities.⁴⁴ This, however, would con-

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

The courts have provided little guidance in determining whether securities should be integrated. The Ninth Circuit has construed "issue" as "all the shares of common character originally though successively issued by the corporation." *Shaw v. United States*, 131 F.2d 476, 480 (9th Cir. 1942). *But see* 1 Loss, *supra* note 1, at 365 n.212; Shapiro & Sachs, *Integration Under the Securities Act: Once an Exemption, Not Always . . .*, 31 Md. L. Rev. 3, 20-21 (1971). *See also* Comment, *SEC Regulation of California Real Estate Syndicates*, 61 CALIF. L. REV. 205, 218 (1973).

42. SEC Securities Act Release No. 5349 (Jan. 8, 1973) (emphasis added). Whether elapsed time, rather than an examination of the securities, should be the focus of the rule might be questioned. Since one of the purposes of the Rule is to provide clear guidelines for all prospective issuers, however, a simple time limit appears appropriate.

43. Letter from the Committee on Federal Regulation of Securities of the American Bar Association to Securities and Exchange Commission (first draft) Feb. 27, 1973.

44. We suggest the concept now recognized in Rule 253(c) of Regulation A, that private offerings may be used in close proximity to public offerings

travene the well-established doctrine that offerings made under more than one exemption may be integrated, resulting in the loss of an exemption. The doctrine has been applied vigorously with respect to Section 3(a)(11), which requires that all securities sold under the intrastate exemption be sold intrastate, and not to nonresidents.⁴⁵ Interstate sales and sales to nonresidents have never been allowed under the intrastate exemption.⁴⁶ Neither should such a result be allowed under proposed Rule 147, for the Commission is attempting to tighten, not relax, the requirements for complying with the intrastate exemption in order to curtail abuse and evasion.

Proposed Rule 147 also requires integration of transactions conducted by business organizations and their affiliates; however, if the securities are offered or sold "by a person which is a business enterprise separate and distinct from the issuer and which is affiliated with the issuer solely by reason of the existence of a common *general partner*, [the securities] shall be deemed not to be part of such issue."⁴⁷ This clause appears to be of particular importance to real estate syndicates, which are abundant in California. The language does not make clear whether securities issued by two real estate syndicates will be integrated where they are affiliated solely by a common general partner. For example, will integration occur where two real estate limited partnerships, having a single common general partner, each develops and constructs a different shopping center, one selling securities pursuant to proposed Rule 147, and other selling to nonresidents in a registered offering or pursuant to Regulation A? While proposed Rule 147 is unclear as to the outcome in such a situation, tacit understandings may have been reached between the real estate investment industry and the Division of Corporate Finance that such offerings will not be deemed to be integrated as long as each real estate syndicate represents a "separate and distinct project."⁴⁸

2. *Nature of Issuer*

a. *Resident Within a State*

In order to claim an intrastate exemption, an issuer must satisfy the same requirement whether complying with the section or the Rule:

under Regulation A so long as the privately purchased securities are not re-offered to the public within one year after the public offering.

Id. at 3.

Regulation A contains Rules 251-263, and Forms 1-A through 6-A, and was promulgated under the legislative authority of Section 3(b) of the 1933 Act.

45. Texas Glass Mfg. Corp., 38 S.E.C. 630 (1958).

46. *Id.*

47. SEC Securities Act Release No. 5349 (Jan. 8, 1973) (emphasis added).

For the full text of the relevant portion of the rule, see note 20 *supra*.

48. Letter from the Committee on Federal Regulations of Securities of the

"the issuer shall be a person resident, and doing business within the state in which the transactions occur."⁴⁹ Existing interpretations have established few guidelines for determining when an issuer is resident.⁵⁰ The Rule's test for residency, however, is very specific: (1) the principal office of the issuer must be located within the state of issuance; (2) if a partnership, it must be organized under the laws of such state and all *general* partners of a limited partnership must be residents of the state; and (3) if a corporation or other business organization, the issuer shall be incorporated in or organized under the laws of such state.⁵¹

The Rule distinguishes between corporations and partnerships by allowing directors of a corporation to reside outside the state, but requiring all general partners of a limited partnership to reside within the state. The residency requirement is an attempt to ensure that offerors, offerees, and purchasers of an issue of securities are residents of one state. To effectuate this purpose, however, it is not necessary to require general partners to be residents for their investment in the partnership is not a security and therefore falls outside of the scope of the Act. They, like directors of a corporation, do not offer or sell securities; rather the securities are offered and sold by the limited partnership which is organized under the law of the state of the residence of the limited partners. Residency under state law should be sufficient as it is with corporations. While the residency requirement may not have much impact on a large state such as California, it would have a detrimental effect on the use of the exemption in small states because many general partners of limited partnerships there might reside outside the state.

b. *"Doing Business Within a State"*

i. *Revenues and Assets.* Proposed Rule 147 also provides a more objective test than the section does of whether an issuer is "doing business within a state" within the meaning of the Act. The section requires the issuer to be located in and conducting its principal or predominant business in the state where the transactions occur, but gives little guidance as to the quantum of business which will meet

American Bar Association to Securities and Exchange Commission (first draft) Feb. 27, 1973.

49. SEC Securities Act Release No. 5349 (Jan. 8, 1973). For the full relevant text, see note 20 *supra*.

50. If an issuer is a corporation, then it is a resident of the state of incorporation. 15 U.S.C. § 77c(11) (1970). See generally 1 Loss, *supra* note 1, at 598-600.

51. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

that requirement.⁵² The Rule's test, however, is much more stringent,⁵³ the issuer must have:

derived at least 80 percent of its gross revenues on a consolidated basis during its most recent fiscal year and subsequent three, six, or nine month period, from the operation of property located in or from the manufacture of products or rendering of services within such state or territory, and has, as at the end of its most recent fiscal quarter, at least 80 percent of its assets within such state or territory.⁵⁴

One criticism of the Rule is that it seems radical to jump from a statute which is silent as to the quantum of business required to a rule requiring that 80 percent of gross revenues and 80 percent of assets be derived from or located in the state of issuance.⁵⁵ Such high arbitrary percentages will surely have a detrimental effect on the use of the intrastate exemption, particularly for the businesses located in the more crowded, industrial, eastern states, for even though organized in one

52. *Chapman v. Dunn*, 414 F.2d 153 (6th Cir. 1969). See also *Selhermer v. Manganese Corp. of America*, 423 Pa. 563, 224 A.2d 634 (1966) (*semble*); SEC Securities Act Release No. 4434 (Dec. 6, 1961); McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959). The Commission has provided the following guideline:

In view of the local character of the Section 3(a) exemption, the requirement that the issuer be doing business in the state can only be satisfied by the performance of substantial operational activities in the state of incorporation. The doing business requirement is not met by functions in the particular state such as bookkeeping, stock record and similar activities or by offering securities in the state.

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

The courts have given little guidance as to the quantum of business required to be conducted within the state. A California corporation which owned assets of \$12,600 in California was found not to qualify for an intrastate exemption for an offering of over \$4 million to be used for the purchase of a business in Nevada. *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Cal. 1957). In *Chapman v. Dunn*, *supra* at 159, the court held that "a predominant amount" of the issuer's business must be conducted within the state.

53. In commenting on Proposed Rule 147, James H. Cheek III has said:

The proposed tests are far more strict than any existing interpretations and questions may be raised about the legitimacy of the level of the percentage tests, and the appropriateness of the measuring period used. This paragraph [Rule 147(c)(2)] further seems to ignore the practical difficulty of tracing proceeds and of determining how proceeds are to be used.

Cheek, *Proposed Rule 147 and The Intrastate Offering Exemption*, in PRACTICING LAW INSTITUTE, THE 140 SERIES, 156 (1973).

54. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

As to the issuer, perhaps a more equitable test would be to measure net rather than gross revenues, for a net measurement would allow the issuer to deduct expenses which could, for the most part, negate gross receipts derived from outside the state and allow more issuers to comply with the rule. A gross revenue test could be detrimental, for it could deter an issuer from seeking markets outside the state.

55. Letter from the Committee on Federal Regulations of Securities of the American Bar Association to Securities and Exchange Commission (first draft) Feb. 27, 1973.

state, it may only have 50 or 60 percent of its assets in the state in which it is organized.⁵⁶ While it is arguable that a better percentage test would require only 50 to 60 percent of the gross revenues and assets to be within the state, the purpose of the Rule is to set objective standards and create a hard and definite line with which issuers may comply. As noted above,⁵⁷ objectivity requires an exact standard, and some arbitrariness is the price of exactitude. After the Rule has been in effect for a time, one might be able to argue with more persuasiveness that one figure would be "better" than another. Such high percentages may deter issuers from choosing to comply with the Rule; it should be reiterated, however, that such issuers would not necessarily be precluded from using the intrastate exemption, for they could opt for complying with the section, thus avoiding the percentage requirements of the Rule.

The strict 80 percent requirement does overlook one problem. Some issuers who would ordinarily meet the test may, in unusual circumstances, derive an exceptionally large part of their gross revenue from outside the state, perhaps even from a single transaction. This could preclude their use of Rule 147 for almost two years. An alternative might be to allow such an issuer to average the past three fiscal years and comparable quarterly periods; thus giving a more reliable average. This would give the Rule more flexibility without destroying its objectivity, while still restricting its use to genuinely local businesses.

The Rule also creates some problems with its requirement that the issuer have 80 percent of its assets within the state. What should be included as an asset? Is it fair to preclude an issuer from complying with the Rule because it holds a large out-of-state note, or because it owns an out-of-state subsidiary? The Rule precludes an issuer from qualifying under it if a substantial asset of the issuer, one exceeding twenty percent of the total assets, is not located within the state. It is easily ascertainable whether a tangible asset is within or without the state, but the location of intangibles is not so readily determinable.

Traditionally, an intangible's situs is the owner's domicile.⁵⁸ An intangible, however, may also have a "business situs," which is different than its owner's domicile,⁵⁹ and which depends on the intangible being sufficiently "tied in with the activities of its owner carried on in the foreign state."⁶⁰ The question then arises whether the traditional domicile or the business situs should be used in determining

56. *Id.*

57. See text accompanying note 43 *supra*.

58. *Southern Pacific Co. v. McColgan*, 68 Cal. App. 2d 48, 58 (1st Dist. 1945).

59. *Id.* at 70.

60. *Id.* at 71.

the location of an intangible for purposes of the Rule. The traditional approach is more objective; it looks only to the domicile of the owner, which is easily ascertainable. The business situs, by contrast, is subjective, for it requires deciding if and where the intangible is "tied in with activities of the owner."⁶¹ Since the major purpose of the Rule is to set easily ascertainable objective tests, the traditional approach should be applied.

ii. Use of Proceeds Derived from Exempt Transactions. The definition of "doing business within a state," under either proposed Rule 147 or the section, incorporates a restraint on the use of proceeds from the sale of exempt securities. The section requires the proceeds to be used primarily for locally conducted business.⁶² The rule does not alter but reinforces the requirements of the section by providing:

The issuer shall be deemed to be doing business within a state . . . if . . . the issuer intends to use and uses at least 90 percent of the proceeds . . . *in connection with the operation of a business* or purchase of real property located in, or rendering of services within, such state . . .⁶³

The immediate question is what is meant by the qualifying phrase, "in connection with the operation of a business." The purchase of machinery or other personal or real property within the state which is used in the operation of local business would appear to meet this condition of the Rule. Similarly, the purchase of goods from a source outside the state which are used in the operation of local business would also appear to be allowed. What happens, however, when an issuer wishes to retire an out-of-state debt? Is such a debt categorized as being connected with the operation of the business? It would be frivolous to categorize the paying in cash for machinery as being connected with the business and the paying of a debt on machinery previously purchased on credit as not being connected with the business but the Rule gives no guidance on the issue.

The section requires the issuer to use the proceeds "primarily" for locally conducted business, but presumably, that portion of the pro-

61. *Id.*

62. *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Cal. 1957).

While proceeds must be used primarily within the state of the issuer in order to obtain the intrastate exemption, an interesting result was reached in *Hynes and Howes Real Estate, Inc.*, CCH FED. SEC. L. REP. ¶ 78,603, at 81,289 (SEC 1971). In *Hynes* the intrastate exemption did not apply to a corporation's proposed offering even though the company did intend to use the proceeds in the home state. The exemption was unavailable because three of the five officers assisting in distribution of the securities were residents of another state, the company had operations in another state, and there had been previously an offering to residents of other states.

63. SEC Securities Act Release No. 5349 (Jan. 8, 1973) (emphasis added). For the full relevant text of the rule, see note 20 *supra*.

ceeds which is not the "primary" portion may be used outside the state for nonrelated ventures.⁶⁴ Likewise, Rule 147 requires 90 percent of the proceeds to be used in connection with local business, and presumably the remaining 10 percent can be used outside the state for ventures not related to locally conducted business.

3. *Nature of Offerees and Purchasers: Person Resident*

In order for an issuer to claim the intrastate exemption, whether under the proposed Rule or the section, offerees and purchasers must be residents of the state of the issuer.⁶⁵ A single sale⁶⁶ or offer⁶⁷

64. A perplexing question is when and what amount of the proceeds may be used outside the state. The court in *SEC v. Truckee Showboat, Inc.*, 157 F. Supp. 824 (S.D. Cal. 1957), held the exemption unavailable for a California corporation primarily dealing in the wholesale pharmaceutical business because it offered the securities for the purpose of acquiring and operating a hotel in Nevada. The Nevada venture was found "not related to the primary business of the corporation." *Truckee, supra*, at 825.

In discussing the amount of the proceeds which may be used outside the state the Commission has said: "[I]f the proceeds are to be used primarily for the purpose of a *new business* conducted outside of the state of incorporation and unrelated to some incidental business locally conducted, the exemption should not be relied upon." SEC Securities Act Release No. 4434 (Dec. 6, 1961), commenting on *Truckee, supra* (emphasis added). This interpretation raises the question whether the proceeds may be used primarily outside the state of issuance if they are used for the purpose of a "new" business related to some incidental business locally conducted, or for an "old" unrelated business. Furthermore, if the proceeds are used primarily within the state of issuance, may the remaining proceeds be used outside the state for any venture?

The answers are unclear, for as is seen in SEC Release No. 4434, *supra*, the Commission does not say that the exemption is not available, but that "the exemption should not be relied upon." In the same release the Commission stated that the exemption is available only for "issues which in reality represent local financing by local industries, carried out through local investment." *Id. See Meeker, Advising Your Client on Securities Problems*, 28 OKLA. B.A.J. 1863, 1868 (1957). *See also Tait v. North American Equitable Life Assurance 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). SEC, Securities Act Release No. 5349 (Jan. 8, 1973), commented on *Truckee* as follows: "[S]ubstantially all of the proceeds of the offering must be put to use within the local area." *Id.*

While no definite answer appears certain, it at least appears possible to use some of the proceeds outside the state.

65. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

66. *Id.* SEC v. *Truckee Showboat, Inc.*, 157 F. Supp. 824, 825 (S.D. Cal. 1957); *Associated Investors Securities, Inc.*, 41 S.E.C. 160, 163 (1962); *Edsco Mfg. Co.*, 40 S.E.C. 865, 869 (1961); *Universal Service Corp.*, 37 S.E.C. 559, 563-564 (1957); *Professional Investors, Inc.*, 37 S.E.C. 173, 175 (1956); *Petersen Engine Co.*, 2 S.E.C. 893, 903 (1937); SEC Securities Exchange Act Release No. 8420 (October 3, 1968); SEC Securities Act Release No. 4434 (Dec. 6, 1961).

Under the section delivery to a nonresident who was a resident at the time of offer and sale will not render the exemption unavailable. *Radio Station KFH Co.*, 11 Pike & Fischer Radio Reg. 1, 138-39. The result should be the same under proposed Rule 147.

67. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

to a nonresident destroys the exemption as to the entire issue. Although this requirement of residence is the same under both methods of compliance, a substantial difference exists between their definitions of residence.

a. Residence Requirements for Individuals

Under the section, the Commission defines residence for individuals as something resembling domicile in the conflict-of-laws sense.⁶⁸ Rule 147 purports to abandon the domicile test,⁶⁹ and instead provides: "An individual shall be deemed to be a resident of a state . . . if such individual has, at the time of the offer and sale, his principal residence in the state . . . and has no present intention of moving his principal residence to a different state . . ." ⁷⁰ A person, therefore, may be domiciled in one state and yet be a resident of another for purposes of the Rule. An issuer choosing to comply with the Rule, must be careful when offering or selling securities since the exemption is unavailable if the issuer offers or sells securities to persons domiciled but not resident.⁷¹ On the other hand, it would appear that the exemp-

SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86, 87-88 (D.N.H. 1958) (quoting the test), 176 F. Supp. 789 (D.N.H. 1959) (permanent injunction), *aff'd*, 276 F.2d 665 (1st Cir. 1960) (without considering the point); SEC v. Truckee Showboat, Inc., 157 F. Supp. 824, 825 (S.D. Cal. 1957).

68. SEC, REPORTS OF SPECIAL STUDY OF SECURITIES MARKETS, H.R. Doc. No. 95, 88th Cong., 1st Sess. pt. 1, at 571 (1963). See also H.R. REP. No. 1542, 83rd Cong., 2d Sess. 22 (1954).

Different interpretations have been given to the term "resident" depending upon the statutory context. "Without more, its normal and usual meaning is 'domiciled.'" Sweeney v. District of Columbia, 113 F.2d 25, 27 (D.C. Cir. 1940), *cert. denied*, 310 U.S. 631. See G. STUMBERG, PRINCIPLES OF CONFLICT OF LAWS 16-17 (3d ed. 1963). However, it has also been held that if the legislature had meant "domicile," it would have said it. Owens v. Huntling, 115 F.2d 160, 162 (9th Cir. 1940). See also SEC v. Van Horn, 371 F.2d 181, 188-89 (7th Cir. 1966); SEC v. Los Angeles Trust Deed & Mortgage Exch., 186 F. Supp. 830, 871 (S.D. Cal. 1960), *modified on other grounds*, 285 F.2d 162 (9th Cir. 1960), *cert. denied*, 366 U.S. 919 (1961); SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86, 87 (D.N.H. 1958).

69. SEC Securities Act Release No. 5349 (Jan. 8, 1973). For the relevant language, see note 20 *supra*.

70. *Id.*

71. Such an outcome, according to Professor Loss, is more consistent with the purpose of the exemption:

[T]he domicil reading of § 3(a)(11) . . . makes it unlawful for a California issuer to offer or sell . . . to an army officer who has been stationed in California for several years complete with family while maintaining his domicil in New York, [however, it] does permit a California issuer to offer and sell to a California-domiciled officer who has had his family with him for some years at his station in New York, or for that matter on the other side of the world. To permit the latter sale seems, if anything, less consistent with the concept of an 'intrastate' issue than to permit the former.

1 Loss, *supra* note 1, at 599.

tion is not lost if the offer or sale is made to a resident who is "temporarily" residing in another state.⁷²

b. Residence Requirement for Business Organizations

A business organization, like an individual offeree, must be a resident of the same state as the issuer. However, the residency tests for business offerees differ from those used to determine the issuer's residence. Under the proposed Rule, a corporation or partnership is a resident of the state where it is incorporated or under whose laws it is organized. Thus, for example, if an offeree is incorporated in Delaware, but does all its business elsewhere, it is still a Delaware resident for purposes of the exemption. It is not clear why corporate offerees, unlike issuers, do not have to meet the gross revenues and gross assets tests for the exemption to be available. The Introductory Note to proposed Rule 147 indicates that the exemption is intended for "local financing by local industries, carried out purely through local purchasing."⁷³ This suggests that purchasers ought to be just as "local" as the issuer. Yet the Rule does not now demand that purchasers be local in any but the most formalistic way.

c. Does a Sale to a Nonresident Preclude the Issuer from Complying with Proposed Rule 147?

Whether an issuer complies with the section or the proposed Rule, a single offer or sale to a nonresident destroys the exemption.⁷⁴ The unavailability of the exemption in such a situation has been criticized as not being intended by Congress,⁷⁵ and a test of "due care" has been suggested as a substitute.⁷⁶ Furthermore, a test of due care

72. Even though a resident may be "temporarily resident" in another state or country, the exemption should still be available, for "physical presence tends to coincide more closely with residence than with domicile." *Id.* at 599 n.149.

73. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

74. *Id.*

SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86, 87-88 (D.N.H. 1958), 176 F. Supp. 789 (D.N.H. 1959) (permanent injunction), *aff'd* 276 F.2d 665 (1st Cir. 1960) (without consideration of the point); SEC v. Truckee Showboat, Inc., 157 F. Supp. 824, 825 (S.D. Cal. 1957).

75. 1 Loss, *supra* note 1, at 604-05.

76. Such a test could be satisfied by objective evidence such as driver's license, bank accounts, and voter registration.

[I]f the issuer stated conspicuously that the securities were available only to residents, required offerees and purchasers affirmatively to represent that they are residents, and in addition undertook to verify this representation by some objective means such as consulting voter registration lists, then the exemption should not be denied . . .

Comment, *SEC Regulation of California Real Estate Syndicates*, 61 CALIF. L. REV. 205, 217 (1973). See 1 Loss, *supra* note 1, at 604-05. See also R. JENNINGS & H. MARSH, *SECURITIES REGULATION CASES AND MATERIALS* 547-48 (3d ed. 1972).

has been hinted at in Commission interpretations. "The mere obtaining of formal representations of residence . . . should not be relied on *without more* as establishing the availability of the exemption" It therefore appears that if an issuer were to require "more," the exemption should be available.⁷⁸

While a test of "due care" may be permissible under the section, there is no language in the rule that would allow such a test. The Rule is explicit: "Offers . . . and sales shall be made only to persons resident within the state . . . [in] which the issuer is a resident."⁷⁹ This inflexibility seems to impose an unfairly heavy burden on the issuer, since it makes the issuer absolutely liable for an offeree's false statements of residence. If the issuer has made a good faith effort to determine its offerees' eligibility, "the exemption should not be denied because of the misrepresentation of an individual purchaser."⁸⁰

4. *Limitations on Reoffers and Resales*

Rule 147 would distinctly change the limitations on reoffers and resales. Ordinarily, under the section, the securities of the issuer must, when distributed, have "come to rest" in the hands of resident investors. Later, the securities may be reoffered or resold to nonresidents.⁸¹ An "investor" is defined as one who purchases without a view to distribute or resell to nonresidents.⁸² One who purchases with a view to resale is characterized not as an "investor" but as a "conduit," and a sale by him to a nonresident will render the exemption unavailable.⁸³ Thus, under the section, the exemption may be lost because of resale to a nonresident by a distributee even though the resale was not a part of the issuer's planned distribution.⁸⁴

77. SEC Securities Act Release No. 4434 (Dec. 6, 1961) (emphasis added).

78. The question, obviously, is what affirmative showings would satisfy the exemption? See note 76 *supra*.

79. SEC Securities Act Release No. 5349 (Jan. 8, 1973). For the full relevant language, see note 20 *supra*.

80. Comment, *SEC Regulation of California Real Estate Syndicates*, 61 CALIF. L. REV. 205, 217 (1973).

81. SEC Securities Act Release No. 1459 (May 29, 1937); SEC Securities Exchange Act Release No. 8420 (October 3, 1968).

82. SEC Securities Act Release No. 1459 (May 29, 1937).

83. *Id.* See also *Brooklyn Manhattan Transit Corp.*, 1 S.E.C. 147, 162-63 (1935).

84. See note 66 *supra*.

The presumption that the exemption should be unavailable in all situations has been criticized.

Unless the facts indicate that the issuer had reason to know otherwise at the time of purchase, representations by the purchaser that he purchased for investment and not for resale or further distribution should be conclusive of this issue.

Comment, *SEC Regulation of California Real Estate Syndicates*, 61 CALIF. L. REV. 205, 219 (1973). See also 1 Loss, *supra* note 1, at 604-05.

Proposed Rule 147 disregards the purchaser's intent, and instead prohibits any sales but those to residents of the state for "twelve months from the date of the last sale of securities which are any part of that issue."⁸⁵ After twelve months, reoffers and resales may be made to nonresidents without jeopardizing the exemption.⁸⁶ The issuer must be cautious, however, for the twelve-month period does not begin to run with the sale of a security, but with the last sale of any part of the issue. Thus, if a subsequent, integrated issue is sold, the twelve months do not begin to run until the date of the last sale of the subsequent issue. In order to protect its exemption, an issuer must ensure that transactions in a subsequent issue will not be integrated, or that the previous issue will not be sold to nonresidents until twelve months after the last sale of the subsequent, integrated transaction.

5. *Precautions Against Interstate Distribution*

Proposed Rule 147 contains requirements absent from the section concerning interstate distribution.⁸⁷ It requires the issuer: to place a legend on the certificate stating the security's lack of registration and the restrictions on its transferability; to issue stop transfer instructions to the issuer's transfer agent; to disclose in writing to offerees the restrictions on reoffers and resales; and to obtain written representation of the purchaser's residence.⁸⁸

The question is whether the exemption is unavailable if the issuer takes the necessary precautions required by proposed Rule 147, but

85. SEC Securities Act Release No. 5349 (Jan. 8, 1973). For full relevant language, see note 20 *supra*.

86. In regard to the limitation on reoffers and resales, proposed Rule 147 is not as stringent as is the section. Under the rule, securities may be purchased with the intent to reoffer and resell to a nonresident and no breach of the rule will occur unless the reoffer or resale occurs within the twelve month period. Under the section, however, if a person purchases securities with a view to resale, the securities have not come to rest and any reoffer or resale to a nonresident destroys the exemption. See text accompanying note 81 *supra*.

87. The Commission has stated that precautions should be taken, but it has not interpreted the statute as requiring them.

It is incumbent upon the issuer . . . to make sure that it does not become an interstate distribution through resales. It is understood to be customary for such persons to obtain assurances that purchases are not made with a view to resale to nonresidents.

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

88. S.E.C. Securities Act Release No. 5349 (Jan. 8, 1973). For the full relevant language see note 20 *supra*.

The Federal Securities Act does not preempt application of Uniform Commercial Code section 8-204. *Edina State Bank v. Mr. Steak, Inc.*, CCH FED. SEC. L. REP. ¶ 94,143 at 94,608 (10th Cir. 1973). Section 8-204 provides that purchasers take with notice of restrictions on securities if the restrictions are noted conspicuously on the security. Applying the rule espoused in *Edina, supra*, an issuer and its transfer agent would be held liable for damages in situations where: the issuer fails to place a legend on restricted securities as required in proposed Rule 147; or a nonresident purchaser buys without knowledge of the restrictions but the transfer agent, aware of

securities are reoffered or resold by a purchaser to nonresidents within the twelve-month period through no fault of the issuer. This problem resembles the situation in which the issuer, after doing everything in its power to ascertain the residence of an offeree, relies on the purchaser's fraudulent representations concerning his residence.⁸⁹ The rule specifically requires securities be sold to residents within the state,⁹⁰ so it appears the intrastate exemption would not be available to the issuer in such a situation.⁹¹

Conclusion

The Securities and Exchange Commission, in order to protect investors, to create a safe harbor for complying issuers, and to curtail abuse of the Section 3(a)(11) intrastate exemption and evasion of the registration provisions of the Securities Act of 1933, proposed Rule 147, which regulates the intrastate exemption. While setting more objective and stringent standards, proposed Rule 147 was intended to be nonexclusive; the intrastate exemption may also be satisfied by complying with relevant administrative and judicial decisions of the statute in effect at the time of the transaction. The Commission, in proposing Rule 147, specifically provided that it was to be nonexclusive, and a comparison of Rule 147 with other rules in the "140 Series", namely Rule 144 (the Section 4(4) brokerage exemption), clearly demonstrates its intent to do so. Proposed Rule 147 explicitly provides for two alternative methods for complying with the exemption, and the courts should so interpret it. Further, although the temptation may be great to look to Rule 147 for guidance when problems arise concerning the application of the section, the Commission and the courts should not use the Rule as a yardstick; to do so would inevitably result in the alternative methods becoming synonymous.

Proposed Rule 147 sets objective and stringent standards, and has the potential of better attaining the overall objectives of the intrastate exemption and the 1933 Act, than does the section, which is more ambiguous and uncertain. The basic requirements for obtaining the intrastate exemption are the same whether the issuer seeks to comply with proposed Rule 147 or the section, but the tests for satisfying them differ substantially. Proposed Rule 147 differs in its treatment of: (1) integration of securities, for which the Rule sets a flat six-month

such restrictions, refuses to transfer the securities because such a transfer would make the intrastate exemption unavailable. It is doubtful that the purchaser could specifically enforce the transfer of the restricted securities, but he would be entitled to damages.

89. See text accompanying notes 74-80 *supra*.

90. SEC Securities Act Release No. 5349 (Jan. 8, 1973).

91. Such a result, however, would be unfair to the issuer. See text accompanying notes 74-80 *supra*.

integration period within which all transactions will be integrated; (2) "doing business within the state," which, under the Rule, requires 80 percent of the gross revenues to be derived from the state and 80 percent of the assets to be located there, and 90 percent of the proceeds from the sale of exempt securities to be used in connection with business within the state; (3) offerees' and purchasers' residence, for which the Rule changes the test from that of domicile to that of "residence"; (4) limitation on reoffers and resales, in which proposed Rule 147 precludes the reoffer or resale of exempt securities to nonresidents for a period of twelve months, after which no restrictions exist as to reoffering or reselling; and (5) precaution against interstate distribution, as to which the Rule requires that specific acts be done to protect against interstate sale. The above are only the broad, substantial differences between proposed Rule 147 and the section. In order to ensure that it will not violate the Securities Act, the issuer needs to be equally aware of the more subtle and less substantial differences which exist and which are discussed in the body of this Comment.⁹²

James A. Askew

92. Adopted Rule 147 changed a few of the tests put forth in proposed Rule 147; some of the changes having been espoused in this Comment as well as by other writers. The Commission, in adopting Rule 147, attempted to tie down the test of integration of transactions. If an offer or sale occurs prior to or after six months from the date of the last offer or sale by the issuer, the transaction will not be integrated. For offers and sales within the six-month period, integration will continue to be a question of fact to be determined case-by-case, provided that during the six-month period no offer or sale occurs of the same or similar class of securities as those offered or sold pursuant to the Rule. The Rule does not state what will happen to transactions if another offer or sale of the same or similar issue is made within the six-month integration period; presumably, the transactions would be integrated automatically.

Concerning the residence of a general partnership issuer, the adopted Rule abandons the test of the proposed Rule based on residence of all general partners. Instead, residence will be deemed to be the state or territory under whose law the partnership is organized. If the partnership is not organized under the law of any state or territory, its residence will be the location of its principal office. When a partnership is an offeree or purchaser, it shall be deemed a resident of the state if its principal office is in the state; thus, whether the partnership is organized under the law of a particular state will not be determinative.

The Commission, in determining whether an issuer is "doing business within the state," has adopted more encompassing phraseology. Instead of requiring that 80 percent of gross revenue be derived from, among other activities, the manufacture of products within the state, the adopted Rule requires that the issuer derive at least 80 percent of gross revenue from the "operation of a business"; thus allowing issuers who buy and sell products already manufactured to comply with the Rule. The Rule exempts from the 80 percent test issuers that have not had gross revenues of \$5,000 from the operation of their business for the last fiscal year. The adopted Rule also requires that 80 percent of the proceeds from the sale of exempt transactions be used in the operation of a business within the state (90 percent under the proposed Rule). In addition, adopted Rule 147 requires that all reoffers and resales of exempt transactions within nine months of the last sale of the issue be made to residents (twelve months under the proposed Rule).