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James H. Cheek, III

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Exemptions Under the Proposed Federal Securities Code

*James H. Cheek, III**

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I. INTRODUCTION

The Federal Securities Code Project of the American Law Institute attempts to integrate into one piece of legislation the various provisions of the seven separate statutes under which the Securities and Exchange Commission (SEC or Commission) exercises its supervisory and advisory responsibilities. This task, under the extraordinary leadership of Professor Louis Loss, succeeds in eliminating from the statutes unnecessary, duplicative, and needlessly complex provisions and in clarifying confused and unsettled areas of securities regulation.

The policy of full, accurate, and continuous disclosure to investors embodied in the Securities Act of 1933 (1933 Act)[1] and in the Securities Exchange Act of 1934 (1934 Act)[2] continues unfettered

* Lecturer in Law, Vanderbilt University. B.A., Duke University, 1964; J.D., Vanderbilt University, 1967; LL.M., Harvard University, 1968; Member, Tennessee Bar.

1. Securities Act of 1933 §§ 1-26 [hereinafter cited as 1933 Act], 15 U.S.C. §§ 77a-77aa (1970).

2. Securities Act of 1934 §§ 1-34 [hereinafter cited as 1934 Act], 15 U.S.C. §§ 78a-78hh (1970).

under the proposed Federal Securities Code (the Code), but the provisions effecting that policy are consolidated and simplified. Under the Code, a company must register itself (not its securities) with the Commission after the first year-end at which it has at least one million dollars in total assets and three hundred holders of its aggregate, nonexempted securities[3] *or* when the Code first requires it to file an offering statement. All reports and other filings thereafter are keyed to that registration, creating a single disclosure file at the SEC. A company generally must file an offering statement containing a prospectus for each distribution of its securities by any person (whether the company, a controlling person, or a noncontrolling person).[4] The offering statement thus replaces the registration statement currently required to be filed under the 1933 Act. Further disclosure is achieved through the filing of periodic reports and proxy statements.[5]

While seeking to further investor protection by requiring disclosure through its filing and registration provisions, the Code also attempts to avoid unnecessary regulation of and interference with honest business or with the process of private capital formation.[6] When such interference is unnecessary or serves only minimal public interest, the Code, through exceptions and exemptions, permits companies to avoid filing and registration requirements. This article focuses upon these Code exceptions and exemptions,[7] which do not

3. ALI FED. SEC. CODE §§ 401, 402 (Reporter's Revision of Text of Tent. Drafts Nos. 1-3, 1974) [hereinafter cited as RD 1-3]. This company registration requirement parallels § 12(g) of the 1934 Act, 15 U.S.C. § 78*l*(g) (1970), except that the number that triggers registration is 300 holders rather than 500 holders and that, in determining that number, the holders of all nonexempt securities are counted instead of only the holders of each separate class of equity securities. *See generally* Bialkin, *The Issuer Registration and Distribution Provisions of the Proposed Federal Securities Code*, 30 VAND. L. REV. 327 (1977) [hereinafter cited as Bialkin].

4. RD 1-3 § 501. Under the 1933 Act secondary sales do not ordinarily create registration problems unless the seller is a controlling person of the issuer. The Code abandons the distinction between secondary distrihutions by a controlling person and those by a noncontrolling person, treating all distributions alike and requiring the filing of offering statements unless the particular transaction or security is exempted. While only an issuer may file an offering statement, the Code permits a secondary distributor who is unable to meet the conditions of an exemption to file with the SEC a distribution statement in lieu of an issuer-filed offering statement if the issuer continuously has been a registrant for one year. Even when the issuer is not a one-year registrant, a secondary distributor may require that an issuer file an offering statement upon demand and payment of expenses. *See* Bialkin, *supra* note 3, at 350.

5. RD 1-3 §§ 601, 602.

6. ALI FED. SEC. CODE § 101 (Tent. Draft No. 6, 1977). These purposes are consistent with those evidenced by the legislative history of the 1933 Act and the 1934 Act.

7. A company may escape filing its initial registration only by avoiding a nonexempted distribution or the triggering levels of total assets and of holders of its nonexempt securities.

eliminate the necessity for compliance with the Code's antifraud provisions and with any applicable state blue sky laws, subjects beyond the scope of this article.

Most of the exempted securities and transactions discussed in this article apply only to special types of issuers, securities, and transactions. The Code does contain, however, certain exceptions and exempted transactions that have general application for most issuers and selling stockholders. A chart appearing at the end of this Article sets forth in a simplistic fashion the principal features of the exceptions and exemptions which most often will be relied upon by issuers and secondary sellers in selling securities.

II. The Distribution Concept

Since an offering statement must be filed only when a distribution occurs, giving content to the concept of distribution is one of the most important tasks of the Code. Section 227 defines distribution as "an offering other than a limited offering or a trading transaction." The limited offering exception is derived from the exemption in section 4(2) of the 1933 Act for nonpublic, or private, offerings. The trading transaction exception is derived from the exemptions provided for routine secondary trading transactions in sections 4(1) and 4(4) of the 1933 Act. Although not cast as specific exemptive provisions, these two exceptions provide essential avenues of escape from filing and registration requirements.

A. *The Limited Offering*

(1) The Current Law

Section 4(2) of the 1933 Act, the precedent for the limited offering exception, exempts from the registration provisions of that Act "transactions by an issuer not involving any public offering." This exemption has caused considerable turmoil and confusion. The 1933 Act does not define the term "public offering," and its legislative history fails to identify the necessary components of an exempt nonpublic, or private, offering. For many years lawyers relied upon

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While this article is generally concerned with the available escape chutes from the offering statement filing and delivery requirements, the discussions relating to the distribution concept, to the local distribution, and to exempt securities and transactions are equally applicable to the initial company registration statement requirement, assuming that the triggering levels of assets and security holders have not been reached. Section 405 of the Code permits a registrant to terminate its registration when the number of holders of all its securities falls below 100 at a fiscal year-end.

the general guidelines provided by an early SEC release,[8] which focused upon the following considerations: (a) the number of offerees (a maximum of twenty-five persons was suggested); (b) the relationship of the offerees to one another; (c) the relationship of the offerees to the issuer; (d) the number of units offered; and (e) the size and manner of the offering. Within the parameters of these guidelines, the bar for many years focused primarily upon the number of offerees in determining whether an offering was exempt as a private offering. In 1953, however, the Supreme Court in *SEC v. Ralston Purina Co.,*[9] its only decision construing the exemption, stated that the focus should be primarily upon the offerees' need for the protection afforded by registration under the 1933 Act rather than upon the number of offerees. The Court indicated that if offerees can "fend for themselves" and have access to the type of information that a registration statement would disclose, then the offering is nonpublic and, therefore, exempt.

Prompted by increasing reliance upon the exemption for sales of speculative issues to small numbers of unrelated and uninformed persons, the Commission in 1962 issued another release again emphasizing the need to consider all the elements set forth in its previous release and noting that, consistent with *Ralston Purina,* the number of offerees is relevant "only to the question of whether they have the requisite association with and knowledge of the issuer which make the exemption available."[10] Despite the warnings contained in the 1962 release and in *Ralston Purina,* many practitioners continued to rely primarily upon a numbers test and generally were frustrated in trying to determine the relative importance of the other considerations. A series of federal circuit court decisions added to the confusion.[11] Some of the decisions, if read literally, seemed to challenge many transactions that historically had been viewed as good "private placements." These opinions stressed the need to prove that all offerees, even if sophisticated and limited in

8. SEC Securities Act Release No. 285 (Jan. 24, 1935), 1 FED. SEC. L. REP. (CCH) ¶ 2740.

9. 346 U.S. 119 (1953).

10. SEC Securities Act Release No. 4552 (Nov. 6, 1972), 1 FED. SEC. L. REP. (CCH) ¶ 2770.

11. Doran v. Petroleum Management Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 95,844 (5th Cir. 1977); Woolf v. S.D. Cohn & Co., 515 F.2d 591 (5th Cir. 1975), *vacated on other grounds,* 426 U.S. 944 (1976); SEC v. Continental Tobacco Co., 463 F.2d 137 (5th Cir. 1972); Henderson v. Hayden, Stone Inc., 461 F.2d 1069 (5th Cir. 1972); Hill York Corp. v. American Int'l Franchise, Inc., 448 F.2d 680 (5th Cir. 1971); Lively v. Hirschfeld, 440 F.2d 631 (10th Cir. 1971); United States v. Custer Channel Wing Corp., 376 F.2d 675 (4th Cir. 1967), *cert. denied,* 389 U.S. 850 (1967).

number,[12] had access to the information a registration statement would provide. One opinion seemed to say that the requisite access could be established only by proof that the offerees had some special or privileged relationship, tantamount to the position of an "insider," with the issuer and between or among themselves.[13] Even the most sophisticated members of the securities bar were disturbed by the decisions' implications, which raised doubts about the availability of the section 4(2) exemption for many venture capital situations and for traditional institutional purchases.[14]

The uncertainties surrounding the necessary components of an exempt private offering resulted in considerable pressure upon the Commission to adopt an objective rule. In 1974 the Commission adopted rule 146 under the 1933 Act setting forth a number of conditions which, if met, qualify an offering for the section 4(2) exemption.[15] The rule sets forth specific standards designed to determine objectively the ability of offerees and purchasers to fend for themselves, specific requirements to ensure offerees' access to information, restrictions limiting the manner of offering and specifying thirty-five as the maximum number of purchasers, and certain requirements designed to control transferability. Although the bar welcomed the Commission's attempt to provide objective standards, the rule's meticulous paperwork requirements, which pose one of several practical problems in satisfying all of the specified conditions, and its failure to recognize the distinctly different types of offerings involved in private placement situations have resulted

12. The private offering exemption may not be available even if it is proved that there are only a small number of sophisticated offerees. In Doran v. Petroleum Management Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 95,844 (5th Cir. 1977), the defendant proved that the offering was made only to eight persons, all of whom were sophisticated investors and only five of whom actually purchased in the offering. The failure to prove that each offeree had access to or had been furnished information that a registration statement would disclose caused the court to conclude that the offering was not an exempt private placement.

13. SEC v. Continental Tobacco Co., 463 F.2d 137, 160 (5th Cir. 1972). *But see* Doran v. Petroleum Management Corp., [Current] FED. SEC. L. REP. (CCH) ¶ 95,844 (5th Cir. 1977).

14. The failure of judicial decisions and administrative interpretations to recognize the practical distinctions between the various types of private placements, which range from the speculative venture capital situation to the blue chip institutional debt private placement in which access in terms of a preexisting relationship rarely exists, and the heavy burden of proof placed upon an issuer claiming the private placement exemption caused great concern among members of the securities bar. *See generally* Rediker, *The Fifth Circuit Cracks Down on Not-So-Private Offerings,* 25 ALA. L. REV. 289 (1973); Analysis, *The Disappearing Private Offering Exemption?,* 144 SEC. REG. & L. REP. (BNA) B-1 (March 22, 1972).

15. SEC Securities Act Release No. 5487 (Apr. 23, 1974), 17 C.F.R. § 230.146, 1 FED. SEC. L. REP. (CCH) ¶ 2710.

in dissatisfaction with and limited use of the rule.[16] These considerations, among others, have caused the Commission to reevaluate rule 146 and to contemplate its rescission.[17]

Rule 146 is not an exclusive rule and, because of the difficulty and impracticality of applying it in many situations, many issuers continue to rely upon the residual law surrounding the statutory exemption. The desire for greater uniformity and certainty in the residual law prompted the organized bar to publish position papers setting forth applicable criteria for determining the availability of the section 4(2) exemption. The papers emphasize that application of standards to an institutional offering should vary in some respects from their application to promotional offerings to individuals of speculative securities.[18] Generally the characteristics set forth in these papers of a valid private offering are as follows: (a) offeree qualification, which may be based upon sophistication, wealth, or personal relationship; (b) access to or actual receipt of information, which may be less extensive than a registration statement (access resulting from economic bargaining power is included specifically); (c) a limited manner of offering; and (d) the absence of redistribution. The papers, while of uncertain authority, are significant, particular in light of the possible rescission of rule 146.

In addition to the problem of determining the components necessary for a valid private offering under the section 4(2) exemption, the exemption is limited by its statutory language to issuers. Nevertheless, persons other than issuers[19] seek to avoid the registration requirements of the 1933 Act by making private sales that would

16. Rule 146 appears to he used primarily for offerings of special types of securities, such as limited partnership interests, in which the practicalities and costs of complying with rigorous conditions are not insurmountable. The rule is rarely relied upon for institutional and venture capital transactions. Indeed the rule appears to have operated in a harmful fashion for the raising of venture capital for small businesses. *See generally* Kripke, *SEC Rule 146: A "Major Blunder,"* 172 N.Y.L.J. 1 (July 5, 1974); Note, *SEC Rules 144 and 146: Private Placements for the Few*, 59 VA. L. REV. 886 (1973).

17. SEC Securities Act Release No. 5779 (Dec. 6, 1976) [Current] FED. SEC. L. REP. (CCH) ¶ 80,820. The Commission in this release recognizes the criticism that rule 146 hinders the obtaining of investment venture capital. The Commission further indicates its concern that the rule is being used fraudulently, particularly with respect to oil and gas tax shelter offerings. The Commission has requested comments on whether the rule should be rescinded, revised, or retained.

18. Federal Regulation of Securities Committee, American Bar Ass'n, *Section 4(2) and Statutory Law*, 31 BUS. LAW. 485 (1975); Committee on Developments in Business Financing, American Bar Ass'n, *Institutional Private Placements Under the Section 4(2) Exemption of the Securities Act of 1933*, 31 BUS. LAW. 515 (1975).

19. Generally, these persons are either in a control relationship with an issuer or purchasers of privately-placed securities from the issuer.

meet the requirements of section 4(2) if made by an issuer. Technically these sellers must rely upon the section 4(1) exemption, but because they must structure the transactions in a manner similar to private placements by issuers under section 4(2) in order to secure the section 4(1) exemption,[20] the exemption is known as the section 4(1-1/2) exemption. Whether the conditions required for a section 4(2) exemption must be met to establish a valid section 4(1-1/2) exemption is unclear, and practitioners often must rely merely upon their intuitive understanding of the area.

Public resales by purchasers of securities in transactions meeting all of the conditions of the section 4(2) or section 4(1-1/2) exemptions pose still another problem. Implicit in the private offering concept is the requirement that purchasers' resales be restricted in order that the private offering does not become a public one by immediate distribution of the securities to the public. In addition, since the section 4(2) and 4(1-1/2) exemptions apply only to single transactions, any subsequent sale by the purchaser must find its own exemption. The section 4(1) exemption ordinarily is relied upon to permit public resales, its availability depending upon whether the security was acquired "with a view to" its distribution.[21] Thus purchasers in private placements customarily represent that they are buying for investment and not with a view to distribution. In advising such purchasers of the permissible times and manner for resale of their securities, attorneys struggled for many years with the ad hoc application of fuzzy concepts, such as "investment intent,"[22] "change in circumstances,"[23] and

20. Section 4(1) exempts transactions by any person other than an issuer, underwriter, or dealer. 15 U.S.C. § 77d(1) (1970). To avoid being classified as an underwriter as defined by § 2(11) of the 1933 Act, 15 U.S.C. § 77b(11), a person must not be selling in connection with a distribution and must carefully plan resales of privately-placed securities to ensure that a public distribution does not occur. *See generally* Schnieder, *Comment Letter on Rule 146*, 228 SEC. REG. & L. REP. (BNA) F-1 (Nov. 21, 1973).

21. The definition of "underwriter" in § 2(11) of the 1933 Act includes a person who has purchased from an issuer (including a controlling person) with a view to the distribution of any security. 15 U.S.C. § 77b(11) (1970). A person who has purchased with such a view becomes an underwriter and is precluded from relying upon the § 4(1) exemption. 15 U.S.C. § 77d(1) (1970).

22. A person buying with investment intent presumably could not have bought with a view to a distribution. Since it was very difficult objectively to prove investment intent, a presumption of investment intent arose if the buyer held the securities for more than a certain period of time, which ranged from two to five years depending on when and with whom one discussed the point. *See* SEC PROBLEMS OF CONTROLLING STOCKHOLDERS AND IN UNDERWRITINGS 25-43 (Israels ed. 1962); Kennedy, *The Case of the Scarlett Letter*, 23 BUS. LAW. 23 (1967).

23. The "change in circumstances" doctrine was developed by the staff to shorten the holding period requirements when the buyer experienced a change of circumstances that generated a need to resell privately-placed securities that was not present at the time of the

"fungibility,"[24] each of which contributed to inconsistency in legal advice rendered. Rule 144, adopted under the 1933 Act by the Commission in 1972, largely resolved the problem by requiring public resales of most securities purchased either in a nonpublic offering from an issuer or in a chain of such offerings to be made in accordance with the rule. In general, the rule permits limited resales in ordinary brokerage transactions after a two-year holding period.[25]

(2) The Code Approach

Recognizing the problems surrounding the private placement exemption under current law and the need to relieve small businesses of the burdens of registration when the public interest in registration is negligible, the Code substantially changes the subjective concepts underlying the section 4(2) exemption.[26] Code section 227(b) sets forth at least four categories of conditions that must be met in order to qualify for the limited offering exception.

1. *Number and Character of Purchasers*. An offering[27] must not result in sales to more than thirty-five noninstitutional persons,[28] although sales are permitted to an unlimited number of institutional investors.[29] No limitation is imposed on the number of offerees, nor must the purchasers be sophisticated, wealthy, or closely

purchase. A resale by such a person would not conflict with the required investment intent at the time of the original purchase.

24. The staff traditionally applied a fungibility concept when a person owned privately-placed securities as well as securities purchased in the market. The staff considered these shares to be fungible and deemed the shares first offered after the private placement as the restricted shares subject to the holding period irrespective of the source of the specific shares delivered. *See* note 44 *infra* and accompanying text.

25. SEC Securities Act Release No. 5223 (Jan. 11, 1972) [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,487. In the staff's view, the old rules relating to the resales apply only to privately-placed securities acquired before April 15, 1972, even though rule 144 is stated to be non-exclusive.

26. As the Reporter, Professor Loss, has stated, the rationale behind the concept is a matter of husbanding resources and balancing federal power in view of the fact that on the one hand the Commission's manpower and budget are limited and on the other hand there are other protective devices such as the state blue sky laws. *See generally* Loss, *The "Limited Offering" Under the American Law Institute's Federal Securities Code*, PLI. 4th Annual Institute on Securities Regulation 35 (1973) [hereinafter cited as Loss, *Limited Offerings*].

27. The definition of "offering" in section 267 of the Code requires a person relying upon the limited offering exception to examine all prior offerings to see if they must be integrated. *See* notes 39-43 *infra* and accompanying text.

28. Under section 276 of the Code a corporation, partnership, association, trust, or organized group of persons is apparently considered one person even if specifically formed for a particular limited offering. The number 35 has no magical significance; it originated from an indication by SEC Commissioner Phil Loomis that the Commission would accept the number 35. *See* Loss, *Limited Offerings*, *supra* note 26, at 41.

29. *See* note 33 *infra* and accompanying text.

related to each other or to the issuer. The purchasers need not have access to or be furnished with information comparable to that provided by registration. Thus the Code significantly modifies existing interpretations of the section 4(2) exemption, relieving issuers from difficult problems of proof in establishing the private placement exemption.

The Code comments suggest that departure from the existing emphasis upon the number of offerees is justifiable because the breadth of the definition of "offer" causes difficulty in counting offerees and because nonpurchasing offerees suffer no injury.[30] Although sound policy dictates removal of the practical burdens caused by the present emphasis upon the number of offerees, restraints should be placed upon the breadth of the offering. Unlimited offers may lead to presale stimulation of interest sufficient to affect existing markets, to condition the market for later offerings, or to mislead ultimate purchasers. The Code deals with this problem, not as a condition of the limited offering exception, but through a separate section prohibiting anyone from engaging in "general advertising" in connection with a limited offering in contravention of Commission rules.[31] Presumably the Commission promptly will adopt rules to protect the public from any potential harm arising from broad advertising in connection with a limited offering. The Code's prohibition, however, is limited to "advertising," a term that may not be broad enough to enable the Commission to block harmful general solicitation that technically is not advertising. In addition, since the restriction on general advertising is not a condition of the limited offering exception, the Code lacks the effectiveness it would have if a seller were faced with civil liability for violations. Although the Code's focus on the number of purchasers, rather than upon the number of offerees, is well-founded, the ramifications of the change would be better controlled by including as a condition to the limited offering exception a prohibition against general solicitation in addition to the ban on advertising and by providing objective definitions for these terms by Commission rule.[32]

Another major departure from the private placement concept of the 1933 Act is the rejection of *Ralston Purina* through the aban-

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30. ALI FED. SEC. CODE § 227, Comment (2)(b) (Tent. Draft No. 1, 1972) [hereinafter cited as TD-1].

31. RD 1-3 § 502(b). Additional restraints upon the misuse of unlimited offers are found in the Code's general antifraud and antimanipulative provisions.

32. Precedents for this approach to the problem may be found in rule 146(c). This approach to imposing limitations on the manner of offering has resulted in few problems.

donment of the "sophistication" and "relationship" tests used by both rule 146 and the residual law of section 4(2) to determine qualified offerees and purchasers. Under the Code's approach, the purchasers of a limited offering can be thirty-five widows and orphans who are thoroughly unsophisticated strangers, and who are unable to bear the economic risk of their investment. By focusing solely upon numbers, the Code adds precision to a subjective and troublesome aspect of the section 4(2) exemption, but places the entire burden of investor protection upon its antifraud provisions and upon applicable state blue sky laws. Such provisions may not adequately protect investors in the private placement process, particularly in the context of speculative offerings by unseasoned companies. The Code also abolishes the requirement that purchasers be furnished with or have access to information about their investments. The difficulty of proving a fraud claim based, as often is the case, upon oral statements and the practical limitations on the budgets and enforcement personnel of the regulatory authorities limit the effectiveness of antifraud provisions and substantive blue sky regulation in providing comprehensive protection of the investing public. As a practical matter, an individual purchaser is better protected if the sale to him destroys the availability of the limited offering exception and thereby subjects the seller to civil liability without the problems of proof involved in an antifraud claim. As a policy matter Congress must decide whether the certainty achieved by the Code's present approach benefits the private capital formation process sufficiently to outweigh the increased likelihood that the savings of naive, uninformed individuals will be tapped by capital-seeking promoters and issuers.

The Code definition of "institutional investors," who are excluded from the restriction on the number of purchasers of a limited offering further clouds the issue relating to the imposition of some minimum self-fending or informational standards for individual purchasers. Section 242 defines institutional investors as including only banks, insurance companies, and registered investment companies, but the Commission by rule may add other types of institutions, such as universities or pension funds, or may remove certain types of banks, insurance companies, or investment companies. Any Commission rule including or excluding an institution from this definition must be based upon such self-fending considerations as financial sophistication, net worth, and amount of assets under management. Thus although the Code suggests that it is important for the Commission to consider the sophistication and financial ability of institutions to fend for themselves, these considerations are immaterial to individuals participating in a limited offering.

The unobstructed access to all private capital provided by the Code's limited offering exception should be restricted when the issuer is not a one-year registrant and has a weak or no financial history.[33] In this situation, purchasers should be limited to those with such financial sophistication, net worth, or preexisting family or business relationship as the Commission shall prescribe by rule.[34] Although the Commission has the power under section 227(b)(3) to add this condition to the limited offering exception, the Code, in order to assure that action is taken, should direct the SEC to promulgate a rule based upon specific criteria.

2. *Resale Restrictions*. The second condition to the limited offering exception places restrictions on resales to prevent the limited offering from becoming a broad public offering. Although such restrictions are essential to the concept of a nonpublic offering under the 1933 Act, the Code's approach is significantly different. Under the Code, unless resales are made pursuant to a filed offering or distribution statement or pursuant to an exemption,[35] no resales may be made that result at any one time in more than thirty-five owners of the securities sold in the limited offering, excluding institutional investors and those who became owners by means other than purchase. This resale restriction applies for three years following the last sale to any of the initial noninstitutional buyers, except that the restrictive period is one year when the issuer is a one-year registrant at the time of a particular resale.[36] Thus there is no hold-

33. In view of the other exemptions available to small businesses, particularly the $100,000 small offering and the local distribution exemptions, this limitation is not likely to interfere unduly with the raising of private capital, except when the public interest is intensified by the need to raise large amounts of capital from investors located in several states.

34. If a self-fending condition is added to the limited offering exception, it is assumed that § 227(b)(7) would protect an issuer or reseller who in good faith believes that the purchaser met the qualifications imposed by the Commission's rule. If such a good faith bar to civil liability is included, the inclusion of this additional condition should not cause great concern. Moreover, if this type of self-fending condition is imposed, relatively few additional henefits would result from including a similar condition requiring the furnishing of or access to information. An information requirement presumably already exists in the Code's antifraud provisions.

35. *See* RD 1-3 § 227, Note 1(c). The specific references to resales during the restrictive period pursuant to a distribution statement conflict squarely with § 509(a)(3), which bars the use of a distribution statement for sales of limited offering securities during the restrictive period. *See* note 57 *infra* and accompanying text. Similarly, unless the Commission adds a useful exemption under its general authority contained in § 302, few if any exemptions are available for resales during the restrictive period. *See* note 37 *infra*.

36. A one-year registrant is defined as a company that has registered with the Securities and Exchange Commission and has been continuously a registrant for one year. RD 1-3 § 270. Operating upon a philosophy of continuous disclosure, the Code in a number of instances

ing period requirement per se, and the abstruse concept of investment intent is irrelevant. Resales may be made immediately and frequently during the applicable restrictive period if the maximum number of owners does not exceed thirty-five.[37] Moreover, the Code eliminates the confusion surrounding the tacking of holding periods in nonsale situations such as pledges or transfers by gift or death. The Code does not count recipients of these transfers in determining whether the maximum number of owners has been reached.

The new approach to the resale problem, although welcome, poses practical difficulties for a reseller in determining when the restrictive period begins and ends and whether thirty-five or fewer owners, other than institutions or recipients of securities in nonsale transactions, are involved. The latter problem is particularly complex because the term "owner" rather than "person" is used and because the term includes indirect as well as direct ownership,[38] thus requiring an issuer or reseller to ferret out the number of beneficial, indirect owners when the record owner is a nominee, partnership, or similar entity. Section 227(b)(7) of the Code remedies this problem by protecting a reseller from civil liability if that person acts in good faith reliance upon a statement by either the issuer or its transfer agent setting forth the number and institutional nature of the current owners. The Code similarly protects a reseller who in good faith receives from his buyer a written undertaking designed to avoid an illegal distribution and complies with any Commission rules concerning certificate legends or stop-transfer orders. The latter protective device also is available to the original seller of the securities in the limited offering. To ensure this protection, an original purchaser should require at the time of purchase a written undertaking from the issuer that, upon request of the owner of the securities, it will furnish the requisite statement of current ownership. An original seller or reseller should require an undertaking from the buyer that he will not resell during the applicable restrictive period if the resale would result in more than thirty-five owners

provides advantages for one-year registrants. The Code permits an issuer to register voluntarily unless prohibited by Commission rule. RD 1-3 § 401(b).

37. Each resale is subject to the offering statement requirements unless there is an available exemption or exception to the distribution concept. Since during the restrictive period the trading transaction exception, the small offering exemption, the local distribution exclusion, and the distribution statement provisions are all unavailable for resales of limited offering securities, a reseller during the restrictive period either must use an effective offering statement or rely upon the limited offering exception or some exemption created by Commission rule under § 302. Consequently, as a practical matter, the restrictive period operates in most cases as a holding period. *See* note 61 *infra* and accompanying text.

38. RD 1-3 § 272(b).

and that he will seek the number of current owners from the issuer or its transfer agent before reselling. Issuers should be able to maintain adequate control over this aspect of the resale problem by maintaining separate transfer books for limited offerings, using appropriate stop-transfer notices and legends, and requiring representations of buyers with respect to indirect ownership.

The Code's approach to another resale problem is less successful. The reseller acts at his own risk in determining whether the issuer is a one-year registrant and whether the applicable restrictive period has ended. Prudent buyers should require at the time of purchase a written undertaking of the issuer that it will provide upon request a statement and an opinion of counsel reflecting the current status of the issuer and indicating when the restrictive period ends. The Code, however, does not protect a reseller who in good faith resells on the basis of such a statement and opinion. In light of the absolute civil liability provisions of the Code, section 227(b)(7) should be expanded to include this protection.

The risks for a reseller arising from uncertainty as to when the restrictive period begins and ends are magnified by the Code's application of the integration concept in defining the term "offering."[39] The definition reflects the gnidelines by which the SEC determines when two or more offerings should be integrated and deemed a single offering for the purpose of examining whether the private placement, intrastate, or some other exemption is available for that offering.[40] Offerings of the same class of securities usually constitute separate offerings if they are substantially distinct in manner, time, purpose, price, and kind of consideration.[41] The Code contains no objective safe harbor provisions similar to those contained in rule 146, based upon the length of time between offerings, but the Commission is authorized to include such a provision should it decide to define "offering" more specifically.[42] The restrictive period does not begin until the last sale to a noninstitutional buyer in the offering.[43] Thus in determining when the restrictive period begins and

39. RD 1-3 § 267.

40. *See* SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 FED. SEC. L. REP. (CCH) ¶ 2270; SEC Securities Act Release No. 5450 (Jan. 7, 1974), 1 FED. SEC. L. REP. (CCH) ¶ 2340.

41. Section 267(b) of the Code states tbat a limited offering, an offering by means of trading transactions, and an offering in exempted transactions under §§ 511(e)-(g) are substantially distinct from each other and thus presumably will not be integrated.

42. This authority does not arise within § 267 itself but is derived either from the general rulemaking autbority in § 1502 of the Code or from the authority granted by § 227(b)(3) to promulgate a modified condition to the limited offering exemption.

43. An initial offering pursuant to the limited offering exception may continue for several months or years. A buyer in such an offering is clearly at a disadvantage since he has

ends, the reseller must examine, in the absence of a safe harbor provision, not only the number of owners but also any other offerings by the same person that might be integrated. A reseller has no ability to gather the information necessary for this determination and must rely upon a statement from the original seller. Again, section 227(b)(7) should be expanded to protect a reseller who relies in good faith upon such a statement.

An additional problem a reseller may have in determining the applicability of the Code's resale restrictions arises when that person owns both securities purchased in a limited offering whose restrictive period has not expired and securities purchased either in the market or as part of a limited offering whose restrictive period has expired. Prior to adoption of rule 144 under the 1933 Act, the SEC staff applied the doctrine of fungibility to this situation. Because the SEC considered the shares to be fungible and thus could not determine whether the resale was of the privately-placed securities, a purchaser of securities in a private placement could not sell any shares of the same issuer during the required holding period. Rule 144 fortunately eliminated this troublesome concept for sales falling within its purview. The Code, in the context of the limited offering exception, continues the rule 144 policy. Under the Code, when the seller owns some securities that are subject to resale restrictions and some that are not, any sale is to be considered a sale of securities other than those subject to the resale restrictions, regardless of what certificates actually may be delivered, if the seller retains (except for permitted resales) at least the number of shares purchased in the limited offering during the restrictive period.[44] Although the Code is silent on the point, if the seller fails to retain a sufficient number of shares, the Commission or a court presumably could apply the fungibility doctrine to restrict all sales.

3. *Rules Adopted by the SEC.* The third condition to the limited offering exception requires the original seller[45] and all resellers

no control over the point at which his restrictive resale period begins. In addition, the Code will not permit a buyer to resell pursuant to a distribution statement even when the issuer is a one-year registrant and will not permit reliance upon either the $100,000 small issue exemption or the trading transaction exception until the restrictive period has expired. The only method of avoidance available to the buyer is through demand registration or through voluntary filing by an issuer of an offering statement. *See* RD 1-3 §§ 227(c)(1)(B), 509(a)(3), 511(d)(2). Buyers in a limited offering can inject some certainty into determining when the restrictive period begins to run by insisting that an issuer undertake an outside date for completion of the offering.

44. RD 1-3 § 227(b)(8).

45. The Code inexplicably uses the term "offeror" instead of seller but since the limited offering exception concentrates only on sales, the condition presumably relates to the original

during the restrictive period to comply with any rules that the SEC may adopt concerning the obtaining of an appropriate written undertaking by a buyer, the placing of appropriate restrictive legends on certificates for securities that are the subject of a limited offering, and the giving of appropriate stop-transfer notices to the transfer agent.[46] Although none of these conditions exists until the Commission acts, the Commission is likely to promulgate a rule similar to rule 146(h), which requires undertakings, legends, and stop-transfer restrictions. These devices are useful to protect against illegal resales and inform buyers of existing restrictions on the ability to resell. To require absolute compliance with a rule requiring such devices, however, is unwise, because an inadvertent omission of a legend or similar requirement would create an illegal distribution and subject the seller to absolute civil liability under the Code. If in fact no resales have violated the second condition of the limited offering exception, it makes little sense to invalidate the exception because of an inadvertent failure to comply with administrative requirements designed to ensure that no illegal resales occur. The Code should be modified to remove this possibility.[47]

4. *Modification of and Addition to the Expressed Conditions.* Section 227(b)(3) grants to the Commission authority to modify or to add to the conditions of the limited offering exception.[48] The section in effect eliminates the necessity for a specific grant of authority to promulgate rules relating to resale protective devices as the third condition to a limited offering. This authority to fashion modified or additional conditions in the context of the limited offering exception is broad enough to permit the Commission to legislate

seller and one does not need to focus on the actions of the original offeror if for some reason that person is not the original seller. RD 1-3 § 227(b)(1)(C).

46. RD 1-3 §§ 227(b)(1)(C), 227(b)(4). The Code recognizes that restrictions on transferability must be policed to be effective and that such policing must occur within the parameters of the Uniform Commercial Code. Recognizing these parameters, § 227(b)(6) states that an issuer or transfer agent need not police the restrictions unless the restriction is between the issuer and the security holder or unless a stop-transfer notice bas been received by the issuer or transfer agent as the result of a resale by a buyer. TD-1 § 227(b)(6), Comment 7.

47. Similar criticisms have been made of the type of condition tbat is included as part of rule 146. *See* Schneider & Zall, *Section 12(1) and the Imperfect Exempt Transaction: The Proposed I & I Defense*, 28 BUS. LAW. 1011 (1973).

48. This section does contain a suggestion that the Commission in modifying or adding conditions should consider, among other criteria, the type of issuer and security, the kind of market, and the issuer's status as a one-year registrant. The suggested criteria do not impose any real limitations upon the basic authority of the Commission to modify or to add conditions, especially since the section clearly states that other criteria may be considered. TD-1 § 227(b)(3).

as if it were Congress, even though its actions may operate to subvert the basic policy that the public interest in federal registration of this type of offering is outweighed by the adverse effects upon business' ability to raise capital. An example of the breadth of this authority appears in one of the comments to the Code, which states that pursuant to this authority the Commission may require impoundment of the proceeds of a limited offering and escrow of promotional shares.[49] Although the Reporter is confident that the Commission would be constrained by the spirit of the Code,[50] the Commission nevertheless *could* promulgate rules restoring many of the subjective qualifications and informational requirements currently in effect under rule 146. This possibility conflicts directly with the desire for objectivity in the area of the limited offering exception. Congress as a matter of policy should determine the appropriate conditions for a limited offering and require that any additions or modifications be made by statutory amendment or pursuant to such general rulemaking powers of the Commission as are set forth in section 1502 of the Code.[51]

5. *Secondary Limited Offerings.* Unlike the private placement exemption under section 4(2), the limited offering exception is not limited to sales by issuers. It is available for secondary sales that meet all of the requisite conditions. The confusion existing under the 1933 Act caused by the section 4(1-1/2) exemption is thus eliminated, but the nonissuer seller may have difficulty in adequately controlling resales during the restrictive period and in complying with any rules that may be adopted by the Commission. These problems likely will be worked out in time. Moreover, since the Code

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49. TD-1 § 227, Comment (6). Section 505 of the Code also provides the Commission with specific authority to promulgate such a rule. This authority to impound proceeds and escrow securities, while subject to criticism, survived a motion to delete at the 1972 annual meeting of the American Law Institute. *See* 49 ALI PROCEEDINGS 389-94 (1972).

50. 49 ALI PROCEEDINGS 376 (1972). The Commission traditionally has favored the view that, above all, registration is the desired end and that exemptions, therefore, are to be limited when possible. In addition, the Commission's enforcement division desires to avoid the certainty of objective exemptions in order to maximize its ability to attack fraudulent and illegal schemes. These forces may bring about the imposition of conditions that are more restrictive than either the Reporter or Congress intends. *Cf. SEC-Congress Rift Is Possible Over Bid To Alter Broker Law,* Wall Street J., Feb. 7, 1977, at 8, col. 2 (Commission interpreting discretionary rulemaking authority more broadly than Congress intended).

51. Section 1502 continues and broadens the Commission's authority under the 1933 Act to adopt, condition, amend, suspend, and repeal rules in a variety of ways, including the defining of terms. This general authority is sufficient for the Commission to impose modified or additional conditions to the limited offering exception but contains some limitations. It requires the Commission to determine that the action is necessary or appropriate in the public interest or for investor protection in connection with carrying out the purposes fairly intended by the policy of the Code. RD 1-3 § 1502.

provides secondary distributors with other convenient exceptions and exemptions and immediately effective distribution and demand offering statements, the need for the limited offering exception in secondary sales may be far less under the Code than under current law.

B. The Trading Transaction

A further exception from the Code's definition of distribution is the trading transaction. The exception, defined in section 227(c), deals with the problem of distinguishing secondary distributions, which are made by persons other than an issuer and need to be channeled through the registration process, from routine trading transactions, which need not be registered. As in the private offering area, the Code seeks to clarify and to remove the subjective uncertainties surrounding present application to secondary transactions of sections 4(1) and 4(4) of the 1933 Act.

(1) The Current Law

Under the 1933 Act the section 4(1) exemption is designed to remove ordinary trading transactions from registration and prospectus delivery requirements while subjecting to those requirements all transactions involving a distribution of securities. Section 4(1) exempts transactions only if they are by a person other than "an issuer, underwriter or dealer." Determining whether a person is an issuer or dealer presents little practical difficulty. Most of the problems relate to the "underwriter" portion of the exemption and arise because of the complex definition of the term contained in section 2(11) of the 1933 Act. That section defines underwriters as those who purchase from an issuer with a view to a distribution, who offer or sell for an issuer in connection with a distribution, or who participate directly or indirectly in any of these undertakings. In defining "underwriter," section 2(11) includes within the term "issuer" any person who directly or indirectly stands in a control relationship with an issuer ("controlling person"). In addition to the previously discussed restrictions imposed by the phrase "with a view to" upon public resales by persons buying securities in an exempted private offering, the definition restricts public resales by controlling persons because these transactions, if they are distributions rather than routine trading transactions, will involve statutory underwriters.[52]

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52. *See generally* United States v. Wolfson, 405 F.2d 779 (2d Cir. 1968), *cert. denied,* 394 U.S. 946 (1969); *In re* Ira Haupt & Co., 23 S.E.C. 589 (1946); Sommer, *Who's "In*

The absence of a statutory definition of distribution, the expansive SEC view of the concept of a controlling person, and the development of such amorphous concepts as "presumptive underwriter"[53] and "float policy"[54] resulted in confusion among lawyers about when and under what circumstances secondary sales by controlling persons were permissible without registration. In 1972, the SEC promulgated rule 144 under the 1933 Act to provide certainty in this area by defining the term "distribution" specifically for the purpose of determining who is an underwriter under sections 2(11) and 4(1). The rule imposes conditions concerning the availability of public information, a two-year holding period for securities acquired in a private offering, a limitation on the number of securities that can be sold within a six-month period, a restriction on the manner of sale requiring ordinary brokerage transactions, and a requirement for the filing of a notice of offering. A transaction must meet all of the rule's specifications to qualify for the section 4(1) exemption. The rule in effect establishes the parameters of the routine trading transaction and is viewed by the SEC as the exclusive means by which a controlling person may sell securities publicly in reliance upon the section 4(1) exemption. The rule does not apply to sales of securities acquired by noncontrolling persons in market transactions, because these secondary transactions generally do not involve a statutory underwriter. Thus, in most cases, noncontrolling persons may sell freely outside of rule 144 in reliance upon the section 4(1) exemption.

Control"?—S.E.C., 21 Bus. Law. 559 (1966); Note, *Regulation of Non-Issuer Transactions Under Federal and State Securities Registration Laws*, 78 Harv. L. Rev. 1635 (1965).

53. The presumptive underwriter doctrine reflects the SEC staff's position that purchasers of more than 10% of a registered public offering are underwriters within the meaning of § 2(11) of the 1933 Act even if such persons are not controlling persons of the issuer. *See generally* Nathan, *Presumptive Underwriters*, 8 Rev. Sec. Reg. 881 (1975).

54. The float policy represented the SEC staff's position that a seller would he deemed an underwriter under § 2(11) if his sales exceeded 10% of the freely traded securities of the issuer (the float). *See generally* Grosz, *SEC 'Float' Policy*, 6 Rev. Sec. Reg. 936 (1973); *cf.* SEC No-Action Letter, *Professional Care Services, Inc.*, (available Oct. 12, 1973), [1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,542. In 1975 the staff abandoned the float policy and hegan to focus upon the nature and size of the selling broker's effort and commission to determine the existence of a distribution when securities are sold outside of rule 144. Nevertheless, the staff still considers the size of the proposed sale relative to the trading market by refusing to issue no-action letters when a sale will have an adverse impact on the trading market. *See, e.g.*, SEC No-Action Letter, *Synergistics, Inc.*, (available Dec. 23, 1976). As a practical matter, this approach is applied most often to secondary sales of large blocks of securities acquired in a private offering prior to April 15, 1972, the effective date of rule 144. Any other secondary sales are made pursuant to rule 144 or clearly are exempt under § 4(1), 15 U.S.C. § 77d(1) (1970). *See generally* Goldwasser, *Resale Exemption Developments*, 8 Rev. Sec. Reg. 860 (1975).

Since most secondary sales are made through the use of a broker, the broker also must find an exemption for its part of the transaction. Because brokers are included in the 1933 Act's definition of dealer, they may not rely upon the section 4(1) exemption. The broker, however, is specifically exempted by sections 4(3) or 4(4), which generally act coordinately with the section 4(1) exemption to permit ordinary trading transactions.[55] Rule 144 requires that all resales made in reliance upon it be made in "brokers' transactions" within the meaning of section 4(4) and defines that term in subparagraph (g) to ensure that the broker is not aware after reasonable inquiry that the seller is engaged in a prohibited distribution and that the broker will not receive an unusual commission or exert unusual selling efforts or pressures.

The cumulative effect of the section 4(1) and 4(4) exemptions and rule 144 is to permit controlling persons to make routine trades by selling limited amounts of securities in ordinary brokerage transactions. All other sales by controlling persons are distributions subject to the registration provisions. Noncontrolling persons, on the other hand, generally are subject to none of these restrictions unless they are reselling privately-placed stock.

(2) The Code Approach

The Code approach to the problem of secondary transactions differs significantly from current law. The troublesome concepts of underwriter, control, and controlling person are abandoned. All secondary sales of nonexempted securities, whether by controlling persons or noncontrolling persons and whether the securities were acquired in the market or otherwise, are treated alike. Unless the transactions specifically are exempted or do not involve distributions, the filing requirements of the Code must be met.

In addition to various exemptions permitting limited secondary distributions when the public interest in registration is *de minimis,*[56] the Code provides a secondary distributor with relatively simple filing requirements. If the issuer is a one-year registrant, the secondary seller may elect to file and deliver to the buyer a distribution

55. *See* SEC Securities Act Release No. 5168 (July 1, 1971), 2 FED. SEC. L. REP. (CCH) ¶ 22,760; SEC Securities Act Release No. 4445 (Feb. 2, 1962), 17 C.F.R. § 241.6721, 2 FED. SEC. L. REP. (CCH) ¶ 22,753; *cf.* SEC Securities Act Release No. 4818 (Jan. 21, 1966), 17 C.F.R. § 231.4818, 1 FED. SEC. L. REP. (CCH) ¶ 2920 (discussing limitations on rule 154).

56. The principal exemption upon which secondary distributors may rely is the small offering exemption, which permits secondary transactions up to $100,000. RD 1-3 § 511(d); *see* note 125 *infra* and accompanying text.

statement that is effective immediately upon filing.[57] If the issuer is not a one-year registrant, the secondary seller may require the issuer to file an offering statement at the selling shareholder's expense in accordance with the registration-on-demand provisions of section 501(b). Despite their availability, the distribution statement and registration on demand are likely to be used only when an exemption is not readily available or when a transaction is a distribution because the seller cannot satisfy the conditions for a trading transaction or a limited offering.

Section 227(c) defines "trading transaction" as a transaction that is made through a broker or with or by a dealer and satisfies a number of conditions. Since a secondary trading transaction under the Code may be made directly with a dealer, the Code eliminates the distinction made by the 1933 Act between brokers and dealers that effectively restricts secondary sales by controlling persons to brokers' transactions only. This change is necessary because the distinction is increasingly formal and artificial. This section of the Code, however, makes additional changes in existing law that are less desirable. Under the 1933 Act, two or more noncontrolling persons who transact a sale between or among themselves without a broker or a dealer fall within the section 4(1) exemption. No policy arguments support application of the offering statement requirements to a transaction between two individuals in which one would sell the other 1,000 shares of IBM common stock without the use of a broker or dealer. Nevertheless, under the Code the seller in such transactions must file an offering statement in the form of a distribution statement unless the limited offering exception with all its restrictions applies.[58]

In addition to selling through a broker or with or by a dealer, a secondary seller must satisfy four conditions before the transaction qualifies for the trading transaction exception.

1. *Prohibition on Issuer Transactions.* Similar to present pro-

57. RD 1-3 § 509. The distribution statement is expected to be a concise document that describes the secondary distribution, identifies the issuer's most recent annual report and all subsequent reports thereto that are on file at the Commission, and contains a certification by the secondary distributor that he is not aware of any material facts that should be disclosed pursuant to the Code's antifraud provisions. Additionally, the annual report and subsequent reports must be incorporated physically if the issuer does not have at least 1,000 stockholders and $100,000 in total assets for its last two fiscal year-ends or when the Commission requires incorporation by rule. The Code imposes civil liability upon a secondary distributor for a false distribution statement. RD 1-3 § 1405.

58. This result assumes that the transaction is an offering in excess of $100,000, which precludes reliance upon the small offering exemption contained in § 511(d), and that the Commission does not promulgate any other applicable exemptive rules.

visions of section 4(1), an issuer or one selling for the account or benefit of an issuer may not rely upon the trading transaction exception. The Code comments, however, suggest that the Commission consider modifying this condition on the theory that trading transactions are so routine that the offering statement protections are unnecessary even for issuer transactions.[59] Regardless of the merits of permitting an issuer to engage in trading transactions, the suggestion demonstrates the troublesome breadth of the Commission's authority under section 227(c)(2) to modify or to add to the statutory conditions to the trading transaction exception and thereby to tamper with legislative policy. This rulemaking authority closely parallels that granted the Commission regarding the limited offering exception and is subject to the same objections.[60] The limited offering and trading transaction exceptions embody fundamental policy considerations that, once made by Congress, should be changed only by Congress or within the parameters established for the Commission's general rulemaking authority.

2. *Prohibition of Limited Offering Securities.* The trading transaction exception is not available for the resale of securities acquired pursuant to the limited offering exception if the applicable restrictive period has not expired, even though the resale would not violate the restriction on number of owners or any other condition contained in that exception. A buyer in a limited offering, in effect, cannot resell publicly through a broker or dealer during the restrictive period except through an offering statement.[61] This prohibition prevents broad public leakage through trading transactions of securities sold in a limited offering by either an issuer or a secondary seller during the applicable restrictive period. Considering the policy behind the limited offering exception, the prohibition is sound. The Code comments, however, suggest that the Commission may soften this condition by using the broad modification authority of section 227(c)(2) to permit buyers in a secondary limited offering to make limited trading transactions up to the volume of trading

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59. TD-1 § 227, Comment (11).

60. *See* note 48 *supra* and accompanying text. The sample criteria included in § 227(c)(2) are the kind of market, the kind and degree of solicitation or other selling effort, and the issuer's status as a one-year registrant. This section, like § 227(b)(3), clearly permits other criteria to be considered in modifying and imposing additional conditions.

61. This limitation arises because neither the small offering exemption nor the immediately effective distribution statement may be used to effect a transaction in a security tbat was the subject of a limited offering during the applicable restrictive period. Subject to the integration concepts contained in the definition of offering, a buyer in a limited offering may make a second limited offering before the restrictive period has expired. TD-1 § 227, Comment (12)(b).

transactions their sellers might have effected.[62] This suggestion is further evidence of the Commission's ability to make basic policy decisions that arguably should be made by Congress.

3. *An Ordinary Broker or Dealer Transaction.* The broker or dealer in a trading transaction must perform no more than its usual function in a trading transaction and must receive no unusual compensation. These conditions are designed to ensure that the trading transaction is in fact an ordinary brokers' or dealers' transaction and that the transaction does not involve the selling pressures or the large commissions associated with a distribution. The term "usual function," unknown to the 1933 Act, is left undefined by the Code and thus may vary in meaning under different circumstances. The Commission, however, may and probably will adopt a rule defining the term in much the same fashion as it defines "brokers' transactions" in rule 144(g) under the 1933 Act, with appropriate adjustments to provide for the practical distinctions between transactions by dealers and those by brokers.

"Unusual compensation" is another undefined term in the Code that is likely to be defined by the Commission. The definition presumably will be based to some extent upon the existing "reasonable relationship to market" rule.[63] Unlike the 1933 Act, the Code contains no prohibition against solicitation by brokers or dealers, although the Commission has authority to impose this condition. Evolving market practices and concepts of what constitutes a customary broker's or dealer's transaction make rulemaking authority in this area particularly necessary to ensure that changing conditions do not undermine the policies underlying the statutory language. The Code's general rulemaking provisions provide ample flexibility without the unlimited authority to modify or add conditions contained in section 227(c)(2).

4. *Limitations on the Amount of Securities Sold.* A secondary seller relying on the trading transaction exception must not exceed limitations specified by Commission rule on the volume of securities that can be sold in all trading transactions by or for the account of the same person during a specified period. Although exact volume and period limitations are currently unknown, the limitations, when established, will become a condition to the trading transaction exception. The limitations likely will be patterned after those contained in rule 144(e), which are keyed to either average weekly trad-

62. TD-1 § 227, Comment (12)(b).

63. *See* TD-1 § 227, Comment (13) and the authorities cited therein.

ing volume or one percent of the outstanding securities during a six-month period. The Commission needs this flexibility to adapt the condition to practical operations of evolving market systems, but this flexibility is not open-ended, being contained within the condition itself and is thus limited by the basic policy decision of Congress that some limitation on the amount of securities sold be a condition to this exception.

Since the conditions to the trading transaction exception relate to the activities of the broker or dealer involved in the transaction, and because these activities generally are outside the control and knowledge of a secondary seller, the Code extends protection from the absolute civil liability accompanying an illegal distribution to those secondary sellers who reasonably believe that the conditions are satisfied.[64] The Code provides similar protection for brokers and dealers when satisfaction of conditions is within the control and knowledge of the secondary seller. This policy is well-founded and will result in continuance of the existing practice of obtaining representation letters from both the seller and the broker or dealer in a trading transaction.

The trading transaction exception ordinarily poses few practical problems for the typical investor. It may be of limited use, however, to the institutional investor who frequently sells in blocks exceeding the probable volume limitation of the exception and in a manner violating the exception's broker-dealer conditions. Section 4(1) of the 1933 Act exempts such sellers and normally allows them to sell freely without volume or other restrictions unless they are selling control or restricted securities. The Code, however, subjects all nonexempt secondary distributions to its filing requirements, and thus requires the block trader or institutional seller to qualify for some exemption or to fit its transaction within an exception to the term "distribution." Recognizing the practical difficulty of qualifying these trades under the conditions to the trading transaction exception, the comments to section 227 suggest that special treatment should be considered in connection with Part IX (Market Regulation) of the Code.[65] Although Part IX was approved by the American Law Institute in April 1976, no provisions for the block trading problem were included.

64. RD 1-3 § 227(c)(3). The reasonable care defense is framed more broadly than the good faith defense provided for an original seller or a reseller in the limited offering exception. The reasonable care defense applies to all of the conditions of the trading transaction exception, including any conditions modified or added by Commission rule. *Compare* RD 1-3 § 227(c)(3), *with* RD 1-3 § 227(b)(7).

65. TD-1 § 227, Comment (18).

III. The Local Distribution

Even if an offering is a distribution because it fails to meet the conditions of either the limited offering or trading transaction exceptions, the offering and distribution statement provisions of the Code do not apply if that distribution is a "local distribution" within the meaning of section 513. The local distribution concept succeeds the intrastate offering exemption provided by section 3(a)(11) of the 1933 Act.

A. *The Current Law*

Section 3(a)(11) exempts from the registration requirements of the 1933 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." This transaction exemption reflects a congressional policy decision to leave purely local sales of securities to state regulation.[66] Despite the clear legislative intent underlying the exemption, considerable confusion and uncertainty exist concerning the requisite components of the exemption. In response to that confusion and uncertainty, the Commission in 1974 promulgated rule 147 to provide greater objectivity in determining when the section 3(a)(11) exemption is available.[67] Rule 147 is not an exclusive rule and because its objective conditions are difficult to meet, the residual law of section 3(a)(11) frequently is relied upon to establish the exemption.[68]

The intrastate offering exemption poses three major problem areas:

1. *Nature of the Issuer.* Although the statute clearly requires that the issuer be incorporated in the state of the offering, the mean-

66. *See* H.R. Rep. No. 1838, 73d Cong., 2d Sess. (1934). The Commission in interpreting the exemption consistently has taken the position that it must be applied narrowly in order to achieve the congressional intent that it be limited to local financing provided by local investors for local companies. *See, e.g.*, SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 Fed. Sec. L. Rep. (CCH) ¶ 2270. Although the exemption occurs under a section of the 1933 Act entitled "Exempted Securities," the exemption always has been considered a transaction exemption. A seller of securities purchased in an exempted intrastate offering must seek another exemption for his sale.

67. *See* SEC Securities Act Release No. 5450 (Jan. 7, 1974) [1973-1974 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79, 617.

68. For a detailed outline comparing the residual law of § 3(a)(11) and rule 147, see Cheek, *Rule 147 and the Intrastate Offering Exemption*, The 140 Series—A How-To-Do-It Approach (PLI Course Handbook No. 178) (1975).

ing of the statutory requirement that the issuer be "doing business" within the state or territory is unclear. Neither the statute nor its legislative history defines the required quantum of business. Current residual law requires an issuer to have "substantial" or "predominant" operations within the state,[69] and rule 147 requires compliance with narrow and restrictive percentage tests before an issuer is deemed to be "doing business" within a state.[70] Another closely related problem concerns the use of the proceeds from the offering; rule 147 requires that eighty percent of the offering's net proceeds be used in connection with local operations, and residual case law prohibits the use of proceeds primarily for the purpose of establishing a new business outside the state of incorporation that is unrelated to some incidental, locally-conducted business.[71] The impracticality of tracing proceeds to their ultimate use often is a major obstacle in satisfying this portion of the exemption.

2. *Residence of Each Offeree and Purchaser.* The 1933 Act requires that the offering be made only to persons "resident" within a state, but does not define residence. The Commission traditionally has construed residence to mean domicile, as that term is applied to conflicts-of-laws questions. Rule 147, however, abandons the domicile test in favor of a test under which residence is established if the state is the principal residence at the time of the offer and sale. Since the residence requirement of both rule 147 and the statute apparently applies to all offerees, issuers face the difficult burden of proving that all offerees resided in the state. In addition, because of the absolute civil liability provisions of section 12(1), good faith reliance by the issuer upon an offeree's or purchaser's representation of residence is no defense if either is in fact a resident of another state. Similarly, a purchaser's representation that he is acting for his own account is not likely to protect the issuer if the purchase is actually for nonresidents. Because the offering of a single share to a nonresident may destroy the exemption, the residence requirement creates substantial risks for an issuer.

3. *The "Coming-to-Rest" Concept.* Even if all offerees and purchasers reside in a single state, securities that are part of an

69. *See, e.g.,* Chapman v. Dunn, 414 F.2d 153 (6th Cir. 1969); SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 FED. SEC. L. REP. ¶ 2270.

70. In general, under rule 147, 80% of an issuer's consolidated gross revenues and gross assets must be generated from within the state. The same percentage of its gross assets must be located within the state. Practical problems often arise in computing the precise percentage and in determining the source of revenues and the location of assets, particularly in businesses that provide services.

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

intrastate issue cannot immediately be resold to nonresidents; the securities must "come to rest" in the hands of residents buying for investment and not with a view to distribution and resale. Once having come to rest, the securities may be resold to nonresidents without affecting the intrastate exemption for the offering. Although no precise holding period is set forth in the statute, the Commission staff generally requires at least a period of one year.[72] Under rule 147 the SEC objectively determines when an issue has come to rest by prohibiting resales to nonresidents during the distribution of any part of an issue and for nine months from the date of the last sale of securities that are part of that issue. Determining the beginning and ending of the nine-month period is often difficult because the integration doctrine may combine separate but related issuances.

Because of this resale restriction, certain precautions such as legends on stock certificates, stop-transfer instructions, and written representations from purchasers generally are taken to protect against interstate distributions. While the language of section 3(a)(11) does not require these precautions, one of the conditions to rule 147 requires these precautions so if one is overlooked inadvertently, the protective presumption of the rule becomes unavailable to the issuer.

The above mentioned problem areas, particularly those relating to restrictions on the residence of offerees and on resales, make the intrastate offering exemption very narrow and risky. The risk element, coupled with the absolute civil liability of section 12(1) of the 1933 Act, limits the practical use of the exemption to those types of offerings that are adaptable to strict control mechanisms and to those occurring in states with large geographical areas.

B. *The Code Approach*

During the drafting of the Code, considerable discussion was devoted to repeal of the intrastate offering exemption, because of the difficulties and risks associated with satisfying the strict requirements of rule 147 and section 3(a)(11).[73] The drafters were

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72. *See generally* SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86 (D.N.H. 1958), *aff'd*, 276 F.2d 665 (1st Cir. 1960); Brooklyn Manhattan Transit Corp., 1 S.E.C. 147 (1935).

73. The arguments made in favor of repeal were: (a) the fortuitous operation of the exemption because of geographical considerations; (b) the uneven enforcement of blue sky regulation among the states; (c) the tendency of the exemption to trap the unsophisticated, particularly in view of the absolute civil liability provisions of the 1933 Act; and (d) the Commission's ample authority under § 302 to adopt exemptive rules that consider the essen-

influenced by state securities administrators, who considered continuation of the exemption to be essential to preserving their responsibilities and effectiveness in regulating local issues. Thus the Code includes in section 513 a local distribution exemption for all securities other than debt securities.[74] The section substantially modifies existing conditions for an exempt intrastate offering by providing greater objectivity and broadening the usefulness of the exemption as an alternative to the offering or distribution statement requirements of the Code.

To qualify as a local distribution, an offering must meet four requirements.

1. *Residence of Purchasers.* The Code dramatically changes the current residence requirements by eliminating the focus upon offerees and examining only the residence of those persons who actually purchase. In addition, instead of restricting sales to residents of a single state, thereby creating fortuitous geographical barriers to the use of the exemption, the Code requires that sales be "substantially restricted" to residents of a single state or of an area in "contiguous states" that the Commission may delineate by rule according to population and economic characteristics.[75] Thus, although some uncertainty will remain until the term "substantially" is defined by Commission rule or case law, the exemption is not jeopardized by a single sale or by a few sales to nonresidents of the state of applicable area. While complete transformation from the single state approach of section 3(a)(11) to the local area approach of the Code depends upon the adoption of rules defining permitted

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tially intrastate character of an offering. *See* TD-4 § 513, Comment (2); 52 ALI PROCEEDINGS 438-44 (1975).

74. Both the 1933 Act and the Trust Indenture Act of 1940 exempt intrastate offerings of debt securities. 1933 Act § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970); Trust Indenture Act § 304(a)(4), 15 U.S.C. § 77ddd(a)(4) (1970). An intrastate offering of a bond issue is not registered under the 1933 Act, and its indenture is not qualified under the Trust Indenture Act and need not provide for an independent trustee unless applicable state law so requires. Over the strong objections of the state securities administrators, the Code removes debt securities from the local distribution exemption and, unless otherwise exempted, subjects a distribution of them to the provisions that succeed the Trust Indenture Act. The federal interest in ensuring that indentures adequately safeguard the rights and interests of buyers and that the trustees are free from conflicting interests should override the desire of state administrators to retain exclusive regulation of intrastate offerings of debt securities. *See* 52 ALI PROCEEDINGS 443-44, 451-54 (1975).

75. TD-4 § 513(a)(1). This provision also authorizes the Commission to define by rule an area including a state and a contiguous foreign country, authority that the comments indicate is designed to permit a local distribution in a concentrated population area that spills over into a foreign country, such as the Detroit-Windsor (Ontario) area. TD-4 § 513, Comment (5)(b).

bistate or multistate areas, the Code strongly—and wisely—suggests that the Commission promulgate rules permitting the use of the exemption in areas with large population concentrations that cross state lines, such as the area surrounding New York City. The Code further broadens the exemption by defining "resident" as "a natural person . . . resident but not necessarily domiciled in a specific place,"[76] thereby avoiding the problems associated with the section 3(a)(11) exemption.

2. *Nature of Issuer*. The Code rejects the approach of the 1933 Act, which limits the use of the intrastate exemption to issuers incorporated in the state of the offering, and requires only that that issuer have its principal place of business in the state or area of the offering. Moreover, the Code does not require the issuer to be "doing business" in the sense that the term is used in 1933 Act. Thus an issuer may qualify for the exemption under the Code even when a substantial portion of its business is conducted outside the relevant state or area.

Unlike rule 147 the section 513 exemption is not limited to issuers. The exemption, with certain limitations, is available to secondary distributors, who need not be residents of the state or area in which the issuer has its principal place of business or in which substantially all of the purchasers reside. However, secondary distributors holding securities purchased in a limited offering whose restrictive resale period has not expired may not use the exemption for secondary distributions of the same class of securities. Although prohibiting the use of the local distribution exemption as an outlet for limited offering securities during their restrictive resale periods is consistent with the policy underlying the limited offering exception, injection of the fungibility concept into the exemption is unnecessary. The fungibility concept does not permit a secondary distributor who owns securities purchased in the market and in a limited offering to rely upon the exemption for the sale of any securities during the restrictive period. The matter, however, probably is not of major significance, as the comments point out, because a secondary seller normally sells either by using a distribution statement if the issuer is a one-year registrant or pursuant to the small offering exemption or the trading transaction exception, neither of which includes a fungibility concept.[77]

76. RD 1-3 § 291.

77. TD-4 § 513, Comment (8). The distribution statement and the trading transaction exception could be used to resell the securities purchased in the market but not to resell those purchased in the limited offering during the restrictive period.

3. *Additional Conditions Specified by the SEC.* As was done with the limited offering and trading transaction exceptions, the Code grants the Commission authority to add by rule other conditions based upon several specified criteria or upon any other similar criteria.[78] This authority is extensive and, given the Commission's traditional disdain for the intrastate exemption, likely will be used in a restrictive fashion. For example, several of the specified criteria could be used to impose conditions similar to those contained in rule 147, and one of the criteria, the size of the distribution, suggests the imposition of dollar limitations, a concept totally foreign to current law and policy. The Code comments further suggest that one of the unspecified "similar criteria" might be the kind (that is, effectiveness) of blue sky regulation in the particular state or area.[79] Such a consideration could result in federal second-guessing and in a limited form of preemption. Should Congress decide to continue some form of the intrastate exemption, which is a matter of substantial and legitimate question, it should not authorize the Commission to gut the purposes and effective uses of the exemption through restrictive rulemaking.

4. *Resales.* The Code does not specify a holding period, but through a cross reference to the section 227(b)(4) rulemaking authority concerning the limited offering exception,[80] permits the Commission to promulgate a rule establishing a restrictive period of up to one year. During this period, resales could be made only in a manner consistent with the conditions of section 513, which would include any rules the Commission had adopted concerning written representations from a buyer regarding residence and other appropriate matters and concerning the policing of resales through the use of legends and stop-transfer notices.

An original seller or a reseller in a local distribution who in good faith receives a written undertaking from his buyer that is reasonably designed to avoid an illegal distribution and who complies with Commission rules relating to legends and other policing devices is

78. TD-4 § 513(a)(3); *see* RD 1-3 § 513(a)(3). The criteria to be considered are the type of issuer and security, the kind of market, the size of the distribution, and the issuer's status as a one-year registrant.

79. *See* TD-4 § 513, Comment (4). That this exemption should be applied only to states that have effective legislation and effective administration of that legislation is a forceful argument. The drafters of the Code, however, found it impractical to devise a scheme for deciding whicb states were effective blue sky states and which were not. *See* 52 ALI PROCEEDINGS 439-40 (1975). If in their collective wisdom the Code draftsmen were unable to devise a satisfactory condition relating to the effectiveness of state regulation, it is unlikely that the Commission would be able to do so and should not be invited to do so.

80. *See* note 46 *supra* and accompanying text.

protected by the Code from the absolute civil liability accompanying an illegal distribution.[81] This protection is not likely to extend either to an issuer that knows or suspects that its principal place of business is not within the applicable state or area, but that otherwise structures the distribution to meet the local distribution exemption, or to a reseller who relies on an issuer's representation of its principal place of business. Consideration should be given to extending the protection to cover the latter situation.

The fungibility question relating to resales of securities purchased in a local distribution is dealt with as it is in the limited offering exception. A reseller who holds some securities that were not the subject of a local distribution and some securities that were the subject of a local distribution for which the restrictive resale period has not expired may sell any of his securities if during the restrictive period he retains at least as many securities as were purchased in the local distribution.

IV. Exempted Securities

Even if an offering is a distribution not qualifying as a local distribution, it does not trigger the registration, offering, or distribution statement provisions of the Code if it involves an exempted security. Exempted securities are set forth in section 301 and have significance beyond the registration provisions of the Code, applying whenever a section specifically excludes exempted securities. In addition, section 302 grants the Commission broad authority to fashion exemptions by rule or order. Consistent with present policy under the 1933 Act, however, no exempted security is exempt from the antifraud provisions of the Code.

The exempted securities under the Code generally are the same as those under the 1933 and 1934 Acts with certain exceptions. The Code, for example, provides neither an exemption for ICC-approved securities of railroads and motor carriers[82] nor a general exemption for either bank or insurance company securities.[83] The following

81. TD-4 § 513(d)(2); RD 1-3 § 513(d)(2).

82. These securities are exempted under the 1933 Act by § 3(a)(6), 15 U.S.C.§ 77c(a)(6) (1970), but are not exempt under the 1934 Act. The Interstate Commerce Commission has favored repeal of the 1933 Act exemption. *See* TD-1 § 301, General Comment (1).

83. While securities issued by insurance companies never have been exempt under the 1933 Act, § 12(g)(2)(G) of the 1934 Act, 15 U.S.C. § 78*l*(g)(2)(G) (1970), exempts insurance company securities from its registration requirements if in substance its domiciliary state regulates insurance companies with legislation that is comparable to the reporting, proxy, and insider trading provisions of the 1934 Act. The many difficulties associated with judging whether a particular state has legislation sufficiently comparable to the 1934 Act convinced

discussion focuses upon those securities exempted by section 301 of the Code and reflects the principal changes in existing law effected by the Code.

1. *Securities Issued or Guaranteed by American Governments.* Section 301(a) exempts Government and municipal securities. The Code defines the term "Government security" as a security (including a revenue obligation) issued by or whose principal and interest are guaranteed by the United States or one of its agencies or instrumentalities.[84] The term "municipal security" is defined as either (a) a security (including a revenue obligation) issued by or whose principal and interest are guaranteed by a state or one of its political subdivisions, agencies, or instrumentalities or (b) an industrial development bond, as defined in section 103(c)(2) of the Internal Revenue Code, on which the interest is excluded from gross income under the Internal Revenue Code as a result of meeting certain standards within section 103(c)(4) or section 103(c)(6) of the Internal Revenue Code.[85]

The exemption continues the substance of the present exemptions for these types of securities except that certificates of deposit for Government or municipal securities are not included. Thus any distribution of the latter that is not otherwise exempt must comply with the applicable filing provisions of the Code.[86] Unlike current law, which either is silent on the matter or permits the guaranty to relate to principal or to interest, this exemption requires that the guaranty relating to Government or municipal securities run to both principal and interest.

2. *Securities Issued or Guaranteed by Indigenous Bodies.* Section 301(b) exempts securities issued or whose principal and interest are guaranteed by the Hopi Tribal Council and securities issued by a corporation pursuant to the Alaska Native Claims Settlement Act. While not recognized under the federal securities laws, this exemption is designed to meet certain special interests and has support

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the Code draftsmen that the exemption should not be continued. *See* 49 ALI PROCEEDINGS 425-27 (1972). With respect to the exemption for bank securities, see note 89 *infra* and accompanying text.

84. TD-5 § 236.

85. TD-5 § 259E. While municipal securities are exempt from the offering statement requirements of the Code, dealers or nonbank brokers in these securities are not. TD-5 § 701(a).

86. The Code's exemption is based generally upon § 3(a)(2) of the 1933 Act, 15 U.S.C. § 77c(a)(2) (1970), § 3(a)(12) of the 1934 Act, 15 U.S.C. § 78c(a)(12) (1970), and § 2(a)(16) of the Investment Company Act, 15 U.S.C. § 80a-2(16) (1970). With respect to the decision not to exempt certificates of deposit, see TD-5 § 259E, Comment (5).

and precedent either directly or indirectly in other existing federal legislation.[87]

3. *Securities Issued or Guaranteed by International Banks.* Section 301(c) exempts a security issued by or whose principal and interest are guaranteed by an international bank of which the United States is a member, a class including at present only the International, Latin American, and Asian Banks. This provision continues exemptions provided for in the federal legislation specifically relating to these banks.[88]

4. *Bank Securities.* The Code eliminates the general exemption for bank securities currently found in section 3(a)(2) of the 1933 Act but retains a limited exemption[89] applicable to securities representing general bank obligations[90] ranking on at least a parity with deposit accounts and to any securities guaranteed by these obligations. Thus a distribution of bank stock or capital notes, unless otherwise exempted, is subject to the offering statement requirements of the Code as administered and enforced by the SEC and not the bank regulators. Because the Code's definition of "security" excludes interests in bank deposit accounts and any certificiate of deposit ranking on a parity with these interests,[91] a note to section 301(d) suggests that the exemption may apply only to those bonds and unsecured debentures that federal or state banking authorities might permit banks to issue on a parity with deposit accounts.

Few policy objections can be raised to eliminating the general exemption or to exempting ordinary bank debt securities, but the other likely use of the exemption—permitting the public distribution of securities simply because they are backed by bank letters of credit or certain other guaranty devices—raises legitimate concern.

87. Act of May 22, 1970, Pub. L. No. 91-264, § 6, 84 Stat. 260 (1970); Alaska Native Claims Settlement Act § 3, 43 U.S.C. § 1625 (Supp. V 1975). The exemption relating to the Alaska Native Claims Settlement Act expires on Decemher 31, 1991.

88. Bretton Woods Agreements Act § 15, 22 U.S.C. § 286k-1(a) (1970); Inter-American Development Bank Act § 11, 22 U.S.C. § 283h (1970); Asian Development Bank Act § 3(b), 22 U.S.C. § 285h (1970). The Code proposes the repeal of the provisions in these three statutes relating to the securities laws.

89. RD 1-3 § 301(d); TD-1 § 301(d). Bank securities never have been fully exempt under the 1934 Act, but under § 12(i) of the Act, 15 U.S.C. § 78*l*(i) (Supp. V 1975), they are regulated by the federal banking agencies on certain matters. The Code does not include a successor to § 12(i) and thus strips the bank regulators of their jurisdiction over many matters relating to bank securities. *See* TD-5 § 1501A & Comments.

90. Section 209 of the Code defines "bank" to include national banks, member banks of the Federal Reserve System, and all state banks if a substantial portion of their business is similar to that of national banks and if they are supervised by a federal or state banking regulatory agency. RD 1-3 § 209.

91. RD 1-3 § 297(b)(4).

Permitting broad public sales of small-denomination commerical paper or debt securities of speculative, high-risk companies is arguably contrary to sound regulatory policy, even when backed by bank letters of credit, which themselves are not always financially sound.[92] Inclusion of bank-guaranteed securities in the limited exemption may be justifiable, however, when one considers: the public interest in gearing up the federal machinery through the Code's offering statement requirements; the economic importance of the continued unfettered use of guarantees as a means of facilitating sales of debt instruments; the Code's antifraud provisions; and the ability of federal banking authorities to exercise effective control over the solvency and liquidity of banks.[93]

5. *Bank Common Trust Funds.* The Code continues the current federal securities law exemption for an interest or participation in a common trust fund or in a similar fund maintained by a bank exclusively for the collective investment of assets held by the bank as trustee, executor, administrator, guardian, or similar personalized fiduciary capacity.[94] The provision exempts interests or participations in such funds if the funds are used for the collective investment of assets held by the bank as a bona fide fiduciary, are incident to its traditional trust department activities, and are not merely vehicles for direct investment by individuals. Thus the exemption does not cover the collective investment of funds from individual retirement accounts (IRA's) established pursuant to section 408 of the Internal Revenue Code or from H.R. 10 retirement plans (H.R. 10's).[95] Because of the increasingly broad use of IRA's and H.R. 10's,

92. *See* 49 ALI PROCEEDINGS, 442-43 (1972).

93. Although a recent report by the General Accounting Office on the efficiency of the federal bank regulators indicates that the regulators often move too slowly in correcting major bank problems, the report does indicate that such agencies are effective in resolving those problems once they have been identified and that few major bankruptcies and insolvencies have occurred. *See generally Banks' Regulators Too Slow in Acting, G.A.O. Study Finds*, N.Y. Times, Feb. 1, 1977, at 37, col. 1.

94. TD-6 § 301(e). Consistent with the legislative intent underlying the 1933 Act exemption for trust funds, the Code adds to the exemptive language contained in the 1933 Act the phrase "similar personalized fiduciary capacity," which is designed to cover banks acting as a "conservator," as a "committee," or as a "custodian" under the Uniform Gifts to Minors Act.

95. *See* RD 1-3 § 301, Note on Balance of § 301, at 45. The collective investment of managing agency accounts is not likely to be included within the meaning of a "common trust fund or similar fund" by the Commission or by the courts. *See* Investment Co. Inst. v. Camp, 401 U.S. 617 (1971).

96. RD 1-3 § 301(f); TD-1 § 301(f). The present exemptions for these interests can be found in § 3(a)(2) of the 1933 Act, 15 U.S.C. § 77c(a)(2) (1970), and in § 3(a)(12) of the 1934 Act, 15 U.S.C. § 78c(a)(12) (Supp. V 1975).

Specific consideration should be given to exempting interests issued under a mandatory, Congress is not likely to change its nonexemptive policy in this area, particularly while the Commission has ample authority under section 302 to exempt the securities conditionally or otherwise.

6. *Tax-Exempt Plans.* The Code retains the current exemption under the federal securities laws for an interest or participation in a single or collective bank trust fund or in a separate account maintained by an insurance company as the investment medium for qualified stock-bonus, pension, annuity, and profit-sharing plans.[96] Similar to the bank common trust fund exemption, this exemption applies to trustee-type funds and annuity plans when substantive investment authority exists, but does not exempt funds and plans that are only vehicles for direct public investment.

7. *Securities Issued by Savings and Loan Associations.* The Code narrows the 1933 Act exemption for securities issued by a savings and loan association or similar institution to securities representing an interest in a deposit account (other than capital stock or a similar security evidencing nonwithdrawable capital) and to securities representing a general obligation of the association ranking at least on a parity with deposit accounts.[97] The specific reference to an interest in a deposit account seems unnecessarily duplicative since the Code excludes from its definition of "security" an interest in a deposit account with a savings and loan association.[98] Nevertheless, the exemption is similar to that provided for bank securities[99] and imposes the Code's offering statement requirements on distributions of capital stock and similar securities in the associations when the transactions are not otherwise exempt. Since these associations by definition must be supervised and examined

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noncontributory pension plan whose administration is subject to the Employees Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1368 (Supp. V 1975), in order to correct the unsettled state of the law created by the recent decision in Daniel v. International Bhd. of Teamsters, [Current] FED. SEC. L. REP. (CCH) ¶ 96,141 (7th Cir. 1977). The interpretative question involved in the *Daniel* case also could be settled by excluding such interests from the definition of security in § 297(b). *See* note 137 *infra* and accompanying text.

97. RD 1-3 § 301(g); *see* TD-1 301(i).

98. RD 1-3 § 297(b)(4). The exclusion contained in § 297(b) may be broader in one respect because it does not contain the language of § 301(g) specifically stating that permanent stock, guaranty stock, permanent reserve stock, or a similar security evidencing nonwithdrawable capital are not exempted. Such interests are not subject to the antifraud provisions of the Code because they occur within an exclusion to the definition of a security.

99. While the Code excludes from the definition of "security" bank certificates of deposit ranking on a parity with interests in bank deposit accounts, no such exclusion is provided for certificates of deposit issued by savings and loan associations. The latter certificates are subject to the Code's antifraud provisions but are exempted by § 301(g)(2) from the offering statement provisions. *See* RD 1-3 § 301(g), Note.

by federal or state authorities,[100] the exemption is supported by the policy considerations underlying the limited bank exemption in section 301(d).

8. *Securities Issued by Industrial Banks.* The Code provides an exemption not presently found under the federal securities laws for securities issued by industrial banks, industrial loan companies, or Morris Plan banks. The institutions must be supervised and examined by state officials or agencies, and the issued securities must be in substance thrift or investment certificates, passbooks, or other instruments evidencing the general obligation of the issuer to repay money loaned to it.[101] These institutions are neither banks nor savings and loan associations as defined under the existing federal securities laws. Thus their certificates representing deposits are not specifically exempted despite the similarity of these securities to deposit accounts in banks and in savings and loan associations.[102] The institutions are supervised and regulated in many states by the same authorities who supervise and regulate state banks and savings and loan associations. Since few problems have arisen with these institutions, only negligible public interest would be served by subjecting their securities to the Code's offering statement requirements despite the lack of federal insurance for the certificates issued and the lack of consistent state regulation, particularly with respect to disclosure.

9. *Certain Indenture Securities.* The Code continues the exemption provided in the 1933 Act and in the Trust Indenture Act for securities issued under mortgage indentures and insured under the National Housing Act.[103]

10. *Securities Issued by Cooperatives.* Section 301(j) exempts securities issued by three different types of cooperatives. First, securities issued by certain farmers' cooperative associations are exempt if the security is part of a class issuable only to persons dealing in commodities with or obtaining services from the association and is transferable by sale only to these persons or to the association. Following the approach of the 1934 Act, the determination of exempt associations is made by reference to the Agricultural Marketing Act of 1929, the effect of which is to exclude almost all true

100. RD 1-3 § 296; TD-1 § 296.

101. RD 1-3 § 301(h).

102. Few if any industrial banks have registered their thrift certificates or investment certificates in reliance principally upon the intrastate exemption.

103. RD 1-3 § 301(i); *see* TD-1 § 301(j). The current exemption is found in § 304(a)(5) of the Trust Indenture Act, 15 U.S.C. § 77ddd(a)(5) (1970).

agricultural cooperatives.[104] The restrictions on transferability and the antifraud provisions of the Code afford sufficient protection of the public interest to eliminate the need for extending the exemption beyond simple membership interests to include patronage refund certificates and debt securities issued to members and patrons.[105] A broader exemption eliminating the restrictions on transferability and permitting sales to anyone, whether member, patron, or neither, is inherently hazardous and unnecessary as a matter of policy.

The second type of cooperative security exempted by the section are those issued by a consumer cooperative that deals in commodities or supplies related services for the benefit of its members. The security must satisfy the conditions prescribed for farmers' cooperatives, and dividends, other than patronage refunds, must not be payable to security holders. Although the 1933 Act contains no similar provisions, a similar exemption is provided in the 1934 Act.[106]

Securities issued by cooperative housing corporations described in section 216(b)(1) of the Internal Revenue Code[107] also are exempted under the Code if the corporation's activities are limited to the ownership, leasing, management, or construction of residential properties for its members. This exemption parallels that provided by rule 235 under the 1933 Act but removes the rule's $300,000 aggregate offering price restriction.

11. *Securities Issued by Nonprofit Companies.* The Code continues the exemption available under both the 1933 and 1934 Acts for securities issued by a nonprofit company and defines the term "nonprofit company" in substantially the same manner. The Code's

104. The 1933 Act exemption for farmers' cooperative associations in § 3(a)(5)(B), 15 U.S.C. § 77c(a)(5)(B), is based on the Internal Revenue Code, but the criteria used for tax purposes is deemed by the Code's draftsmen to be irrelevant for the purpose of securities regulation. The definition in the Agricultural Marketing Act, § 12, 12 U.S.C. § 1141j(a) (1970), includes only securities of agricultural cooperatives that (i) operate for the mutual economic benefit of their farmer members, (ii) are primarily engaged in marketing farm products or furnishing farm supplies or farm business services, and (iii) permit only one vote for each member or limit dividends on stock or membership capital to 8% annually. *See* RD 1-3 § 301(j), Note (2)(b).

105. *See* RD 1-3 § 301(j), Note (2)(c).

106. 1934 Act § 12(g)(2)(F), 15 U.S.C. § 78*l*(g)(2)(F) (1970).

107. Section 216(b)(1) of the Internal Revenue Code defines "cooperative housing corporation" as a corporation with only one class of outstanding stock entitling each holder, solely by reason of owning the stock, to occupy a house or apartment owned or leased by the corporation. Additionally, no stockholder of the corporation may receive any distributions other than the earnings and profits of the corporation except upon complete or partial liquidation of the corporation.

definition, however, permits the Commission to restrict by rule the ability of a promoter to profit from activity associated with the financing or the organization of the nonprofit company.[108] In view of the narrow administrative and judicial interpretations of the present exemption, the general power of the Commission to define terms, and the availability of the Code's antifraud provisions, the necessity for including specific authority to regulate promoter's profits is questionable. The authority may negate by inference present interpretative restrictions on promoter's profits and may result in a rule restricting the fund-raising ability of charitable organizations whose financing programs need to be promoted.

12. *Commercial Paper.* Certain short-term promissory notes and similar instruments, commonly referred to as commercial paper, are exempted from the registration provisions of the 1933 Act and are excluded from the definition of a security under the 1934 Act. The difference in the two approaches results in the exclusion of commercial paper from the antifraud provisions of the 1934 Act but not from those of the 1933 Act. The Code follows the approach of the 1933 Act, although it modifies significantly the substantive elements of the 1933 Act exemption.

The exemption provided by section 3(a)(3) of the 1933 Act has been interpreted to apply "only to prime quality negotiable commercial paper of a type not ordinarily purchased by the general public, that is, paper issued to facilitate well-recognized types of current operational business requirements and of a type eligible for discounting by Federal Reserve banks."[109] In effect this interpretation limits application of the exemption to commercial paper sold privately in large minimum denominations to institutions or sophisticated individuals by financially sound issuers. Additionally, the 1933 Act requires that the commercial paper arise out of a current transaction or have its proceeds used for such a transaction and

108. RD 1-3 §§ 301(k), 264; TD-1 §§ 301(m), 264. These sections are based upon § 3(a)(4) of the 1933 Act, 15 U.S.C. § 77c(a)(4) (1970), and § 12(g)(2)(D) of the 1934 Act, 15 U.S.C. § 78*l*(g)(2)(D) (1970). In essence, the company must be organized and operated *exclusively* for charitable, educational, religious, or social purposes or as a chamber of commerce or trade or professional association. No portion of the company's net earnings may inure to the benefit of any person.

109. SEC Securities Act Release No. 4412 (Sept. 20, 1961), 1 FED. SEC. L. REP. (CCH) ¶ 2045. The interpretations set forth in this release are based upon the congressional reports issued in connection with consideration of the exemption at the time of its passage. The release ignores the fact that Congress specifically deleted wording in the exemption that would have permitted the exemption only when the commercial paper was not being offered for sale to the public. *See generally* Comment, *The Commercial Paper Market and the Securities Acts,* 39 U. CHI. L. REV. 362 (1972).

must mature in not more than nine months. The latter requirement generally has confined the exemption to paper which has a fixed maturity, is not payable on demand, and has no automatic roll-over, extension, or renewal provisions. The "current transactions" requirement creates numerous interpretative problems that have confused both the bar and the SEC staff; for example, what qualifies as a "current transaction" and whether sales proceeds must be traceable specifically to a current transaction are presently unclear.[110]

The Code exempts "commercial paper with a denomination of at least $100,000" and defines "commercial paper" as either a note or a banker's or trade acceptance that is payable on demand or that matures within, or is renewed for not more than nine months, exclusive of days of grace, after the date of issue or renewal.[111] Thus the Code effects changes in current law primarily by imposing a $100,000 minimum denomination, by permitting demand paper to qualify as exempted commercial paper, and by eliminating the troublesome and antiquated "current transaction" requirement. In addition, except as may indirectly flow from the $100,000 limitation, the express requirements of a private sale, purchaser sophistication, prime quality, and discountability have been eliminated.

Although most of the Code changes are consistent with the practicalities of current commercial paper markets, the $100,000 limitation will hamper a variety of issuers who in the past have raised substantial funds with the Commission's approval through direct sales to sophisticated individuals and institutions of commercial paper having minimum denominations ranging from $25,000 to $50,000.[112] No policy seems to justify an arbitrary increase of this amount to $100,000, which effectively may restrict the ability of some issuers to raise needed capital in commercial paper markets especially when interest rates are high and money scarce. The Code's limited offering exception would be available for sales of lower denominations, but given the need of many companies to

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110. *See, e.g.*, Harrington, *Use of the Proceeds of Commercial Paper Issued by Bank Holding Companies*, 29 BUS. LAW. 207 (1973).

111. RD 1-3 §§ 216A, 301(*l*); *see* TD-1 §§ 216A, 301(m). Section 216A also authorizes the Commission to include within the defined term any other instrument or interest of primarily a mercantile or noninvestment character. *Cf.* RD 1-3 § 297(b)(3) (excluding from the definition of "security" notes or other evidence of indebtedness issued in a mercantile transaction).

112. A majority of all commercial paper is direct issue paper. The balance is dealer paper, which generally is not offered in denominations lower than $100,000. *See* TD-1 § 301(n), Comment (3).

borrow continuously in the commercial paper market and the integration concepts incorporated into the Code's definition of offering, the exception may be of limited value in facilitating lower denomination sales to individuals and to nonfinancial institutional investors such as universities, pension funds, trust funds, and foreign entities because the numerical restrictions on the limited offering quickly may be exceeded. Presumably the $100,000 limitation is designed to prevent broad public offerings of the commercial paper to unsophisticated individuals who should be afforded the protection of the Code's offering statement process. That policy could be implemented just as successfully by a lower or no denomination requirement when the exemption is restricted to one-year registrants and limited by the prohibition against general advertising contained in section 502(b) of the Code. In addition, the protections of the antifraud provisions are always available. Even as drafted, the exemption does not restrict the number or type of investors to whom the commercial paper may be sold. Presumably a public offering of the paper could occur in spite of the $100,000 limitation if groups of individuals were solicited to purchase a single large-denomination note through a to-be-formed organization or entity, a trustee, or some nominee.

13. *Securities Issued in Connection with Bankruptcies and Railroad Modifications.* Section 301(m) of the Code is similar to the section 3(a)(7) exemption provided by the 1933 Act for certificates issued with court approval by a receiver or by a trustee in bankruptcy. In addition, the Code exemption incorporates without substantive change the exemptions currently available under the Federal Bankruptcy Act for any security issued with court approval by a receiver, trustee in bankruptcy, or debtor in possession and for a certificate of deposit issued by a committee under the Bankruptcy Act that represents a security of or claim against a debtor.[113] Certificates of deposit issued by a committee in connection with a railroad modification under the Interstate Commerce Act continue to be exempted under the Code.[114] These securities currently are not exempted from the provisions of the 1934 Act.

14. *Securities Exempted by Rule or Order.* Section 302 of the Code provides broad authority for the Commission by rule or order to exempt any person, security, or transaction, or any class of per-

113. Bankruptcy Act §§ 77(f)(3), 77(f)(4), 264(a)(1), 393(a)(1), 518(a)(1), 11 U.S.C. §§ 205(f)(3), 205(f)(4), 664(a)(1), 793(a)(1), 918(a)(1) (1970). *See also* note 127 *infra* and accompanying text.

114. Interstate Commerce Act § 20(b)(11), 49 U.S.C. § 20(b)(11) (1970).

sons, securities, or transactions from any or all of the provisions of the Code with certain special exceptions. Under this section the Commission may apply retroactively any exemptive rule or order that it is authorized or required to adopt and may impose any conditions upon the rule or order.[115]

The wisdom of granting broad authority to the Commission has been discussed intensely by those who have examined the Code.[116] While the grant avoids artificial limitations on the Commission's exemptive authority, as was the result of section 3(b) of the 1933 Act, and in addition provides the flexibility necessary in a Code that encompasses many diverse areas of concern, concern is raised by the grant since the Commission does have statutory authority that in good faith can be misapplied. Nevertheless, since one can assume that the Commission's exemptive authority (in contrast to its authority to restrict or condition statutory exemptions) will be used only sparingly, the provision's benefits outweigh the negatives arising from any conjectured misuse.

V. Exempted Transactions

The offering or distribution statement filing requirements of the Code generally must be complied with for the distribution of a nonexempted security unless the transaction falls within an exemption provided by sections 511 or 512 of the Code or unless it is a local distribution under section 513. The exemptions provided by sections 511 and 512 are true transactional exemptions. Any subsequent distribution of a security purchased in an exempted transaction must comply with the offering or distribution statement provisions unless otherwise exempt. Moreover, the antifraud provisions of the Code apply to all exempted transactions. The Code provides for the following transaction exemptions.

1. *Sales to Underwriters.* Section 511(a) of the Code exempts any transaction incident to an offer or sale to an underwriter. The exemption is derived from the exclusion of preliminary negotiations or agreements between and among underwriters and issuers from the definitions of "offer" and "sale" in section 2(3) of the 1933 Act.

The 1933 Act exclusion reflects the practical necessity for an issuer to be able to discuss and firm up a proposed offering with underwriters prior to commiting itself to the large expenditures of

115. TD-5 § 302. A bank regulator, to the extent that it is the appropriate regulatory agency, has substantially the same authority as the Commission under this section.

116. *See, e.g.*, 49 ALI Proceedings 411-14 (1972).

time and money involved in preparing and filing a registration statement. The exclusion was drafted carefully to apply only to negotiations and agreements with underwriters, thereby prohibiting the formation of the selling group and offers of securities to dealers until the registration statement is filed.

The Code's exemption seeks to accomplish the same objectives as the 1933 Act exclusion. According to the comments, however, the exemption is cast as a transaction exemption rather than as a definitional exclusion in order that an underwriter acting as a buyer will be entitled to the benefit of the antifraud provisions of the Code.[117] Since an underwriter-buyer currently has antifraud remedies under the 1934 Act, this change in form is unlikely to have any major ramifications. The only substantive problem arises from the use of the undefined term "transaction." A certain interpretive gloss currently surrounds the terms "preliminary negotiations" and "agreements," and the shift to the term "transaction" may result in confusion in determining which prefiling activities are to be deemed transactions. If transaction is defined broadly, as it should be, in order to permit the normal range of prefiling activities, the issue is moot. If the term is defined so broadly, however, that virtually all types of activities, such as forming a selling group or engaging in prefiling publicity, arguably could be transactions "incident to" an offer or sale to an underwriter, then the policy underlying the exemption clearly is frustrated. Use of a Comment or of the 1933 Act language would help avoid such difficulties.

2. *Sales by Brokers or Dealers.* Following the basic pattern of section 4(3) of the 1933 Act, the Code exempts any transaction by a broker or a dealer but excepts from those exempt transactions the following situations:[118]

> (a) *When the broker or dealer acts as an underwriter.* The Code defines "underwriter" as any person who buys from or sells for an issuer or secondary distributor in aid of a distribution unless that person's interest is limited to the usual and customary commission or discount from an underwriter, broker, dealer, or secondary distributor.[119] Thus a broker or dealer must determine whether it is buying or selling "in aid of a distribution" only if it is acting for an issuer or secondary distributor and is receiving unusual compensation in connection with the transaction.

117. TD-1 § 511(a), Comment.
118. RD 1-3 §§ 511(b), 511(c); *see* TD-1 §§ 511(b), 511(c).
119. RD 1-3 § 299.11; *see* TD-1 § 299.11.

(b) *When the broker or dealer sells part or all of an unsold allotment or subscription as a participant in a distribution.* The ordinary trading exemption for brokers and dealers is not available under section 4(3) of the 1933 Act for a broker or dealer who is a participant in a distribution and who engages in a transaction in securities that are part or all of an unsold allotment or subscription of that distribution. Section 511(b)(1) of the Code continues this exception from the exemption and subjects such transactions to the prospectus delivery requirements of section 503. While the policy underlying the exception is sound, the Code's language is too broad in view of the applicability of the distribution concept to all secondary transactions. Unless the exception is limited to distributions subject to the offering or distribution statement requirements, it will impose unintended limitations and investigation responsibilities upon a broker-dealer handling an ordinary secondary sale.

(c) *When the transaction by the broker or dealer occurs during a certain restrictive period.* Another exception to the Code's broker-dealer transaction exemption that parallels the section 4(3) exemption in the 1933 Act for broker-dealer transactions applies to transactions in securities of issuers that are not one-year registrants. The exception subjects broker-dealers engaging in these transactions to the Code's prospectus delivery requirements for ninety days following the later of (i) the effective date of an offering statement relating to those securities or (ii) the first day on which a security of the same class became the subject of a distribution covered by the offering statement. The exception also applies to transactions occuring within ninety days after the first date on which a security of the same class was offered in violation of the Code's offering or distribution statement requirements. Thus the Code continues the 1933 Act's policy of subjecting both participating and nonparticipating broker-dealers to its prospectus delivery requirements for a ninety-day period when an offering statement is filed or when an unlawful distribution to the public commences involving securities of an issuer that is not a one-year registrant. To enable a broker or dealer to comply with the prospectus delivery requirements, the Code requires an issuer, upon request, to provide prospectuses without charge to brokers and dealers during the restrictive period.[120]

120. RD 1-3 § 504(c); TD-1 § 504(c). The Commission has promulgated rule 15c2-8 under the 1934 Act to ensure the adequate supply of prospectuses necessary for broker and

Under the 1933 Act the Commission has the authority to shorten the ninety-day period by rule or order, and the Code extends this authority to the unlawful distribution situation. Under the 1933 Act the Commission used its authority to eliminate the restrictive period for 1934 Act reporting companies,[121] an unnecessary step under the Code since section 511(c) specifically excludes the securities of a one-year registrant from the exception to the broker-dealer exemption.[122]

When the transaction involves securities of a company that is not a one-year registrant, the Code applies a fungibility concept that extends the prospectus delivery requirements during the restrictive period to transactions in securities of the same class as those that are the subject of an offering statement, even if the securities being sold are not traceable to the offering statement.[123]

(d) *When the broker or dealer sells continuously offered registered investment company securities.* Section 511(b)(3) removes from the general broker-dealer exemption transactions in "continuously offered securities issued by a registered investment company and currently being offered or sold by the issuer or by or through an underwriter" except as the SEC may prescribe by rule. Section 24(d) of the Investment Company Act currently excludes from the section 4(3) exemption of the 1933 Act transactions in the securities of investment companies that currently are being offered or sold to the public in nonexempt distributions, thereby requiring broker-dealers to use prospectuses in offering and selling these securities if the investment company continues to offer or sell securities of the same class in nonexempt distributions. The Commission is, however, authorized to modify that exclusion by rule. Section 511(b)(3) of the Code continues this exception, which applies even to exempted distributions of "continuously offered" securities. The section's use of the term "continuously offered," however, may create new interpretative problems unnecessarily.

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dealer compliance with the 1933 Act delivery requirements. 17 C.F.R. § 240.15c2-8 (1976).

121. 17 C.F.R. § 230.174 (1976).

122. Section 511(c) of the Code exempts "a transaction in a security of a one-year registrant that would be exempted under section 511(b) except for clause (2) of that section." RD 1-3 § 511(c), TD-1 § 511(c). Section 511(b)(2) imposes the restrictive 90-day period during which transactions by brokers or dealers are not exempted. RD 1-3 § 511(b)(2); TD-1 § 511(b)(2).

123. TD-1 § 511(b), Comment (3).

3. *Small Offerings*. Section 3(b) of the 1933 Act grants the Commission authority to exempt by rules and regulations any class of securities if it finds that registration is unnecessary for the protection of investors because of "the small amount involved or the limited character of the public offering." The Commission's authority under that section, however, is limited to situations in which the aggregate amount of the issue offered to the public does not exceed $500,000. The Commission has promulgated, among other rules, Regulation A and rule 240. Regulation A exempts an interstate public offering by an issuer of up to an aggregate amount of $500,000 in a twelve-month period if the issuer first has filed with the Commission a notification and offering circular. The exemption is in reality a limited form of registration. Recognizing the effects of inflation and the need to broaden available means of raising equity capital, former SEC Chairman Roderick M. Hills has suggested that the Regulation A exemption be simplified and its dollar limits increased to one million dollars, changes that would necessitate an amendment to section 3(b).[124] Rule 240, adopted in 1975 to increase the ability of "Mom and Pop" issuers to raise equity capital, exempts the sale of securities by an issuer other than an investment company for an aggregate amount of up to $100,000 within any twelve-month period if its securities are held by fewer than one hundred beneficial owners both before and after any transaction in reliance on the rule and if notice of the sale (Form 240) is filed in a regional office of the Commission.

No Code provisions specifically parallel the provisions of Regulation A and rule 240. Section 511(d) of the Code, however, expressly exempts a "transaction incident to an offering of not more than $100,000" except (a) when the transaction involves a security that is subject to the applicable resale restrictive period of the limited offering exception or (b) when the Commission has acted by rule to reduce the exempted amount to not less than $50,000 in any twelve-month period, to impose conditions, or to withdraw the exemption when the offering exceeds $50,000. In addition, the Commission, pursuant to the broad exemptive authority contained in section 302, may exceed the $100,000 maximum limitation of section 511(d). Thus until the Commission acts by rule, issuers and secondary distributors have available an unqualified automatic exemption for interstate public offerings of up to $100,000. This is normally the

124. A Report from the SEC, FED. SEC. L. REP. (CCH) ¶ 80,339 (Dec. 5, 1975) (address by Chairman Hills before the Securities Industry Association).

only exemption, other than the limited offering exception and the local distribution exemption, under which the "Mom and Pop" corporation can raise equity capital without registration. Additionally, under section 302 the Commission by rule may adopt other exemptions, including a successor to Regulation A, and this authority is not limited by dollar amounts.

The exemption reflects a genuine need to relieve issuers and secondary sellers of small offerings from the expense and complication of federal registration. The only major problem relates to the Commission's ability to reduce or to restrict the amount of the exemption and thus to frustrate the financing needs of small businesses. On the other hand, the Commission should have the ability to restrict or to remove the exemption when a high potential exists for ahuse. The compromise reached by the Code permits reduction of the exempted amount to $50,000 during a twelve-month period and authorizes the imposition of restrictions upon or withdrawal of the exemption only if the offering exceeds $50,000.[125] Given the *de minimis* effect of such small offerings, the increasing effectiveness of blue sky regulation, and the general application of the Code's antifraud provisions, the Commission's authority to limit the amount to $50,000 in a twelve-month period and its authority to exclude certain types of offerings from the exemption are unnecessary. The Commission can effectively control abuse through its antifraud powers and through the imposition of restrictive conditions tailored to meet the particular problem. The Code should leave no room for doubt that its federal machinery should not be cranked up for small issues unless some overriding public policy considerations so demand, and this point is made more conclusively if the Commission has less authority to modify the exemption.

Reliance upon this exemption requires careful examination of the circumstances surrounding an offering to determine if it will be integrated with prior sales, since the exemption cannot be used in tandem with a limited offering or trading transaction exception when section 267 requires integration and results in a loss of the exemption or exception.[126]

4. *Judicially or Administratively Approved Transactions.* Both the 1933 Act and the Federal Bankruptcy Act[127] exempt the

125. *Compare* TD-1 § 511(d), *with* RD 1-3 § 511(d). *See generally* 49 ALI PROCEEDINGS 399-401 (1972).

126. *See* note 39 *supra* and accompanying text.

127. Bankruptcy Act §§ 77(f)(1), 77(f)(2), 264(a)(2), 393(a)(2), 518(a)(2), 11 U.S.C. §§ 205(f)(1), 205(f)(2), 664(a)(1), 793(a)(1), 918(a)(1) (1970).

issuance of securities in exchange for outstanding securities, claims, or property interests when the fairness of the terms and conditions has been approved by some governmental and judicial authority. In addition to being applicable to normal corporate reorganizations and issuances of securities by public utilities, the 1933 Act exemption in section 3(a)(10) has been particularly useful in exempting securities issued in insurance company and bank mergers that are subject to the approval of state authorities and in class action litigation settlements when the terms and conditions are subject to the approval of the court. The present exemptions, however, do not apply when securities are issued solely for cash and not at least partially in exchange for any other securities, claims, or property interests, except any security may be issued for cash or otherwise pursuant to a confirmed railroad organization plan under section 77(f) of the Bankruptcy Act.

The Code consolidates these various exemptions into one section with only two substantive changes. First, the current, somewhat illogical restriction on the issuance of securities solely for cash is eliminated. Secondly, the security involved in the exempted transaction must be issued only to existing security holders or to creditors of the issuer.[128] The latter change seemingly will result in rendering the exemption unavailable in merger transactions when the fairness of the terms is appropriately approved but the issuance is to security holders of the to-be-acquired company rather than to the existing security holders of the issuer. This change is justifiable because the protection of investors may not be the agency's primary consideration in approving the merger and because the shareholders of the acquired company generally need the protection afforded by the filing of an offering statement. More importantly, this change is likely to affect the ability of a company in a reorganization to attract equity capital from fresh sources, although from the investor's viewpoint it is not unreasonable to subject such sales to the offering statement requirements of the Code.

5. *Exercise of Rights, Conversion Privileges, and Nonconversion Exchanges.* Section 3(a)(9) of the 1933 Act exempts on a transaction basis only securities exchanged by an issuer with its existing shareholders exclusively when no commission or other remuneration is involved. This section was enacted to allow companies to make certain voluntary readjustments of their financial obligations

128. TD-4 § 511(e); RD 1-3 § 511(e); TD-1 § 511(e). The exemption excludes debt securities to whose distribution the offering statement requirements of the Code's successor provisions to the Trust Indenture Act apply. *See* note 74 *supra.*

and encompasses only bona fide exchanges that are not a part of a scheme to avoid the registration requirements of the 1933 Act.[129] Since the securities must be "exchanged exclusively" for those held by existing shareholders, no cash payment by the exchanging shareholders is permitted except as allowed by rule 149 under the 1933 Act. Rule 149 permits shareholders to pay cash to effect an equitable adjustment of dividends or of interest paid or payable on the securities involved in the exchange. Similarly, the issuer may not pay any cash to the exchanging shareholders unless such payments are part of the terms of the exchange within the meaning of rule 150. This narrow exemption raises a number of difficult questions, many of which relate to warrants and convertible securities.[130]

The exemptions provided by sections 511(f) and 511(g) of the Code generally are based upon the policies underlying section 3(a)(9) of the 1933 Act but make several substantive changes. First, the Code's exemptions apply only to transactions in securities of a one-year registrant on the theory that if no current information about the issuer is in the public domain, then the exchanging shareholder needs the information that would be provided by an offering statement. While there is presumptively less reason to worry about providing information to an existing shareholder than to an outside investor, even when the company is not a one-year registrant, the narrowed application of the exemption is sound, given the Code's general scheme.

Secondly, section 511(f) of the Code treats the exercise of outstanding warrants or rights in the same manner as the exercise of conversion privileges. Unlike section 3(a)(9), which does not exempt such an exercise because the exercising holders ordinarily pay cash to the issuer at the time of exercise, the Code does not restrict payment of cash in the exercise of warrants, rights, or conversion privileges. The only conditions to the section 511(f) exemption are that all securities must be of the same issuer and that remuneration must not be paid for soliciting the exercise. Although removal of the distinction between rights calling for cash payments and those calling for surrender of securities is helpful, the exemption for the exercise of an outstanding warrant, right, or conversion privilege does not extend to the continuing offer of the underlying security inher-

129. H.R. REP. No. 152, 73d Cong., 1st Sess. 25 (1933). *See also* SEC Securities Act Release No. 646 (Feb. 3, 1936), 1 FED. SEC. L. REP. (CCH) ¶ 2136.

130. *See generally* TD-1 § 511(g), Comment (10). *See also* Hicks, *Recapitalizations under Section 3(a)(9) of the Securities Act of 1933,* 61 VA. L. REV. 1057 (1975); McGuigan & Aiken, *Amendment of Securities,* 9 REV. SEC. REG. 935 (1976).

ent in a warrant, right, or convertible security.[131] Thus the practical effect of the section 511(f) exemption is simply to remove the necessity for an issuer to keep a current prospectus over the long life of a particular convertible security or right. Moreover, the exemption is available only for securities of one-year registrants to ensure sufficient disclosure protection for the investor. These restrictions, particularly when combined with specific Code provisions permitting all corporate reports to be obtained by the holders of convertible securities or rights during the life of such rights, successfully provide disclosure protection for the purchasers of warrants or rights.[132]

The Code in section 511(g) more closely follows the substance of section 3(a)(9) in connection with exchanges of securities that are not made pursuant to an outstanding conversion privilege. The Code imposes a condition that the buyers must not pay any consideration other than the surrender of outstanding securities, the equalizing cash payments currently permitted by rule 149, and the unpaid interest or accrued unpaid dividends thereon.[133] The remaining conditions to the section 511(g) exemption require, as does the section 511(f) exemption, that there be no paid solicitation and that all of the securities involved in the exchange be of the same issuer. Thus exchanges involving different issuers, even if they are parent and subsidiary, are not covered by the exemption; a current prospectus must be delivered unless the exchange is otherwise exempt. Given the limitations on the exemption that ensure the availability of public information, exclusion of exchanges involving related companies is needlessly restrictive, particularly when no cash is paid. Moreover, exemption of exchanges involving unrelated companies is consistent with the Code's disclosure approach if both companies are one-year registrants.

An additional change in existing law relates to nonconversion exchanges and abandons the "exclusively-in-exchange" condition contained in the section 3(a)(9) exemption. Through the application of integration concepts to an issue, the condition in section 3(a)(9)

131. Section 293(d) of the Code states that an offer or sale of a convertible security or right is also an offer of the underlying security regardless of whether the right to convert or acquire is exercisable immediately or only in the future. RD 1-3 § 293(d). Thus unless otherwise exempt, the underlying security must be included in an offering or distribution statement. *See* TD-1 § 511(g), Comment (10).

132. RD 1-3 §§ 601(a)(2), 601(d); *see* TD-1 §§ 601(a), 601(d).

133. The interest and dividend exclusion settles the question under the § 3(a)(9) exemption whether the waiver by some security holders of unpaid interest payments or accrued dividends violates the prohibition against giving other consideration. *See* TD-1 § 511(g), Comment (5).

effectively eliminates reliance on the exemption when, as part of the same financing plan, a simultaneous offering of securities for cash occurs. Under the Code, the exchange is exempt as a separate transaction, and no offering statement is required if the concurrent cash offering is not a distribution or is otherwise exempt.[134]

6. *Put and Call Options*. The 1933 Act does not contain an exemption for puts and calls. For many years, however, the Commission did not require the registration of put and call options under the 1933 Act, although generally they were considered subject to the fraud provisions and in some instances to the broker-dealer registration provisions of the federal securities laws. With the increased trading activity in the option markets and the advent of the Chicago Board of Options Exchange (CBOE), the staff began to treat these options as securities that must be registered under the 1933 Act. Recognizing the historical pattern of no registration, however, the Commission in 1973 proposed rule 238 to exempt from registration put and call options, other than limited price options and options written on the CBOE, if gross proceeds from all related options did not exceed $500,000.[135] Proposed rule 238 has not been adopted to date, and no exemption exists under the 1933 Act. General enforcement of the registration provisions, however, has not occurred.

Section 511(h) of the Code specifically exempts transactions in puts, calls, and similar options or privileges and in the guaranties of these options if neither the issuer of the option or privilege nor any guarantor thereof is the issuer of the underlying security or in a control relationship with that issuer. The Commission, however, is granted authority to condition or withdraw the exemption by rule with respect to any or all classes of issuers, securities, or offerings. Thus the Code reflects present practice in this complex and fast-developing area but appropriately leaves the ultimate burden of setting the parameters of the exemption to the Commission.

7. *Transactions Between Exchange Members and Dealers*. Rule 153 under the 1933 Act relieves a selling broker-dealer from any

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134. TD-1 § 511(g), Comment (6). *See also* SEC Securities Act Release No. 2029 (Aug. 8, 1939), 1 FED. SEC. L. REP. (CCH) ¶ 2140.

135. SEC Securities Act Release No. 5366 (Feb. 8, 1973), [1972-1973 Transfer Binder], FED. SEC. L. REP. (CCH) ¶ 79,222. The proposed rule was revised in December 1973. *See* SEC Securities Act Release No. 5444 (Dec. 13, 1973) [1973-1974 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 79,602. At the same time the Commission proposed rule 9b-2 under the 1934 Act requiring broker-dealers to furnish customers with written disclosure statements explaining the nature and risk of the options and to provide a reasonable basis for believing that the recommended transaction would be suitable for the customer. *See generally* Frankhauser, *Options Regulations*, 7 REV. SEC. REG. 887 (1974).

applicable prospectus delivery requirements for transactions effected on a national securities exchange if the issuer or underwriter has provided the exchange with sufficient copies of the prospectus. The rule is designed to ease secondary trading on exchanges by removing technical prospectus delivery requirements and at the same time to ensure that the exchange has sufficient copies to deliver to selling broker-dealers that request them.

Section 512 of the Code continues and expands the substance of rule 153 by exempting from the Code's prospectus delivery requirements transactions between members on the floor of a national securities exchange and between dealers if at least one of the dealers quotes the security in an inter-dealer quotation system. As is true under rule 153, the exemption under the Code does not extend to an offer or sale by a member or dealer to its customer. Therefore a buyer's broker must comply with any prospectus delivery requirements applicable to the buyer when the broker solicits the buy order and executes it through an exchange.

VI. Miscellaneous Methods of Avoiding Code Filing Requirements

In addition to specific exemptions, the Code provides other methods of avoiding its various filing provisions. In order for the Code's prospectus provisions to be applicable, an issuer or secondary distributor must use the requisite jurisdictional means in connection with an offer or sale of a security. If any of the requisite elements is missing from the transaction, then the transaction is not subject to the Code's offering or distribution statement requirements. Each of these methods of escape is quite restricted and only rarely may be confidently relied upon.

1. *Lack of Jurisdictional Means*. A securities transaction is subject to the federal securities laws if appropriate jurisdictional means are employed to effect the transaction. Securities transactions, however, seldom escape coverage due to a lack of jurisdictional means, given the judicial gloss imposed upon the statutory language which creates a broad jurisdictional base. The Code broadens the existing jurisdictional base to the greatest extent possible under current constitutional interpretations. Under the Code, a jurisdictional base exists (a) if in doing business generally or if in any aspect of the transaction from the initial offering through payment and delivery, there is any use of the mails or federal commerce, which is defined as including the making of an intrastate phone call or (b) regardless of the use of the mails or federal commerce if the

actor is involved in a business affecting federal commerce or has a class of securities traded by use of the mails or federal commerce.[136]

2. *Transactions Not Involving a Security.* If a transaction uses the requisite jurisdictional means but does not involve a "security," the Code's offering or distribution statement provisions do not apply. Section 297 of the Code defines "security" very broadly and contains only a few changes from and clarifications of the definition contained in section 2(1) of the 1933 Act. The Code expands the 1933 Act definition only by including puts (a right to sell) and continues the Act's flexibility by retaining the broadly interpreted term "investment contract." Moreover, the introduction to the definitional portion of the Code states in terms similar to those used in the 1933 Act that definitions apply "unless the context otherwise requires," and thus enables courts to separate investment instruments from bona fide commercial instruments even when specific definitional language includes or excludes the instrument.

Despite the breadth of the definition of a "security," section 297(b) specifically excludes the following instruments from the basic definition: currency; checks, drafts, bills of exchange, or bank letters of credit; notes or other evidences of indebtedness issued in mercantile transactions; interests in bank or savings and loan association deposit accounts; bank certificates of deposit; traditional insurance policies; and annuity contracts issued by an insurance company other than investment-based variable annuities. These exclusions are designed principally to settle various interpretative questions that have arisen under the 1933 Act. Several recent cases, for example, have struggled with the issue of whether certain promissory notes are securities within the 1933 and 1934 Acts;[137] the Code resolves the issue by excluding notes issued in mercantile transactions. The "context" language contained in the introduction of the definitional portion of the Code should be sufficient protection to ensure that the exclusions will not be misused. Exclusion of an instrument from the definition of security is of greater significance than classification as an exempted security, because the exclusion removes the instrument not only from the filing provisions of the Code but also from its antifraud provisions.

3. *No Offer or Sale.* Even if a security is involved, the transac-

136. TD-5 § 1601; *see* RD 1-3 § 1601; TD-3 § 1601; RD 1-3 § 234B; TD-3 § 234B.

137. *See, e.g.*, Exchange Nat'l Bank v. Touche, Ross & Co., [Current] FED. SEC. L. REP. (CCH) ¶ 95,614 (2d Cir. 1976); Emisco Indus. Inc. v. Pro's Inc., [Current] FED. SEC. L. REP. (CCH) ¶ 95,761 (7th Cir. 1976); Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976).

tion is not subject to the offering or distribution statement requirements of the Code if it does not involve a sale or offer. The terms "sale and offer" are defined by section 293 of the Code in a broad sense much as they are presently defined by section 2(3) of the 1933 Act. They include every attempt to dispose of, every solicitation of an offer to buy, and every disposition for value and contract to sell or of sale. The Code, however, slightly expands certain points and codifies several interpretations that have developed over the years. Under the Code, for example, any offer or sale of a convertible security is considered an offer or sale of the underlying security; under the 1933 Act there is no offer or sale when the right to convert cannot be exercised until some future date.[138] In addition, the Code acts to shut the door on the old "shell company" game by specifically including within the definition of "sale and offer" the payment of a dividend in a security of another company unless the other company is a one-year registrant and nothing of value is given for the dividend.[139] Section 293(f) codifies and broadens present interpretations relating to merger and reorganization transactions by deeming the issuance of a security in any merger, including a short-form merger, consolidation, recapitalization, or asset acquisition to be a sale and offer. Thus under the Code, change-of-domicile mergers and parent-subsidiary mergers are subject to the offering statement requirements unless otherwise exempted.[140]

Section 293(g) clarifies certain troublesome areas under the 1933 Act by excluding from the definition bona fide gifts, pledges, security loans, stock splits, and transfers by death or by termination of a trust. A donee or pledgee who wishes to sell given or pledged stock is considered a secondary distributor subject to the offering or distribution statement requirements unless the transaction or security is exempted or involves no distribution. The actual gift or

138. RD 1-3 § 293(d); TD-1 § 293(d).

139. RD 1-3 § 293(f)(4); *see* TD-2 § 293(f)(4); TD-1 § 293(f)(2). The "shell company" game was designed to effect an instant public market for securities of a nonpublic company without going through the registration process. By entering into an acquisition agreement under which securities were exchanged for assets of nominal value with a public company that would then distribute the shares of the nonpublic company to its public shareholders as a dividend, the nonpublic company would obtain a public market without registration. The Commission and the courts have indicated that these schemes are subject to the registration provisions of the 1933 Act. *See* SEC Securities Act Release No. 4982 (July 2, 1969), 1 FED. SEC. L. REP. (CCH) ¶ 3055; SEC v. Harwyn Indus. Corp., 326 F. Supp. 943 (S.D.N.Y. 1971).

140. The notes to § 293 of the Code indicate that the merger of a wholly-owned subsidiary into its parent should not require an offering statement. The notes suggest that the introductory language "unless the context otherwise requires," and the Commission's authority to promulgate exemptions under § 302 and to define terms under § 1502 are sufficient to dispose of the problem. *See* RD 1-3 § 293, Note (2).

pledge, however, is not subject to the Code's filing or fraud provisions since it is excluded from the terms "sale and offer." Thus banks and charitable institutions will be concerned with available resale exemptions regarding all pledged and donated securities rather than merely with those pledged and donated by controlling persons, as is presently the case.

VII. Conclusion

New legislation frequently is scrutinized more carefully for means of avoiding its provisions than for means of complying with its requirements. Because the burdens and expenses imposed upon registered companies are substantial especially in connection with the raising of capital through nonexempt distributions, most practitioners will devote substantial attention to the exemptive provisions of the Federal Securities Code. This is particularly so, since the Code abandons the "control" concept of the 1933 Act and requires that all sales by individuals fit within an exception or exemption or be made by an effective offering statement, which a secondary seller may demand or which a seller may provide by filing a distribution statement.

Ordinary small businesses engaged in the process of raising capital generally can avoid the Code's provisions only by making a limited offering or a local distribution or by selling less than $100,000 (or the maximum amount the Commission adopts by rule). Secondary sellers also generally can avoid the filing requirements by relying upon these exceptions and exemptions. Additionally, secondary sellers may rely upon the trading transaction exception, which is unavailable to issuers. Although these exceptions and exemptions generally are not as complex and ambiguous as their counterparts under the 1933 Act, each is subject to complication or constriction by the Commission.

The Code reforms many of the exemptive provisions of the 1933 and 1934 Acts and significantly clarifies the interpretations given them since their enactment. The broad authority granted the Commission to modify existing and to add new conditions relating to those Code exemptions and exceptions that most often will be relied upon by small businesses and ordinary investors, however, threatens the order and objectivity the Code otherwise would achieve. Since the general rulemaking provisions of Code section 1502 provide sufficient flexibility for the Commission to meet changing conditions and demands, elimination of the specific authority to add to and to modify the conditions to these important exceptions and exemptions should be considered.

With the possible exception of the soft spot created by the breadth of Commission authority, the practitioner examining the routes of escape under the Code should be pleased generally with the changes effected by the Code. The federal system of securities regulation, and the life of the securities practitioner, will be vastly improved under the Code and thus Congress should act expeditiously to enact the Code.

EXCEPTIONS AND EXEMPTIONS OF GENERAL APPLICABILITY

Limited Offering Exception	Local Distribution Exemption	Small Offering Exemption	Trading Transaction Exception	General Exemptive Authority
1. This exception is the successor to the private offering exemption provided by section 4(2) of the 1933 Act but its substance is significantly changed in an objective fashion. 2. The principal conditions are that the initial buyers must not exceed 35 non-institutional persons though may include an unlimited number of institutional investors; that during the applicable restrictive period resales do not result in more than 35 owners other than institutional investors; and that applicable requirements relating to written representations, legends, and stop-transfer orders are complied with. 3. The applicable restrictive period for resales is three years unless the issuer is a one-year registrant in which case it is one year. 4. The SEC may add to or modify the conditions to this exception. 5. Secondary sellers may rely upon this exception.	1. This exemption is the successor to the intrastate offering exemption provided by section 3(a)(11) of the 1933 Act but is broader in scope and objectivity. 2. Sales must be substantially restricted to residents of a single state or to an area in contiguous states as may be defined by SEC rule. 3. The issuer's principal place of business must be in the state or area of the sales. 4. Resales may be restricted for a period up to one year. 5. The SEC may add to or modify the conditions to this exemption. 6. Secondary sellers may rely upon the exemption except for resales of securities acquired in a limited offering during the applicable restrictive period, and such sellers do not need to be residents of the state or area of the sales.	1. This exemption is the successor to rule 240 and Regulation A under the 1933 Act but provides an automatic exemption for offerings of not more than $100,000. 2. The SEC may adopt a rule reducing the maximum amount permitted to be offered under the exemption to $50,000 in any twelve-month period. 3. The SEC may also impose conditions or withdraw this exemption at any time the offering exceeds $50,000. 4. Secondary sellers may rely upon this exemption except for resales of securities acquired in a limited offering during the applicable restrictive period.	1. This exception is only available for transactions by secondary sellers and issuers may not rely upon it. 2. This exception is the successor to sections 4(1) and 4(4) and rule 144 under the 1933 Act to permit routine trading transactions but applies to all transactions by secondary sellers and not just to transactions by controlling persons or persons reselling restricted securities. 3. The transaction must be made through a broker or with a dealer who must perform only its usual function and must receive no unusual compensation. 4. The SEC is to adopt a rule imposing volume restrictions as a condition to this exception, which restrictions are likely to parallel those in rule 144(e). 5. The SEC may add to or modify the conditions to this exception. 6. This exception may not be relied upon by secondary sellers for the resale of securities acquired in a limited offering during the applicable restrictive period.	1. This exemptive authority is the successor to section 3(b) under the 1933 Act but contains no dollar or other limitations and is not restricted therefore to small or limited offerings. 2. The SEC may act by rule or order to exempt any person, security, or transaction from any or all of the provisions of the Code.