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A LAWYER'S GUIDE TO THE INTRASTATE EXEMPTION AND RULE 147†

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Every lawyer who has handled any type of securities issuance for a small corporation or who has advised his client in connection with the purchase of securities not registered with the Federal Securities and Exchange Commission has been involved with the use at one time or another with the intrastate exemption whether he realizes it or not. My basis for this statement is this. Section 5 of the Securities Act of 1933[1] requires that all securities which are sold or delivered by the use of the mails or by any means in interstate commerce must be registered with the SEC or an exemption from that registration found. At one time it was thought that it would be possible to sell securities in a face to face type of transaction without using the mails or any means which would cause the securities to move in interstate commerce and thus avoid the application of the Federal Act. However today most knowledgeable securities lawyers are convinced that such a transaction is a virtual impossibility. A literal reading of section 5 would suggest that the registration requirement is not triggered unless the mails or some means of communications or transportation actually moving in interstate commerce are used or the

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1. 15 U.S.C. § 77e (1970).

securities themselves are transported by mail or in interstate commerce. However the vast majority of the cases have not so held.[2] Rather it appears clear from the decisions that the use of the mails can come at any point from the initial contact to the final disposition of the funds received. Thus it has been held that the use of the mails by a bank to forward a check for collection which the corporation received in payment is sufficient to provide the jurisdictional basis for the registration requirement.[3] Likewise recent decisions[4] have indicated that the use of any means of transportation or communication which is a part of an interstate system will suffice even though the communication or means of transportation is not itself in the stream of interstate commerce.[5] Thus it is now clear that a long distance telephone call from Des Moines to Sioux City will provide the necessary jurisdictional means and there are several cases suggesting that purely local calls within a metropolitan area such as Des Moines or Sioux City would also qualify on the basis that the lines used are part of the larger interstate telephone system.[6] One recent case has gone to the ultimate extreme of suggesting that the movement of an automobile over any portion of the interstate highway system might provide the necessary trigger.[7]

From this it is clear that all securities issues will come within the purview of the Federal Act and an exemption from the registration requirements will have to be found.[8] The exemption most often used, in terms of the number of transactions,[9] either consciously or unconsciously is the intrastate ex-

2. *See, e.g.*, Kerbs v. Fall River Indus., Inc., 502 F.2d 731 (10th Cir. 1974) (a meeting leading to sale set up by telephone call); Welch Foods, Inc. v. Goldman, Sachs & Co., CCH FED. SEC. L. REP. ¶ 94,806 (S.D.N.Y. Sept. 30, 1974) (confirmation by mail of purchase).

3. Starck v. Dewane, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,340 (N.D. Ill. Sept. 12, 1973).

4. *See, e.g.*, Aquionics Acceptance Corp. v. Kollar, CCH FED. SEC. L. REP. ¶ 94,824 (6th Cir. Oct. 9, 1974); Myzel v. Fields, 386 F.2d 718 (9th Cir. 1967). *Contra*, Burke v. Triple A Mach. Shop, Inc., 438 F.2d 978 (9th Cir. 1971); Dupuy v. Dupuy, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,569 (E.D. La. Apr. 26, 1974); Rosen v. Albern Color Research, Inc., 218 F. Supp. 473 (E.D. Pa. 1963).

5. It should be noted that many of the "jurisdictional means cases" arise under SEC Rule 10b-5, 17 C.F.R. 240.10b-5 (1974). While section 5 talks in terms of the "use of any means of instruments of transportation or communication *in* interstate commerce," SEC Rule 10b-5 speaks in terms of "the use of any means or instrumentality *of* interstate commerce." While some have argued that the use of the word "in" in section 5 requires a different interpretation than the use of the word "of" in Rule 10b-5, the courts have generally treated the two provisions as interchangeable. *See, e.g.*, Reube v. Pharmacodynamics, Inc., 348 F. Supp. 900 (E.D. Pa. 1972); Ingraffia v. Belle Meade Hosp. Inc., 319 F. Supp. 537 (E.D. La. 1970); Lennerth v. Mendenhall, 234 F. Supp. 59 (N.D. Ohio 1964).

6. Aquionics Acceptance Corp. v. Kollar, CCH FED. SEC. L. REP. ¶ 94,824 (6th Cir. Oct. 9, 1974); Heyman v. Heyman, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,924 (S.D.N.Y. Mar. 27, 1973); Levin v. Marder, 343 F. Supp. 1050 (W.D. Pa. 1972).

7. Aquionics Acceptance Corp. v. Kollar, CCH FED. SEC. L. REP. ¶ 94,824 (6th Cir. Oct. 9, 1974).

8. It should be remembered that the intrastate exemption, like all exemptions, merely forgives registration of the security. The anti-fraud provisions of the 1933 and 1934 Acts still apply. Kelly v. West Printing Co., CCH FED. SEC. L. REP. ¶ 94,835 (E.D. Mich. Apr. 1, 1974).

9. It is difficult to get any accurate figures on how often the intrastate exemption is used since there are no filing or notification provisions which must be complied with

emption found in section 3(a)(11) of the Securities Act. This exemption reads:

> Any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within, or, if a corporation, incorporated by and doing business within, such State or Territory.[10]

While this exemption is very frequently relied upon by corporations who have not retained legal counsel and unfortunately all too often by inexperienced counsel, the experienced securities attorney rarely, if ever, recommends the use of this exemption. The feeling of the securities bar, I think, is well summarized by the statement of a former chairman of the SEC when he said: "[A]s a practical matter the intrastate exemption is loaded with dynamite and must be handled with very great care."[11]

I think that two examples, one actual and one hypothetical, will help illustrate why the securities bar shies away from this exemption. In considering these cases, keep two things in mind. First, a claim of exemption is an affirmative defense on which the person claiming it must bear the burden of proof.[12] Second, in order to meet this burden, the issuer must show that the person complaining meets the requirements.[13] As a result a single sale or *offer of sale* which falls outside of the exemption destroys the applicability of the exemption to *all offers or sales.*

The first illustration is an actual case involving a corporation in the State of Washington. It was a substantial old-line corporation with an established product and reputation. A substantial portion of the corporation's business was conducted pursuant to a line of credit in the amount of several million

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before its use. It is a purely self-executing exemption. However, as a part of its special study of the securities market, the SEC concluded during the year 1961 that there were at least 90 offerings under the exemption, fifteen of which were for amounts of a million dollars or more. *See* SECURITIES AND EXCHANGE COMM'N, REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. REP. NO. 95, 88th Cong., 1st Sess., pt. 1, at 573 (1963). The actual number of times this exemption is used each year, I am sure, greatly exceeds this number.

10. 15 U.S.C. § 77c(a)(11) (1970). Several cautionary comments about this exemption are in order. First the exemption is not available to a company which has to register under the Investment Company Act of 1940 because section 24(d) of that Act, 15 U.S.C. § 80a-24(d) (1970), specifically withdraws the availability of the exemption. *See* Founders Life Corp., BNA SEC. REG. & L. REP. (No. 274), at C-1 (SEC NAL Aug. 9, 1974). Further it has been held that a Rule 147 offering constitutes a public offering, so that a company which uses the Rule cannot qualify for the exemption under the Investment Company Act, section 3(c)(1), 15 U.S.C. § 80a-3(c)(1) (1970), exempting an investment company which has less than 100 shareholders and which has not made a public offering. *See* American Equity Corp., BNA SEC. REG. & L. REP. (No. 263), at C-1 (SEC NAL June 17, 1974). Finally it has been held that a broker-dealer whose primary purpose is to sell the stock of a company which is not entitled to rely on the intrastate exemption cannot qualify as an intrastate broker-dealer and avoid broker-dealer registration under section 15 of the Securities and Exchange Act of 1934, 15 U.S.C. § 78 (1970). Corporate Investment Co., CCH FED. SEC. L. REP. ¶ 79,953 (SEC NAL May 23, 1974).

11. Gadsby, *The Securities and Exchange Commission and the Financing of Small Businesses,* 14 BUS. LAW. 144, 148 (1958).

12. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).

13. Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972).

dollars which the corporation had been able to secure from the local bank. The corporation wished to expand and wanted to raise the capital through additional sales of its common stock. Upon extremely poor advice of counsel, it elected to issue one million dollars worth of new stock pursuant to the intrastate offering exemption. The corporation sold the stock to Washington residents taking care to establish that the purchasers were in fact bona fide Washington residents. Several months after the corporation had completed the sale of its stock, a relative of one of the purchasers came for a visit from California. After hearing about how great the investment was, the relative badgered the Washington resident into selling him part of the original investment. The corporation did not learn of the sale until the stock was presented for transfer. At this point, the corporation realized that it had trouble. It asked the California purchaser if he would like to rescind the transaction. He said no since he was happy. The corporation inquired of other purchasers and they appeared happy. However it felt that it was obliged to notify the bank which had extended the line of credit that it had a potential liability for rescission of the entire one million dollar offering. It went on to point out that the potential liability did not appear real because the shareholders appeared happy with their investments. The bank on the other hand took a slightly different view of the matter. It immediately cancelled the line of credit, telling the company that they would review the matter again at the end of one year.[14] Without the line of credit, the corporation went bankrupt within three months.

The second case, while not as dramatic, illustrates another not uncommon situation. In this case, the corporation seeking to place its securities under the intrastate exemption engaged the services of a small intrastate broker-dealer. The corporation was careful to instruct the broker about the need to determine that the purchasers were bona fide residents of the state and that they could not sell the securities outside the state for a period of one year or more. One Friday a person came in and wanted to buy some of the corporation's stock. The representative had not made many sales over the week. The people indicated that they wanted a sizeable block of the stock. The representaative looked the people over and decided if they were not domiciliaries of the state they ought to be. He filled out the necessary form indicating that they were domiciliaries and had them sign the form without reading it on the pretext that it was necessary paper work that had to be filled out, but was unimportant. They were happy about their purchase as was the representative because he got the commission. It was not until months later, after the representative had moved on to a different job and the entire issue had been sold, that the corporation learned that these customers were not domiciliaries of the state. At this point the stock had declined severely in value due to the fact that the nation was in a recession. When the news got around about

14. The statute of limitations for civil liability under section 12(1), 15 U.S.C. § 77*l* (1970), for the sale of a security in violation of the registration provisions is one year from the date of sale. 15 U.S.C. § 77m (1970).

this mistake, many shareholders demanded that the corporation rescind their purchase.[15]

I think that these illustrations point out why the seasoned securities counsel will not recommend that his client attempt to rely on this exemption. It is simply too difficult to be sure that the exemption is available; and, even if it is available, it can be lost too easily after the fact by actions of individuals over which the corporation has no real control.

The SEC has long realized that there were many problems with the practical use of this exemption. Early last year, as part of its overall attempt to give the practicing bar some guidelines under which they could safely plan their clients' transactions under the various exemptions, the Commission adopted Rule 147 dealing with the intrastate exemption.[16] Like all of the 140 series, Rule 147 does not purport to be exclusive, and therefore the lawyer may still attempt to chart his own course through the administrative and judicial decisions under the basic exemption, if he or his client is unwilling to comply strictly with the terms of the Rule. Realizing that many lawyers either out of choice or necessity will continue to recommend that their clients rely on either Rule 147 or the intrastate exemption directly, I think the time is ripe to consider both the pre-existing case law and the provisions of Rule 147 in detail. Others have written extensively about the basic exemption and the existing case law[17] and a number of articles have appeared discussing Rule 147 as it was proposed and later adopted.[18] In this article, I will attempt to pull all this information together into a single source and add to it a large number of

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15. Nor are the investors the only people that the corporation has to worry about. The SEC is also interested in this type of violation and has a variety of actions it can take. It can threaten an injunction to prohibit further violations of the registration provisions. 15 U.S.C. § 77t(b) (1970). It can force the corporation to make a public disclosure of the insurer's contingent liability under 15 U.S.C. § 77*l*(1) (1970). It can insist that the corporation make a rescission offer to all those persons who bought including those who were state residents. It could also recommend criminal prosecution under 15 U.S.C. § 77x (1970). For a discussion of these alternatives, see Comment, *The Intrastate Exemption: Current Law, Local Practice and the Wheat Report*, 31 OHIO ST. L.J. 521, 532 (1970). While it may be a little far-fetched to think that the Commission will become too concerned about the single sale in our example, it should be kept in mind that a single sale has led to at least one criminal prosecution and a number of SEC proceedings. *See* Shaw v. United States, 131 F.2d 476 (9th Cir. 1942); Edsco Mfg. Co., 40 S.E.C. 865 (1961); Universal Serv. Corp., 37 S.E.C. 559 (1957); Professional Investors, Inc., 36 S.E.C. 173 (1956); Peterson Engine Co., 2 S.E.C. 893 (1937).

16. SEC Securities Act Release No. 5450 (Jan. 7, 1974), 1 CCH FED. SEC. L. REP. ¶ 2253 (1974).

17. Much of the case and administrative law which had developed was collected in an excellent 1961 SEC Release. *See* SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2270 (1974). *See also*, Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779 (1971); Gadsby, *The Securities and Exchange Commission and the Financing of Small Businesses*, 14 BUS. LAW. 144 (1958); McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937 (1959); Schaefer, *An Annotated Checklist for the Federal Intrastate Exemption from Registration of Securities*, 34 MONT. L. REV. 1 (1973).

18. *See, e.g.*, Kant, *SEC Rule 147—A Further Narrowing of the Intrastate Offering Exemption*, 30 BUS. LAW. 73 (1974); Comment, *A New Approach to the Intrastate Exemption: Rule 147 vs. Section 3(a)(11)*, 62 CALIF. L. REV. 195 (1974); Comment, *SEC Rule 147—Distilling Substance From the Spirit of the Intrastate Exemption*, 79 DICK. L. REV. 18 (1974).

"no-action" letters which have not been discussed before or which have been issued since the promulgation of the Rule.[19] I think that this is an especially appropriate time to attempt such a project because the SEC indicated at the time that it adopted Rule 147 that it would not continue to issue "no-action" letters under the basic exemption except in unusual and compelling circumstances.[20] It has subsequently adhered to this practice.[21] As a result the body of law surrounding the basic exemption is now relatively static, being changed only by the infrequent "no-action" letter or court decision. Further Rule 147 has now been in operation for a little more than a year and a number of interpretive opinions are now available which were not discussed in the earlier articles which appeared soon after the Rule was adopted.

The acknowledged purpose of the intrastate exemption is to free local industries seeking local financing from local investors from the reach of the federal securities act registration requirements and to leave their regulation, at least as to registration, to local blue sky law.[22] To make sure that this purpose is fulfilled, but that other financing operations do not abuse this exemption, the SEC has developed some five areas of inquiry based upon the language of the exemption. First, the SEC seeks to determine whether the issuer is a resi-

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19. I think a word is in order about the SEC "no-action" letters. Unfortunately only a small fraction of the total number of these letters are ever published in a form readily available to either the average lawyer or researcher. There are three services which publish these letters on a selected basis. These services are: The Commerce Clearing House, Federal Securities Law Reports (CCH FED. SEC. L. REP.), The Bureau of National Affairs, Securities Regulation and Law Reports (BNA SEC. REG. & L. REP.), and the New Mathew Bender, Federal Securities Regulation Compliance Service, (FED. SEC. REG. COMPL. SERV.). One service not generally available publishes all of these letters. This is the Commerce Clearing House, Federal Securities Microfilm (CCH FED. SEC. MICROFILM). In the preparation of this article, I have attempted to collect all the "no-action" letters which are generally available as well as those not so available to which I have had access. Unfortunately there are a number to which I did not have access because I did not have available the microfilm service. I have, however, included a citation to that service where I was able to find reference to it. Obviously the "no-action" letters do not compare with court decisions and do not have a binding effect on the SEC other than in the particular situation presented, and even then the SEC can withdraw the letter and proceed contrary to the position stated, since the letters are issued by the Staff and have no binding effect on the Commission itself. However, these letters do furnish an important source of information concerning the SEC's thinking in a particular area. In some cases, the Staff may take a position which they realize that they might have a difficult time establishing in court. The recipient of such a letter is free to proceed contrary to the letter realizing that he may be challenged. On the other hand, the Staff may not recommend enforcement action if the person acts contrary to its position in a particular case because of its limited enforcement resources. Yet it may not be willing to endorse the particular practice even though it does not contemplate enforcement action in the particular area in the immediate future. For a discussion of the effect of "no-action" letters, see Lowenfels, *SEC No-Action Letters: Conflicts With Existing Statutes, Cases, and Commission Releases*, 59 VA. L. REV. 303 (1973).

20. SEC Securities Act Release No. 5450, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,617 (Jan. 7, 1974).

21. *See, e.g.*, Sentry Financial Serv. Corp., FED. SEC. REG. COMPL. SERV. § J 1118 (SEC NAL Aug. 30, 1974); Woodbury Telephone Company Employee Stock Plan, FED. SEC. REG. COMPL. SERV. § J 1085 (SEC NAL July 25, 1974).

22. Keep in mind that the anti-fraud and civil liability sections of the Federal Act continued to apply so long as the jurisdictional means are used, even though registration under the Federal Act is excused. Smith v. Jackson Tool & Die, Inc., 419 F.2d 152 (5th Cir. 1969); *see* 15 U.S.C. §§ 77*l*(2), 77q, 78j(b) (1970); SEC Rule 10b-5, 17 C.F.R. ¶ 240.10b-5 (1974).

dent of the particular state where the securities are being issued. Further, if the issuer is a corporation, then the SEC seeks to determine whether the corporation is also incorporated in that state. Second, the SEC wants to discover whether the issuer is doing a substantial portion of its business within the state of issuance, since this will help determine whether the financing is strictly local in nature. Toward this same end, the SEC next inquires whether the proceeds are going to be employed within the state. Then it seeks to determine whether all the original offerees and purchasers were residents of the state in which the offer was made and whether these securities have remained within the state or have passed out of the state through secondary sales to offerees or purchasers elsewhere. Finally, the SEC is interested in finding out whether the securities sold under this claimed exemption were merely a part of a larger financing operation, other parts of which the issuer claims fit under other exemptions.

Let us examine each of these areas briefly, outlining the problems which have developed and the position that the decisions have taken.

I. Residency Within the State of the Issuer

The first area of inquiry—that the issuer be a resident of the state wherein the securities are issued—is mandated by the language of the statute itself. This portion of the requirement has not caused any great problem in interpretation except in determining the residence of certain non-legal entity issuers such as limited partnerships. Here the question has been whether for the residence purpose we look to the state under whose laws the partnership is formed, or whether we look through the partnership and impose the residency requirements upon the various general and limited partners. Originally it was believed that the former was the approach to be followed.[23] However in 1971, in a "no-action" letter, the SEC appeared to switch and hold that all the partners both general and limited must meet this single state residency requirement.[24] However in another letter the SEC Staff took the position that the general partner was the issuer of the securities and it was his state of residence which controlled.[25] Finally the Staff appeared to come full circle back to the position that the partnership itself was the issuer and its residence was the state under whose laws it was formed.[26] We will see later that

23. McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. Pa. L. Rev. 937, 948 (1959).

24. Pacific Income Plan (SEC NAL Aug. 6, 1971). *See also* Western Mall Shopping Center, [1971] CCH Fed. Sec. Microfilm, roll 5, frame 10308 (SEC NAL July 22, 1971).

25. American Plan Invest. Corp., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,044 (SEC NAL Feb. 9, 1971). This position may be explained by the fact that the interests in the limited partnership were sold *before* the partnership actually formed by filing the articles of partnership with the Secretary of State. In this case, the firm which became the general partner was the real issuer since the limited partnership did not exist and could not be the issuer. Under these circumstances the residency of the general partner issuer would be relevant.

26. Louisiana Motor Inns, [1972-1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,902 (SEC NAL May 23, 1972).

this problem has been handled under Rule 147, but it remains an open question under the basic exemption.[27]

Another area that has caused some concern is the problem of multiple corporations, each of which is incorporated in the particular state where it does business. There are two fairly common examples of this type of problem. One is where corporation *A* is incorporated in one state and does most of its business there, but happens to own a subsidiary corporation, corporation *B*, which is incorporated in another state and does most of its business there. The second example is the parent corporation which creates a series of subsidiary corporations, one to operate in each state in which it does business. This latter aproach is often dictated by local regulations or other business reasons and is not motivated by an attempt to circumvent securities registration. In spite of this fact, in its 1961 release, the SEC took the position that in such a situation the parent corporation and all its subsidiary corporations are a single business entity and the intrastate exemption would be unavailable.[28] Since then the SEC has adhered to this interpretation in a series of "no-action" letters.[29]

There are two further items that need to be discussed under this heading. First, note that the statute has a specific provision dealing with when the issuer is a corporation. In this case the corporation has to be *incorporated in* as well as *doing business within* the state where the securities are issued. The net effect of this provision is to make the intrastate exemption unavailable to all corporations incorporated in a state of convenience. Thus a Delaware corporation, which was doing no business in Delaware, its state of corporation, but all its business in Oklahoma where it was domesticated as a foreign corporation could not use the intrastate exemption in *either* Delaware or Oklahoma. It could not use the exemption in Delaware because it was not doing business there, a point considered in the next section. Nor could it use it in Oklahoma because it is not incorporated there. We will see that Rule 147 attempts to alleviate this problem, but to my mind there is a very serious question whether under the explicit language of the statute this provision of the Rule is supportable.[30]

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27. As this article goes to press it appears that one court at least will follow the lead of Rule 147 under the basic exemption. Grenada v. Spitz, CCH FED. SEC. L. REP. ¶ 95,008 (S.D.N.Y. Mar. 6, 1975).

28. SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2270, at 2609 (1974).

29. Liberty Loan Corp., BNA SEC. REG. & L. REP. (No. 284), at C-1 (SEC NAL Nov. 26, 1974); Citicorp, BNA SEC. REG. & L. REP. (No. 259), at C-1 (SEC NAL May 24, 1974) (both holding neither Rule 147 nor 3(a)(11) is available); *see* Commercial Credit Co., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,544 (SEC NAL Nov. 5, 1971); International Funeral Serv., Inc., [1971] CCH FED. SEC. MICROFILM, role 1, frame 00986 (SEC NAL Apr. 7, 1971). But see *Dart Industries, Inc.*, (SEC NAL Oct. 6, 1971) holding a Delaware corporation could establish a California subsidiary and use the exemption. *See generally* Modesitt, *Exemptions from Registration Under the Securities Act of 1933*, 27 NEB. L. REV. 43, 45 (1947).

30. I think that this is an appropriate time to point out that those issuers who rely upon Rule 147 in this regard will be protected even though the provision is declared beyond the SEC's rule making power. Section 19(a) of the Securities Act, 15 U.S.C. § 77s(a) (1970) provides in part: "No provision of this subchapter imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the

Second, it is generally conceded that the intrastate exemption can be used by control persons to dispose of their stock. Thus in *Katz & Besthoff, Inc.*,[31] the Commission Staff advised an executor of a control person that he could dispose of shares held by the estate under the exemption. We will see later that Rule 147 is not available to control persons and therefore they are going to have to continue to rely upon the basic exemption. A reading of the statutory language would suggest that the residency of the control person was irrelevant, but that he could sell his stock only in the state of the corporation's residency.[32] This was thought to be the correct interpretation of the law.[33]

However a 1971 "no-action" letter raises some doubt as to the continued validity of this interpretation. In *Continental Investors Life Insurance Co.*,[34] National Investment Corporation, a Kansas corporation, which owned two-thirds of the stock in Continental Investors Life Insurance Company, wanted to institute an employee's stock purchase plan for the employees of Continental. Continental was a Colorado corporation and all its employees which were going to be covered by the stock purchase plan were Colorado residents. Thus under the previous interpretations that the residence of the control person was irrelevant, this sale would seem to qualify for the intrastate exemption since both the corporation and the purchasers were residents of Colorado. The SEC Staff however disagreed. It pointed out that the sales by National were going to be processed through the Merchants-National of Topeka, Kansas which was acting as trustee for the plan. Thus both the processing agent and the control person were not residents of Colorado. This led the Staff to say: "The diversity of citizenship of the parties and the payment of proceeds to a non-Colorado corporation in our opinion destroys the local nature of the offering."[35] Whether this opinion was an aberration caused by the particular facts outlined or constitutes a shift in SEC thinking as to the availability of the exemption to a control person whose residence or domicile is not the same as that of the corporation remains to be seen.

II. Doing Business in the State

The second area of concern by the SEC is to determine that the issuer is doing business in the state where the securities are issued. The exemption itself

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Commission, notwithstanding that such rule or regulation may, after such act or omission, . . . be determined by judicial or other authority to be invalid for any reason."

31. BNA Sec. Reg. & L. Rep. (No. 199), at C-2 (SEC NAL Mar. 16, 1973).

32. This may or may not be the same as the control person's residency. For example, the control person could have taken his shares by private placement a number of years before and live outside the state. Alternatively, he might have taken the shares under an intrastate exemption and later moved from the state of the corporation's residence.

33. SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH Fed. Sec. L. Rep. ¶ 2271 (1974). *See also* Gardiner, *Intrastate Offering Exemption: Rule 147—Progress or Stalemate?*, 35 Ohio St. L.J. 340, 367 (1974).

34. [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,084 (SEC NAL Mar. 4, 1971); *cf.* Hynes & Howes Real Estate, Inc., [1971-1972 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,603 (SEC NAL Dec. 6, 1971). *See also* Space Corp., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,096 (SEC NAL Mar. 25, 1971).

35. [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 78,084, at 80,350 (SEC NAL Mar. 4, 1971).

says nothing more than that the issuer has to be doing business in the state of issue. It does not elaborate further as to what type of activity will satisfy the requirement. Treating this provision in isolation without consideration of the case law or the SEC's position papers, it could be argued that all this requires is that the issuer maintain some business activities in the state, not necessarily its major activities and certainly not the activities into which the funds being raised are going to be funnelled.[36] Thus arguably, the corporation could maintain its bookkeeping, stock records, and other administrative functions in the state of issue, but its income-producing activities in another and use the exemption.[37] However both the pronouncements from the SEC and the case law negate such an interpretation. In its 1961 Release the SEC said:

> In view of the local character of the section 3(a)(11) exemption, the requirement that the issuer be doing business in the State can only be satisfied by the performance of substantial *operational* activities in the State of incorporation. The doing business requirement is not met by functions in the particular State such as bookkeeping, stock record and similar activities or by offering securities in the State.[38]

The SEC position has been sustained by the case law both before the issuance of the 1961 Release and since then.[39] There are four major cases in this area which need to be considered. The first case to involve the question of doing business was *SEC v. Truckee Showboat, Inc.*,[40] in which a California corporation sought to sell almost 5,000 shares of stock at $1,000 a share to residents of California pursuant to the intrastate exemption. At the time of its expansion, the corporation owned a small wholesale pharmaceutical business in San Francisco whose total assets were listed on the corporate balance sheet as slightly less than $13,000. The $5,000,000 that the corporation hoped to raise was to be used to buy and operate the El Cortez Hotel in Las Vegas, Nevada. Since the corporation did have an existing business in California, it could be argued that it met the doing business test. The court without elaboration simply held that the exemption was not available.

The same court three years later reconsidered the question in *SEC v. Los Angeles Trust Deed & Mortgage Exchange*.[41] Here the defendant was offering to select mortgages on property located out of California for local residents. The Exchange would manage the mortgages for the investors and agreed to pick up any that were in default. In this way, the Exchange guaranteed the investor a fixed percentage return on his investment. This arrangement was held to be an investment contract and since the mortgages which were the subject of the

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36. Likewise it could be argued that the purpose of the exemption would require the corporation to do all its business in the state. Professor Loss argues against this based on statutory construction. 1 L. Loss, SECURITIES REGULATION 601 (2d ed. 1961).

37. Such an argument was made and rejected in *North American Acceptance Corp.* [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,724 (SEC NAL Jan. 18, 1974).

38. SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2271, at 2609 (1974) (emphasis added).

39. *But see* SEC v. Curtis Minerals, Civ. A. No. 336-69 (D. Utah Nov. 18, 1971).

40. 157 F. Supp. 824 (S.D. Cal. 1957).

41. 186 F. Supp. 830 (S.D. Cal. 1960).

investment contracts were on land outside of California the intrastate exemption was held not to apply.

In 1969 the Sixth Circuit considered the doing business problem in *Chapman v. Dunn*.[42] This case involved the sale of Ohio oil and gas interests. The defendant maintained an office in Michigan and offered these interests to Michigan residents. The court conceded that the defendant was the issuer of these interests and that the defendant's activities would constitute the doing of business for many purposes such as state taxation and service of process, but held that it did not meet the standard required under the intrastate exemption. The court held for the issuer to be able to use the intrastate exemption, it must conduct a "predominant" amount of its business in the state of issue, and by "business" it meant income-producing activities, not managerial or administrative activities.[43]

Most recently the problem was considered by a Minnesota federal district court in *SEC v. McDonald Investment Co.*[44] McDonald, whose only business office was in Minnesota, was selling unsecured corporate installment promissory notes to Minnesota residents. The proceeds from these promissory notes were used to make loans to land developers outside the state, secured by mortgages or liens running to the corporation. After quoting from *Chapman v. Dunn* the court said:

> This language would seem to fit the instant case where the income producing operations of the defendant, after completion of the offering, are to consist entirely of earning interest on its loans and receivables invested outside the state of Minnesota. While the defendant will not participate in any of the land developer's operations, nor will it own or control any of the operations, the fact is that the strength of the installment notes depends perhaps not legally, but practically, to a large degree on the success or failure of land developments located outside Minnesota, such land not being subject to the jurisdiction of the Minnesota court.[45]

The SEC has consistently followed its earlier interpretation in a number of "no-action" letters.[46] Three of these "no-action" letters are worthy of discussion here. The first of these is *General Motel Corp.*[47] Here the factual situa-

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42. 414 F.2d 153 (6th Cir. 1969).

43. This particular decision was foreshadowed in the earlier SEC release where it was stated:

> Thus, the exemption would be unavailable to an offering by a company made in the State of its incorporation of undivided fractional oil and gas interests located in other States even though the company conducted other business in the State of its incorporation. While the person creating the fractional interests is technically the "issuer" as defined in section 2(4) of the Act, the purchaser of such security obtains no interest in the issuer's separate business within the State.

SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2271, at 2609 (1974).

44. 343 F. Supp. 343 (D. Minn. 1972).

45. *Id.* at 345.

46. *See, e.g.*, Hynes & Howes Real Estate, Inc., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,603 (SEC NAL Dec. 6, 1971).

47. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,332 (SEC NAL June 24, 1971).

tion is the reverse of the *Truckee Showboat* case. General Motel was an Oregon corporation, which issued a large part of its original stock in exchange for a motel located in Texas. General had no present business operations within the state of Oregon, but wanted to issue additional stock under the intrastate exemption in order to raise funds to acquire and construct additional motels in Oregon. The Commission Staff, quite properly I submit, held that the exemption was unavailable because General was not doing business in Oregon *at the time the issue was proposed.* The fact that it would be doing business in Oregon after the proceeds of the issue were used to acquire motels would seem to be irrelevant. The doing business test must be met at the time of offering, not after the conclusion of the offering.

The second letter is *First Hawaii Investment Properties, Inc.*[48] First Hawaii was in the business of reselling vacant, unimproved land located in Hawaii and other states. The company proposed to transfer some land that it had acquired outside of Hawaii to a trust company under a deed of trust. The Company would be the sole beneficiary of the trust and would have the right to control the use of the land. The Company would then sell to public investors in Hawaii fractional increments of its beneficial interest. The purchaser would have the same voting and other rights as a result of this purchase as did First Hawaii, as the trustee agreed to recognize the sale to the investor.

The Staff took the position that the intrastate exemption could not be used because it was not shown that sufficient business was being done in Hawaii. This position is clearly sustainable, if the Staff was referring to the operations of the trust, since it was to hold no land in Hawaii. Based upon this the letter would simply be an example of the "doing business" requirement applied in a non-corporate setting.

While it is not entirely clear, it appears, however, that what First Hawaii was doing was assigning a portion of its beneficial interest in the trust. Such an assignment would be a separate security apart from the beneficial interest in the trust, and First Hawaii would be the issuer of such security. Therefore the question should be does First Hawaii, not the trust, have sufficient other business in Hawaii to meet the doing business test. Since it is indicated that First Hawaii did have some Hawaiian operations, but their extent was not enumerated, it is impossible to judge whether they are sufficient to satisfy the test.[49]

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48. BNA SEC. REG. & L. REP. (No. 217), at C-2 (SEC NAL July 15, 1973).

49. There is a third possibility that the Staff was treating the trust and First Hawaii as a single issuing unit. The Staff took this approach in *Associated Developers of Florida, Inc.*, BNA SEC. REG. & L. REP. (No. 243), at C-3 (SEC NAL Feb. 1, 1974). Here there were two Florida corporations, Associated Developers of Florida, Inc. and Andrew Roberts Corp., under common ownership. Andrew Roberts was in the business of selling parcels of Georgia real estate to Florida residents. As the condition for purchasing one of the parcels, the purchaser had to also buy 50 shares in Associated Development. The proceeds from the sale of stock was going to be used by Associated Developers in its development business in Florida. The Staff took the position that the two companies would have to be considered together for the purposes of determining whether the "doing business" test had been met.

The only question that would seem to remain is to determine what amount of business is necessary to meet the "doing business" requirements. It is not clear that the courts will interpret the "predominant" test outlined in *Chapman* in the same way that the SEC interprets its "substantial" test.[50] It should be obvious that a company which does all its business in a single state will have no problem with this requirement and it has been so held.[51] The early SEC "no-action" letters however do not offer much guidance as to how much less than 100 percent will qualify. Thus in *Grubin, Horth & Lawless Properties*,[52] the Staff denied the exemption to a real estate developer who intended to have 65 percent of his properties located in the state of issue. The following year, in *Pan Agra Cattle Fund*,[53] the Staff refused to confirm the availability of the exemption where approximately 80 percent of the operational business was to be conducted in California, the state of issue, with the remaining 20 percent to be done in Arizona.[54] More recently, in *Katz & Besthoff, Inc.*,[55] the Staff confirmed that the exemption was available to a company which operated 43 stores in Louisiana, generating annual proceeds of $51,500,000, as well as four stores in Mississippi, generating $1,300,000. Both in terms of number of stores and dollar volume, this company had over 90 percent of its business in Louisiana.

However with the adoption of the 80 percent rule in Rule 147, the SEC's thinking appears to have solidified. In two recent "no-action" letters, it has taken the position that the 80 percent rule also applies under the basic exemption *and that it was the rule prior to the adoption of Rule 147*.[56] While the last assertion is open to question, it is at least now clear what the SEC considers "substantial". Whether the courts will accept this as being "predominant" remains to be seen, but a fair speculation is that they will.

III. Use of the Proceeds Test

The next area of concern is the use of proceeds. Will the money received be used to develop or expand a business conducted in the state of issue or will the money be taken for use in another state? We will see that there is a specific

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50. For some guidance on this problem, see Note, *The Intrastate Exemption: Current Law, Local Practice and the Wheat Report*, 31 Ohio St. L.J. 521, 531 (1970).

51. Ocala Breeders Sales Co., Inc., BNA Sec. Reg. & L. Rep. (No. 276), at C-7 (SEC NAL Sept. 28, 1974).

52. *See also* Woodbridge Ins. Co., BNA Sec. Reg. & L. Rep. (No. 128), at C-2 (SEC NAL Nov. 15, 1971).

53. [1972] CCH Fed. Sec. Microfilm, roll 2, frame 01621 (SEC NAL Jan. 19, 1972).

54. It is clear from the "no-action" letters that the critical point for determining the doing of business is the point of manufacture and not the point of sale of the goods. Power Hybrids, Inc., (SEC NAL July 8, 1971); Kebco Inc., (SEC NAL June 17, 1971); Puget Sound Plywood, Inc., (SEC NAL May 4, 1971). *See* Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. Cin. L. Rev. 779, 790 (1971).

55. BNA Sec. Reg. & L. Rep. (No. 199), at C-2 (SEC NAL Mar. 16, 1973).

56. Corporate Investment Co., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,954 (SEC NAL June 17, 1974); North American Acceptance Corp., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 79,724 (SEC NAL Jan. 18, 1974).

provision under Rule 147 dealing with this question. However, there appears to be little foundation for this new area of concern in the pre-existing case or administrative interpretations. Certainly the 1961 release did not address itself to this point. While it could be argued that both the *Truckee Showboat* case and *Chapman v. Dunn* could have been decided on this basis, a reading of the text indicates that they were not. Instead they were based upon the idea that the corporation did not have substantial operations within the state of issue. *McDonald Investment Co.* comes closer to supporting this position. There is dicta in the case which tends to point to a use of proceeds test,[57] but it is clear that the case itself was decided under the "doing of business" test.

Only two "no-action" letters have come to my attention which discuss this test outside the context of Rule 147. The first of these, *General Motel Corp.*,[58] discussed in detail above, appears to indicate that this test will be applied only after the "doing business" test has been satisfied. Thus in that letter, the SEC Staff denied the availability of the exemption to a company whose present business was located entirely outside the state, but which wished to use the proceeds from the present sale to develop new business within the state. The denial of the exemption under these circumstances has been criticized,[59] but seems justified.

The second letter is *Robert Enright.*[60] In this letter, Enright indicated that he wished to form a corporation to speculate in commodities and commodities futures contracts. The corporation was to be a California corporation, and the shares were to be sold only to California residents. However the proceeds from the stock sales were to be used to purchase commodities and commodities futures contracts on various commodity exchanges *located outside* California. Thus the question is clearly presented as to whether it can be said that the proceeds can be considered to have been used in California. The SEC Staff indicated that they felt that the purchase of the commodities contracts outside California *alone* would not prevent the use of the exemption. However they made it quite clear that the exemption would be lost unless the commodity contracts were physically kept in California and all profits or proceeds from their sale likewise were held by the company in California or banked there.[61]

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57. The court said "[Y]et to relieve [the issuer] of the federal registration requirements where none or very little of the money realized is to be invested in Minnesota, would seem to violate the spirit if not the letter of the Act." SEC v. McDonald Inv. Co., 343 F. Supp. 343, 346 (D. Minn. 1972).

58. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,332 (SEC NAL May 25, 1971).

59. Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779, 792 (1971).

60. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,671 (SEC NAL Dec. 3, 1973).

61. This position was subsequently re-affirmed in an opinion issued under Rule 147 involving a stock purchase plan. H.R. 10 Master Plan & Group Trust of Md. Nat'l Bank, BNA SEC. REG. & L. REP. (No. 285), at C-2 (SEC NAL Dec. 5, 1974). Here again while the stocks and bonds were bought on the New York Stock Exchange, the bank emphasized that the certificates would be held physically in Maryland as would all profits from their trading.

This letter would seem to emphasize that it is unimportant where the proceeds are *spent* as long as the property, tangible or intangible, so purchased is presently located in the state or will be brought into the state. Certainly this interpretation is reasonable. A company obviously should be able to go to another state and purchase a machine to be used in its local plant with the proceeds of the intrastate offering. The importance should not be where the machine is *acquired*, but rather where it is *used*.

This letter however does raise a rather disturbing situation in connection with the ownership of actual commodities. It suggests that the retention of the evidences of ownership of the commodity within the state would be sufficient and that the actual commodity would not have to be located in the state. The usual practice for those dealing in actual commodities is to deposit the commodity in a public warehouse and take a warehouse receipt as evidence of the ownership of the commodity. The *Enright* letter suggests that the corporation could store the commodity in one state, say Iowa, take a warehouse receipt for it, hold this in California, and satisfy the use of the proceeds test. This may be a practical solution to the problems of the commodity trader since it would be virtually impossible to trade exclusively in commodities stored within the state. But such a practice would effectively destroy the "use of proceeds" test if a similar practice is allowed for other firms. For example, should a manufacturer be able to avoid the test by storing his inventory in another state in a public warehouse and take a warehouse receipt in exchange for it? More thought needs to be given to how to handle the "use of proceeds" test in connection with documents which represent ownership to physical assets.

In spite of the criticism that has been directed toward the "use of proceeds" test and the lack of historical basis for the test, it now appears firmly entrenched in Rule 147 and there appears little likelihood that the SEC will abandon its use in cases under the basic exemption outside Rule 147.[62]

IV. Residency of the Offerees and Purchasers

The fourth areas of inquiry by the SEC is the residency of the offerees and purchasers. This point in turn must be broken down into two sub-groups, residency requirements as to the original purchasers and residency requirements as to purchasers in the secondary market.[63] Before considering these categories, I think there are several comments that can be made.

First, I want to emphasize that the requirement applies not only to actual purchasers, but also to *offerees* in the case of both the original distribution and

62. Gardiner, *Intrastate Offering Exemption: Rule 147—Progress or Stalemate?*, 35 Ohio St. L.J. 340, 365 (1974).

63. Apparently these residency requirements have never applied to the underwriter or broker-dealer who purchases a block of the securities for later resale, but merely to the ultimate purchaser. *See* Letter Ruling, Acting Chief Counsel, Division of Corporate Finance, [1952-1956 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 76,411 (SEC NAL Sept. 28, 1956); Comment, *SEC Rule 147—Distilling Substance from the Spirit of the Intrastate Exemption*, 79 Dick. L. Rev. 18, 26 (1974).

secondary trading.[64] I think that this requirement may well be the greatest obstacle to an issuer using the exemption. Keep in mind that as we have indicated before the issuer has the obligation of establishing its entitlement to the exemption when it is challenged by the SEC or a purchaser seeking rescission of his purchase.[65] Recently in connection with the private placement exemption,[66] the Fifth Circuit indicated that the proof necessary to meet the burden of establishing that exemption included the showing that each *offeree* came within the exemption.[67] Further the court specifically affirmed a judgment for the plaintiff where the defendant had not negated the existence of offerees other than those who purchased.[68]

Applying this to the intrastate exemption, it would mean that the issuer would have to keep records to demonstrate that all the offerees were residents of the state of issue. Further he would have to show a systematic keeping of these records to show that there were no offerees other than those for which he had records. This would be a nuisance but would be possible. The problem comes with resales by the original purchasers. The issuer will get some idea of the subsequent purchasers at the time that the securities are presented for transfer on the issuer's books. But of course that is too late. The damage is already done at this point, if the purchaser is not a resident. However, the issuer has no way of knowing how many other people the seller offered the securities to before he found a purchaser and whether these offerees were residents of the state. The only possible solution to this problem which might allow the continued use of the exemption would be to legend the securities as required under Rule 147, indicating that the securities cannot be sold to a non-resident. Then the issuer could argue that under the Uniform Commercial Code there could be no offer or sale by the original purchaser to a non-resident because the Code makes such a restriction valid where such a legend appears on the face of the stock.[69] There is a definite question in my mind whether the courts will accept this position in light of the extremely broad definition of offer and

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64. Shaw v. United States, 131 F.2d 476 (9th Cir. 1942); SEC v. Dunfee, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,970 (W.D. Mo. 1966); *In re* Ned J. Bowman Co., 39 S.E.C. 879, 882 (1960); *In re* John Paul Hunt, 4 SEC Jud. Dec. 788, 789 (1946); Corporate Investment Co., CCH FED. SEC. L. REP. ¶ 79,954 (SEC NAL June 17, 1974). *See also* Comment, *SEC Rule 147—Distilling Substance from the Spirit of the Intrastate Exemption*, 79 DICK. L. REV. 18, 25 (1974).

65. SEC v. Ralston Purina Co., 346 U.S. 119, 126 (1953).

66. Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970).

67. Henderson v. Hayden, Stone, Inc., 461 F.2d 1069 (5th Cir. 1972).

68. Further, for the SEC enforcement actions, it does not appear that the SEC needs to show that an offer to a non-resident was ever made. In *SEC v. Dunfee*, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,970 (W.D. Mo. 1966) and *In re Whitehall Corp.*, 38 S.E.C. 259, 270 (1958), it was held sufficient for the SEC to show that offering circulars had been circulated through the mails or out of state or that advertisements had appeared in newspapers circulated out of the state without a clear warning that the offer was limited to bona fide residents of the state of issuance because these things would raise the presumption that a violation had occurred. *See also* Comment, *SEC Rule 147—Distilling Substance from the Spirit of the Intrastate Exemption*, 79 DICK. L. REV. 18, 22 n.26 (1974).

69. UNIFORM COMMERCIAL CODE § 8-204, 12A OKLA. STAT. § 8-204 (1971).

sale found in the Securities Act itself.[70] However acceptance of such an argument may be necessary to give the intrastate exemption any validity at all.[71]

The second point that I think needs to be taken into consideration here is that while the statute talks in terms of residency or that the purchaser must be a resident of the state of issue, the SEC has traditionally taken the position that this should be interpreted to require that the purchaser be a domicile of the state.[72] The idea behind the SEC's reasoning appears to be that the issue under the statute is to be confined to a single state. A person may have several residences, but only one domicile. Therefore if we allow sales to only domiciliaries, then we assure that the issue remains in a single state.[73] I think this point is illustrated by reference to the Minnesota domiciliary who has a second home in Florida. To allow him to purchase under the intrastate exemption tends to defeat the purpose of the exemption. The SEC position has been subjected to a great deal of criticism.[74] We will see that Rule 147 has departed from this position at least in part by adopting the concept of "principal residence." However I think that the change is more a question of semantics than that of substance. I think it will be very difficult in many cases to distinguish between a person's principal residence and his domicile. It is true that in this case, the Minnesota resident who spends all his time in Florida, but has the intent to return to Minnesota and his house there at some unspecified time in the future, might well be held to have his principal place of residence in Florida. Yet I think that it could be equally argued that the purchaser's principal residence is where he thinks it is, in which case we are back to the subjective test that we have under domicile.

There are several areas which are going to continue to cause problems for issuers in this area whichever concept is followed. Certainly the winter visitor is one. But there are at least two others which are not as obvious. One is military personnel. Because of the unique provisions of federal law dealing with military personnel, they are not considered to be domiciled or have their principal residence where they happened to be stationed at the time. Their domicile and principal residence remains at the place where they came on active duty from unless they have consciously changed that residence or domicile in the meantime. Two unreported cases have held that the intrastate exemption

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70. Securities Act of 1933, section 2(3), 15 U.S.C. § 77b(3) (1970) reads in part: "The term 'offer to sell', 'offer for sale', or 'offer' shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value."

71. All the definitions in section 2 of the Securities Act of 1933, 15 U.S.C. § 77b (1970), are prefaced by the statement, "When used in this subchapter, unless the context otherwise requires . . . ." This may be one place where the context will require a more narrow interpretation. Courts have used this approach in other areas. *See, e.g.*, Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973).

72. *See* SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2270, at 2609 (1974); SEC REPORT OF SPECIAL STUDY OF SECURITIES MARKET, H.R. REP. No. 95, 88th Cong., 1st Sess., pt. 1, at 571 (1963).

73. *See* McCauley, *Intrastate Securities Transactions Under the Federal Securities Act*, 107 U. PA. L. REV. 937, 945 (1959).

74. *See, e.g.*, 1 L. LOSS, SECURITIES REGULATION 598-600 (2d ed. 1961).

was not available where sales were made to military personnel stationed in the state of issue.[75] This problem may be a significant one for Oklahoma issuers in view of the large number of military bases within the state. The second problem area is students. Many students maintain at least "temporary" residences where they are going to school, but permanent or "principal" residences at places from whence they came.

Another problem area which remains unanswered under the basic exemption, but which is covered by Rule 147, is the problem of how to classify a purchasing corporation for residency purposes. The statute gives us a specific rule for the corporation which is the issuer, but leaves the problem of corporate purchasers unanswered. One argument would be to follow the issuer standard and say that a corporation is a resident or domicile of its state of incorporation. Thus a Delaware corporation doing all its business in Oklahoma would not qualify because it would be considered a resident of Delaware. As long as domicile is the standard this would appear to be consistent with general corporate law. The other position would be to argue that the failure to specify in the case of the purchasing corporation leaves the question to general corporate law and does not demand the same standard as for the issuer. If we then apply the standard of residency, we could conclude that the corporation is a resident of every state in which it does business. Neither of these standards really appear to fit the purpose of the exemption. Therefore in Rule 147, as we will see, the SEC adopted a middle ground holding that a purchasing corporation is considered to be a resident where it has its *principal office* as distinguished from its *principal place of business*.

The last area and probably the most important in terms of the number of potential transactions are the group of people who work in one state and live in another. The person cannot be sold securities under the exemption in the state where he works. Thus the man who works on Wall Street in New York, but lives in Greenwich, Connecticut, has his "principal" residence in Connecticut and is a Connecticut domiciliary.

This problem was recently considered by the SEC in *First Kentucky Trust Co.*[76] The Trust Company wanted to act as trustee for a number of H.R. 10 self-employed pension and profit sharing plans. These plans would be offered to self-employed individuals working in Louisville, Kentucky. The Trust Company realized, however, that many of these self-employed individuals or their employees, who would by necessity be required to be covered, lived in the Louisville metropolitan area, but on the Indiana side of the Ohio River. The Trust Company argued that it would not be in the public interest to deny these

75. SEC v. Big Top, Inc., SEC LITIG. REL. No. 2756 (D. Nev. 1963); SEC v. Capital Funds, Inc., Civ. A. 46-60 (D. Alas. 1960). The natural consequence of this position is that a company could sell to a serviceman whose domicile was in the state even though he was stationed elsewhere. *See* Op. Gen. Counsel, SEC Securities Act Release No. 1459 (1937). Likewise this would mean that an Oklahoma domiciliary could be sold securities of an Oklahoma corporation while in New York on a visit. *See generally* 1 L. Loss, SECURITIES REGULATION 599 (2d ed. 1961).

76. BNA SEC. REG. & L. REP. (No. 236), at C-5 (SEC NAL Dec. 10, 1973).

people the right to participate in these plans under the intrastate exemption. The Commission Staff, quite properly, was unimpressed and indicated that the exemption was not available if any Indiana residents participated, even though they might work in Louisville.

The last general point is to note that the statute talks in terms of "residents" not the issuer's bona fide belief that the purchasers are residents. We will see that Rule 147 does not alter this requirement.[77] This would seem to mean that the issuer may not be protected where he has asked the purchaser about his residency and gotten him to sign a declaration where the purchaser lies.[78] Certainly this means that the issuer is going to have to make reasonable independent investigation and even then he may not be protected if a sale is made to an out-of-state resident.

Little needs to be said beyond these general points as far as the original purchasers are concerned except to point out that the setting up of a subterfuge to qualify non-residents will not work. Rule 147 has a specific provision requiring that a corporation or other entity which was formed specifically for the purpose of investing in the securities offered under an intrastate offering will be disregarded and the residency of the various individuals owning interests in the entity will control.[79] The same appears to be true under the basic exemption. In *Control Awnings, Inc.*,[80] the company asked the SEC Staff if it would be possible to set up a local trust which would participate in an intrastate offering where the beneficiaries of the trust would be non-residents. The company argued that this procedure would meet the requirements of the exemption because the trust would be a local resident[81] even if the beneficiaries of the trust were not. The Staff took the position, quite properly I submit, that the trust would be disregarded and the residency of the beneficiaries would control as to whether the exemption would be available. This however leaves open the very vexing question of what to do with the trust, investment club, or corporation which is not formed *solely* to invest in this particular issue. Rule 147 handles this by disregarding only those organizations *specifically* formed for the purpose of investing in this issue.[82] Thus a pre-existing investment club is not disregarded nor is the club newly formed which purchases part of the intrastate issue as one of its general investments. It remains to be seen whether the SEC

77. Some authors have criticized the Rule for not adopting a bona fide belief standard. *See, e.g.*, Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147*, 69 NW. U.L. REV. 167, 194 (1974). However, since this is a statutory requirement, I doubt that the Commission has the authority to adopt this type of standard unless it does so under the guise of interpreting the intent of the statute.

78. I would think that the lying purchaser would be estopped from changing his story later in order to recover. *Cf.* Dokken v. Minnesota-Ohio Oil Corp., 232 So. 2d 200 (Fla. Ct. App. 1970). However, what effect does this have on the exemption as far as the non-lying purchasers who learn of it and claim that the entire exemption has been lost?

79. Rule 147, ¶ d(3).

80. [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,333 (SEC NAL Apr. 4, 1973).

81. *See* 1 L. LOSS, SECURITIES REGULATION 599 (2d ed. 1961).

82. Rule 147, ¶ d(3).

will take a similar approach under the basic exemption. This approach however would seem to be the most equitable way to solve this problem.

The major problem is going to be with the secondary purchasers who buy from the original purchasers. First, I think it is important to note there are no restrictions as found under the private placement exemption upon sales made to other residents or domiciliaries of the state of issue. Thus the securities may be sold dozens of times. Brokers may be used as may public advertising. The only restriction here is that for a period there can be no *offer or sale* to a non-resident. The restriction is not a permanent restriction; it is only for a period of time. The problem is what is the period of time. This question and the integration problem are probably the two most difficult problems under the exemption.

Until Rule 147 there has never been an official statement as to what this period amounted to. The problem was similar to the holding period under the private placement exemption. In both cases, the SEC is attempting to distinguish between the distribution of the issue which is governed by the Federal Act and secondary trading in the securities which is not because of the section 4(1) exemption.[83] Separating the two involves the "coming to rest doctrine". When the securities are issued, the original issuance or distribution process continues until the securities come to rest in the hands of the general public. After that point when the general public trades the securities among themselves, this is secondary trading which is exempt.

The problem with applying this concept under the intrastate exemption is that the original purchasers for all practical purposes are members of the general public since they have no other special qualifications as required under the private placement exemption other than that they are residents or domiciliaries of the state of issue. However to allow the stock to be traded immediately without restriction to anyone within or without the state would effectively emasculate the securities act registration requirement. The problem first received attention in *In re Brooklyn Manhattan Transit Corp.*[84] where the SEC discovered that many of the sinking fund bonds which the corporation had claimed to have issued pursuant to the intrastate exemption were in the hands of non-residents within a very short period after the initial sales. While it was not necessary for the decision in this case to determine when an issue came to rest, the SEC did indicate a rule which has become a rule of thumb. If no sales are made to non-residents for a period of one year from the date of the last sale by the issuer, then a presumption will be raised that the issue has come to rest.[85] Like all presumptions there are situations which would tend to negate this presumption.[86]

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83. 15 U.S.C. § 77d(1) (1970).
84. 1 S.E.C. 147 (1935).
85. The apparent basis for this one-year period was, in 1954, changed to a mere 40 days. 15 U.S.C. § 77d(3) (1970).
86. A former SEC staffer has expressed the opinion for example that if either an underwritten issue or a truly public issue is made pursuant to the exemption then the issue never comes to rest if the underwriter has done his function of marketmaking and continued

We will see that Rule 147 has shortened this period to nine months. Others have suggested the period should be shortened to as little as 90 days.[87] The only court decision in the area indicates that a sale within 30 days is too soon and the exemption would be lost.[88] Unfortunately this is an area, because of its factual nature, that the SEC has been reluctant to issue "no-action" letters and what letters have been issued have raised questions which do not seem appropriate for consideration under the exemption.[89]

The important thing to note here under any of these interpretations is that the time period does not start to run until after the original distribution has been completed by the issuer. Thus if one of the earlier purchasers buys on January 1 he is not necessarily free to sell to a non-resident January 1 the year following. If the issuer continues to sell the original issue until December of the same year, then the original purchaser is not free to sell under the one year rule until the following December or some 23 months after his own purchase.

Also keep in mind that we are talking about the entire distribution process when we speak of sales by the issuer and this will include the efforts and sales of all those who are classified as statutory underwriters under section 2(11).[90] This point was recently illustrated in *Subaru of America, Inc.*[91] In this letter the broker-dealer who had handled the intrastate offering of Subaru stock on a best efforts basis had received two blocks of stock. The first block the broker claimed was a private placement in payment for his services in floating the intrastate issue. The second block he claimed was a pure gift. The intrastate offering had taken place in 1968-1969 and in 1973 the broker wanted to sell the shares he had received without restriction, claiming that the intrastate offering was complete and the shares had come to rest. The SEC Staff disagreed. It first took the position that the two blocks of stock were not separate transactions, but amounted to an unsold allocation of the shares under the intrastate offer-

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sponsorship correctly. In this type of situation there are always speculators who purchase to resell within a very short period and these people, like broker-dealers who repurchase the original issue, are not concerned with geographical boundaries. Because of this the SEC will often begin an investigation to see that the exemption has not been abused where extensive secondary trading begins in the issue almost immediately after the initial issue. *See* Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 CASE W. RES. L. REV. 110, 117-18 (1964).

87. Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779, 787 (1971).

88. SEC v. Hillsborough Inv. Corp., 173 F. Supp. 86 (D.N.H. 1958), *permanent injunction granted*, 176 F. Supp. 789 (1959), *aff'd*, 276 F.2d 665 (1st Cir. 1960).

89. *See, e.g.*, Hynes & Howes Mortgage Co., [1973] CCH FED. SEC. MICROFILM, roll 2, frame 01825 (SEC NAL Dec. 1, 1972); First Midwest Inv. Corp., (SEC NAL Aug. 14, 1971). Both *Providers Benefit Co.*, (SEC NAL Aug. 5, 1971) and *Security Investing Co.*, (SEC NAL Oct. 19, 1971) mention that the size of the offering is relevant here. While size may be a factor in determining as a practical matter whether the issuer can control the re-sales, size in itself is not a factor as to where the exemption itself is available. But see *Cape Codder System, Inc.*, BNA SEC. REG. & L. REP. (No. 287), at C-1 (SEC NAL Dec. 16, 1974), holding without extraneous discussion that an issue made from December 15, 1969, to December 15, 1970, had come to rest by December 1974.

90. 15 U.S.C. § 77b(11) (1970).

91. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,233 (SEC NAL Jan. 18, 1973). *See also* Space Corp., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,096 (SEC NAL Mar. 25, 1971).

ing. Since these shares had never been sold, the original intrastate offering still continued and had never been completed. Thus the one year period after the completion of the offering had never started, and the shares could not be sold without restriction. The Staff did however indicate that the broker could sell the shares under the intrastate exemption in Pennsylvania where the original intrastate offering had taken place.

While this letter involved broker's shares, I think it is also important because it indicates that the original purchasers of Subaru stock in 1968-1969 could not sell their stock free of restriction either, because the unsold allotment prevents the original distribution from ever being completed. In a situation like this the offering could remain open for years if the broker does not dispose of his stock. Yet few, if any, of the original purchasers would have any reason to believe that the issue had not been completed. This could also have severe consequences in the area of integration where the company wants to make a subsequent issue of securities.

V. INTEGRATION

The last area of inquiry by the SEC is probably the most difficult to understand or to try to explain. This is the concept of integration.[92] The problem stems from the fact that the entire issue of securities must be offered and sold within the state of issue in order for the exemption to apply.[93] The problem is what constitutes a single issue for this purpose. To be sure there are some situations where integration is obvious. One example would be where a corporation wanted to sell some of its class A common stock. It sold one block of this stock to a group of Eastern insurance companies claiming the private placement exemption. At the same time or within a month or so, the corporation also offered another block of this same stock to Oklahoma residents claiming the intrastate exemption. The two sales in this situation will be integrated and treated as a single issue, and both exemptions will be lost because, while each half meets the requirements of one of the exemptions, the entire issue does not meet the requirements of either. Thus it is not possible to divide an issue. This concept would apply, even if a part of the issue were registered under section 5 of the Act.[94]

A rather poignant but typical example of how this problem can be a trap for the small corporation attempting to get started is outlined in *Environmental*

92. For detailed discussions of this concept see Shapiro & Sacks, *Integration Under the Securities Act: Once an Exemption, Not Always . . .*, 31 MD. L. REV. 3 (1971); Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 CASE W. RES. L. REV. 110 (1964); Comment, *SEC Rule 147—Distilling Substance from the Spirit of the Intrastate Exemption*, 79 DICK. L. REV. 18, 36-43 (1974).

93. *See, e.g.*, SEC v. Van Horn, 371 F.2d 181 (7th Cir. 1966); Jackson Tool & Die, Inc. v. Smith, 339 F.2d 88 (5th Cir. 1964); Stadia Oil & Uranium Co. v. Wheelis, 251 F.2d 269 (10th Cir. 1957).

94. *In re* Texas Glass Mfg. Corp., 38 S.E.C. 630 (1958). *See also* Presidential Realty Corp., [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,066 (SEC NAL Feb. 19, 1971).

Mobile Concepts, Inc.[95] Environmental Concepts is a small California corporation which had been formed to develop mobile home and recreational vehicle parks in California. At the time of its founding, shares were sold to fourteen people. Of these fourteen people, eight were promoters and five were closely related to the promoters through family and business ties. All thirteen were California residents. The fourteenth purchaser was an uncle of one of the founders, who lived in New York. The sale to him was merely a courtesy to the founder-nephew. These original sales were made nominally at least under the private placement exemption of section 4(2),[96] there being some question whether the New Yorker had the necessary intent to hold the securities for investment purposes. The corporation now finds that it needs additional funds to complete its projects and wants to use the intrastate exemption. The problem lies in the fact that it is going to issue stock of the same type as issued to the original purchasers to finance the same projects. Therefore there is a great likelihood that the two issues would be integrated. Counsel for the company recognized this likelihood and proposed to avoid it by making a rescission offer to the New York resident who indicated his willingness to accept. If this were done, then the corporation would have only thirteen shareholders all of which were California residents, the original offering would qualify under the intrastate exemption, and the integration of it with the new offering would cause no problems. The Staff, I think quite properly, refused to sanction the use of the exemption in connection with the new sales. The damage was done when the sale was made to the New Yorker, and a rescission cannot erase the fact that the corporation originally relied on a different exemption and could not qualify for the intrastate exemption.

I think this letter has a very great message for lawyers who handle the incorporation of small corporations. They need to think, and cause their client to think, about financing down the road. Here the company would have been alright had it sold only to California residents because then it could later claim *either* the private placement or the intrastate exemption, whichever fit better into its subsequent financing plans. Environmental did not do so, and if the sale to the New Yorker does not qualify under the private placement exemption, it has probably lost the right to use either the private placement or the intrastate exemption anytime in the immediate future, placing the company in an almost impossible position to raise additional funds.[97]

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95. BNA SEC. REG. & L. REP. (No. 218), at C-2 (SEC NAL Aug. 28, 1973). *See also* Founders Preferred Life Ins. Co., BNA SEC. REG. & L. REP. (No. 106), at C-1 (SEC NAL June 16, 1971).

96. 15 U.S.C. § 77d(2) (1970).

97. A somewhat similar thing happened in *Hynes and Howes Real Estate, Inc.*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,603 (SEC NAL Dec. 6, 1971). Here the company which operated offices in both Illinois and Iowa, in August 1971, about three months before its attempt to use the intrastate exemption, sold stock to twelve persons, some of whom were not Iowa residents, relying on the private placement exemption. The company now wants to use the intrastate exemption to raise funds to expand its Iowa operations. The Staff denied the exemption on the basis of integration of the two issues and also on the unusual grounds that three of the five company officers who were going to partici-

The concept of issue becomes much more difficult where the corporation issues different types of securities, *i.e.*, common stock and corporate bonds, or the sales of the same type of securities are issued in transactions widely separated in time and for differing purposes. Yet the case law and the SEC interpretations give us some guidance in this area. For example, it is now clear that issues of the same class or type of securities which are sold at the same time or nearly the same time even though for different considerations will be treated as part of the same issue.[98] Thus we are going to consider the concept of issue as equating with this concept "class". It has been suggested that if this concept is carried to its ultimate extreme that it would prevent a corporation from ever relying upon the exemption in the issuance of additional shares of stock of a class which is outstanding and which was marketed by any other means than the intrastate exemption, or which is presently in the hands of non-residents.[99] I would agree, but feel that the "class" concept will be limited to stocks issued within a reasonable period of each other. It has been suggested that the SEC informally has developed the rule that offerings of the same class will not be integrated if they are separated by one year.[100] We will see later that Rule 147 has a specific provision dealing with the time limit between issues.

But quite early it was established that the concept of "issue" referred to more than simply "class of securities". Instead in *In re Unity Gold Corp.*,[101] the SEC equated the concept of "issue" with a single plan of financing whether it involved a single type of securities or a number of different types. Thus if the corporation is seeking to finance the building of a new plant and attempts to secure part of the financing by the issuance of bonds to one group and the remainder from another group through the sale of common stock, the financing plan would be integrated and the bonds and stock treated as a part of a single issue.

Both the "class" concept and the "single plan of financing" concept were carried forward by the SEC into its 1961 Release which outlines five areas which are going to be considered in determining integration. These five areas are:

(1) Whether the offerings are part of a single plan of financing;

(2) whether the offerings involve issuance of the same class of securities;

(3) whether the offerings are made at or about the same time;

(4) whether the same type of consideration is to be received;

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pate in the new sales were Illinois residents. This latter point raises the question of whether the SEC is now going to look to the residency of the corporate officers as well as that of the corporation.

98. Shaw v. United States, 131 F.2d 476 (9th Cir. 1942).

99. Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147*, 69 NW. U.L. REV. 167, 172 (1974).

100. Goldman, *The Intrastate Offering*, in NEW TRENDS AND SPECIAL PROBLEMS UNDER THE SECURITIES LAWS 173, 182 (A. Sommer ed. 1970). *See also* Hicks, *Intrastate Offerings Under Rule 147*, 72 MICH. L. REV. 463, 470 (1974).

101. 3 S.E.C. 618 (1938).

(5) whether the offerings are made for the same general purposes.[102]

This release indicated that the presence of "any one or more of these factors" would be sufficient to cause the integration of the two offerings. However in 1962 the SEC issued another release again setting out these factors, but omitting the "one or more" language.[103] This has led to speculation that the presence of only one of these factors might not require integration, but that all five factors would have to be considered and weighed together.[104] However the "no-action" letters in this area suggest that the "any one or more" language is still very much alive.[105]

There are two reported "no-action" letters which I think help illustrate the complexity of this problem. The first is *Presidential Realty Corp.*[106] Presidential Realty owned a tract of land in Connecticut on which it wanted to build apartment complexes. It divided the tract into two pieces. On the first piece, it built a 122-unit apartment group. It then caused a subsidiary corporation, Sylvan I, to be organized as a cooperative apartment corporation and transferred the property to the new corporation. This corporation paid for the property by selling capital stock which also entitled the purchaser to enter into a proprietary lease for one of the apartments. The shares in Sylvan I were sold only to Connecticut residents under conditions which would insure compliance with the intrastate exemption. At the time of the "no-action" letter, the offering was not yet complete as a number of shares and 42 apartments had not been sold. These shares had been transferred to a control person, and another subsidiary of Presidential was acting as exclusive sales agent. Presidential then wanted to develop the second tract in a similar manner and sell the completed apartment complex to another subsidiary cooperative housing corporation, Sylvan II. However, rather than selling these apartments and shares on an intrastate basis, Presidential wished to have the shares registered and sold on an interstate basis. It asked the Staff whether the Staff would take a position that the registered sales by Sylvan II would be integrated with the intrastate sales of Sylvan I causing the loss of the intrastate exemption for Sylvan I. The Staff indicated that, indeed, it would take the position that the two sales should be integrated.

The second letter is *Property Investments, Inc.*,[107] in which the company

102. SEC Securities Act Release No. 4434 (Dec. 6, 1961), 1 CCH FED. SEC. L. REP. ¶ 2272, at 2608 (1974).

103. SEC Securities Act Release No. 4552 (Nov. 6, 1962), 1 CCH FED. SEC. L. REP. ¶ 2770, at 2918 (1974).

104. Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147*, 69 NW. U.L. REV. 167, 173 (1974); Sosin, *The Intrastate Exemption: Public Offerings and the Issue Concept*, 16 CASE W. RES. L. REV. 110, 124 (1964).

105. *See* Kenbak Corp. (SEC NAL Aug. 12, 1971). Other "no-action" letters have suggested that the SEC may also consider integrating "issuers" instead of just merely "issues". *See* Lexton-Ancira, Inc., (SEC NAL July 23, 1971), *discussed in* Emens & Thomas, *The Intrastate Exemption of the Securities Act of 1933 in 1971*, 40 U. CIN. L. REV. 779, 794-95 (1971).

106. [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,066 (SEC NAL Feb. 19, 1971).

107. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,123, at 82,428 (SEC NAL Oct. 18, 1972).

sought to sell $25,000,000 worth of its promissory notes to the general public in Texas under the intrastate exemption. The proceeds of this note sale would be used to finance its general business of developing, subdividing, and marketing recreational land in Texas. The company also contemplated a registered public stock offering of company common stock through a firm commitment underwriting. This offer however would not be made until after the promissory notes offering had been completed. The proceeds of the stock offering, like the funds from the note offering, would be added to the general working funds of the corporation. The Staff indicated that the two offerings would be integrated saying:

> The proximity in time of the two proposed offerings, the similar use consideration to be received, and the similar use of the proceeds cause the two proposed offerings to be [a] substance [of] one integrated scheme of financing so that the Section 3(a)(11) exemption . . . would not apply to the notes since the common stock part of the offering would be offered out of state.[108]

It should be obvious from the foregoing discussion that the concept of integration is an extremely complex question which can be solved only upon a case by case basis.[109] The SEC releases and "no-action" letters do provide some guidelines as does Rule 147. However the problem of integration is far from solved, and Rule 147 only gives a partial answer for a limited number of cases which come within its narrow integration provisions. Therefore the old rules and the case law will continue to operate in many cases where Rule 147 is used.

VI. Rule 147

With this background about the basic exemption we are now in a position to take a brief look at Rule 147 as it was adopted.[110] The Rule is reproduced in full in Appendix A. Again before examining the individual provisions of the Rule, I think a number of general observations are in order. First, as we have already noted, Rule 147 like the other Rules of the 140 series does not claim to be exclusive. Issuers may continue to operate under the basic exemption outside of the Rule. However if they do so they will not have the protection from civil liability that is afforded by operation under any Rule of the Commission,[111] and they are subject to challenge by the Commission in court to establish their entitlement to the exemption. Because of this protective feature and the underlying ability to continue to rely upon the basic exemption, the SEC has made clear that in order to come within the coverage of the Rule all its provisions must be strictly complied with.[112] Thus the issuer will not be able to comply

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108. *Id.* at 82,429.
109. First Midwest Inv. Corp. (SEC NAL Aug. 14, 1971).
110. SEC Securities Act Release No. 5450 (Jan. 7, 1974), 1 CCH Fed. Sec. L. Rep. ¶ 2340 (1974); 17 C.F.R. § 230.147 (1974) [hereinafter cited as Release]. For a short analysis of the Release and Rule, see BNA Sec. Reg. & L. Rep. (No. 236), at B-1 (Jan. 23, 1974).
111. Securities Act of 1933, § 19(a), 15 U.S.C. § 77t(a) (1970).
112. Preliminary Notes to Rule 147, § 1, Release, *supra* note 110.

with most of the provisions, but omit one, *i.e.*, the legend requirement and claim benefit of the Rule.[113]

On the other hand, the SEC has made clear that the Rule cannot be used as a subterfuge to avoid the registration requirements by technical compliance with its provisions where the offering does not meet the spirit of the Rule or the basic exemption.[114] Finally, while it has been generally accepted that the basic exemption is also available to a control person of the issuer who is seeking to divest himself of his interests, Rule 147 specifically restricts itself to offerings made by the issuer.[115]

The organization of the Rule itself generally follows the areas of concern by the Commission that we have outlined earlier. Paragraph a, labelled "Transactions Covered," tracts the general language of the basic exemption and, in addition, outlines the limitations noted above about use only by issuers and only in strict compliance with the Rule's substantive provisions.

Paragraph b, entitled "Part of an Issue," deals with the integration problem. The first subparagraph reiterates the idea that we have seen developed under the basic exemption that all of the securities deemed to be within the "issue" must be sold pursuant to the exemption. However the paragraph also extends this requirement to offer or sale pursuant to the Rule. Such a requirement is necessary to prevent the issuer from selling part of the issue, omitting some provision which might be considered burdensome, such as the legend requirement, and claiming the Rule. Of course in such a situation, the issuer could claim that the entire issue comes within the basic exemption, but the requirement would prevent him from getting the benefit of the Rule as to any part of the issue.

This problem came up in the recent "no-action" letter, *Founders Life Corp.*[116] Founders Life sought to buy a controlling interest in another insurance company, Founders Security Life Insurance Company. To raise the necessary 1.5 million dollars, Founders Life started an intrastate offering in October, 1972. This offering was terminated in April, 1974, with only $400,000 raised. Founders Life wanted to start the offering again under Rule 147.

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113. Of course, compliance with the other features of the Rule may well show that the issuer has complied with the basic exemption. However, the issuer may come to grief in those areas where the Rule requirements appear to be in conflict with the basic exemption.

114. Preliminary Notes to Rule 147, § 3, Release, *supra* note 110. This caveat has been used twice within the last year in "no-action" letters. In *Citicorp.*, BNA SEC. REG. & L. REP. (No. 259), at C-1 (SEC NAL May 24, 1974), the Staff indicated that a subsidiary corporation of Citicorp which operated an industrial loan company could avail itself of Rule 147 to sell its passbooks and thrift certificates, but then stated that the exemption would become unavailable should Citicorp acquire other subsidiary corporations of a similar type which also elected to rely on the Rule. The Staff felt that use by two or more subsidiaries in the same general business might be in technical compliance with the Rule, but would be a part of a plan to make an interstate distribution which the Rule was not intended to cover. A similar result was reached in *Liberty Loan Corp.*, BNA SEC. REG. & L. REP. (No. 284), at C-1 (SEC NAL Nov. 26, 1974) where the Staff denied the availability of the exemption to a holding company which operated a number of "Morris Plan" banking subsidiaries in Oklahoma and Kansas.

115. Preliminary Notes to Rule 147, § 4 and Rule 147, ¶ (a), Release, *supra* note 110.

116. SEC. REG. & L. REP. (No. 279), at C-2 (SEC NAL Nov. 11, 1974).

Counsel for the company admitted that inadequate protection against interstate sales and transfers were involved in the earlier offering, but felt that this could be corrected by making a rescission offer. The Staff disagreed, indicating that the earlier intrastate offering would have to be integrated with the present offering and since the protection against interstate transfers in the earlier offering were not up to the Rule 147 standards, Rule 147 was unavailable for the entire "issue". The Staff did reiterate its position that the unavailability of Rule 147 to the second transaction did not prevent the issuer from attempting to rely on the basic exemption for the entire integrated issue.[117]

This restriction also becomes important in connection with subparagraph 2 which sets out a new rule concerning integration. It indicates for the *purpose of this Rule only* that securities sold pursuant to any exemption under section 3 of the Act (basically Regulation A which is a section 3(b) exemption or the intrastate exemption) or under the section 4(2) (private placement) exemption or registered pursuant to section 5 of the Act which are sold more than six months *before or after* the present offering will not be considered a part of the present offering. The effect of this provision is to establish an irrebutable presumption that all securities, whether of the same class as the present issue or issued pursuant to a common plan of financing, which are legally issued—it would appear that any securities issued in violation of section 5 are the only securities excluded—which are offered or sold more than six months removed from the present offering are not a part of the present "issue".[118]

Giving an illustration of this provision, let us assume that the issuer makes the offer of 1,000 shares of class A common stock pursuant to the private placement exemption to insiders beginning January 1, 1974. This offering was concluded on January 10. Assuming the other conditions of Rule 147 are met, the company could commence a sale of class A common stock under the Rule on July 11, 1974, without fear that the stock sold in the earlier private placement would be integrated. Further assume that the company did make such an offering which was completed on July 30, 1974, and that the private placement and the intrastate offering were part of a plan to secure financing for a new plant. The final step in this financing plan is to issue $250,000 worth of corporate bonds. The issuer could register these securities or seek a Regulation A exemption and offer them beginning January 31, 1975, again without fear of integration. The net effect of the Rule then is to allow the issuer to make a new offering pursuant to Rule 147 roughly every six months or to insulate itself from the effects of earlier or subsequent financing by separating them by at least six months.

This Rule does not have any effect upon securities of the same or similar class, or conceivably unrelated securities sold pursuant to a common financing

117. Of course, if counsel were correct that there had been improper safeguards in the prior portion of the issue, the exemption may already have been lost and continued sales would be in violation since no exemption is available to cover the second half of the issue.

118. For a detailed discussion of this rule with numerous hypothetical transactions, see Hicks, *Intrastate Offerings Under Rule 147*, 72 MICH. L. REV. 463, 469-77 (1974).

plan, which are sold *within* six months before or after the Rule 147 offering. The note to section b points out that as to these securities the normal integration rules, as developed under the basic exemption and elsewhere, still apply.

Paragraph c combines the two questions as to the residence of the issuer and the doing of business within the state of the issuer. First, I think it is important to note that the language of the paragraph talks in terms of residence rather than domicile. Whether this constitutes a rejection of the domicile concept here is not entirely clear. Certainly the language used, especially in the case of the individual issue, would suggest so, but on several occasions members of the SEC Staff have indicated to me that the domicile concept was still being used. I think only time will tell.

Subparagraph 1 appears to have three alternative rules to be applied. If the issuer is an entity which is required to be formed pursuant to the laws of a particular jurisdiction, then the issuer is considered to be a resident of that jurisdiction. This would seem to be following the existing law as to corporate domicile rather than residency. This rule by its language applies to corporations, trusts, and limited partnerships[119] as well as any other form of business organization requiring specific legal recognition. If the business organization is one such as the general partnership[120] which requires organization under any particular state's laws, then residence is to be determined by location of its principal office. This may cause problems because the concept of principal office is generally thought to be rather synonymous with "headquarters" or administrative control center. Thus a partnership could have its executive offices in one state and therefore be a resident of that state for purposes of this subsection and have its manufacturing or business operations in another. Under these circumstances, the partnership could not use the intrastate exemption in either state. A similar situation has existed for many years as far as the corporation incorporated in a state of convenience, and the new position by the Commission is consistent with the idea of treating business organizations in the same manner regardless of their technical legal form.

The final rule deals with the individual issuer and states that he will be considered to be a resident of the state wherein he maintains his principal residence. The use of principal residence here would seem to indicate a departure

119. The operation of this subparagraph in connection with limited partnerships was recently illustrated by *Laundura Corp.*, BNA SEC. REG. & L. REP. (No. 290), at C-2 (SEC NAL Jan. 6, 1975), where the SEC Staff told a Delaware corporation that it could act as the only general partner in a limited partnership to be formed under North Carolina law without the limited partnership losing the right to use Rule 147 in the sale of the limited partnership interests in that state. Further the Staff indicated that the Delaware corporation was free to set up a subsidiary corporation to act as the general partner without losing the availability of the exemption. *See also* Security Land & Dev. Co., BNA SEC. REG. & L. REP. (No. 284), at C-1 (SEC NAL Nov. 28, 1974).

120. The distinction between the limited and general partnership lies in that the limited partnership is solely a creature of statute and requires compliance including the filing of certain documents and information in order to exist. This is not so with the general partnership which requires nothing more than an oral agreement.

from the concept of domicile. This last rule is helpful in the area of determining residence in those situations where the promoter issues pre-incorporation certificates or investment contracts or where the trustee of a voting trust is treated as the issuer of voting trust certificates.[121]

The second subparagraph[122] deals with the "doing business" and "use of proceeds" concepts, is much more complicated, and has been the source of most of the "no-action" requests since the Rule was adopted. The subparagraph outlines four separate tests which the issuer must satisfy in order to get the protection of the Rule. The easiest of the tests to understand and to comply with is the last one, that the issuer must have its principal office within the state of issue.[123] Again the concept of principal office as used here would denote corporate headquarters or administrative control center as opposed to manufacturing or storage facilities.

The second test is that the issuer must intend to use 80 percent of the net proceeds derived from the sale of the offering in connection with the "operation of a business or of real property, the purchase of real property located in, or the rendering of services within such state or territory . . . ."[124] Further this intent must actually be carried out by the expenditure of the money for these purposes.[125] Like the similar test under the basic exemption, this provision has been interpreted not to require that the proceeds be used to *purchase* goods or materials located in the state. It means merely that the goods and materials purchased be brought into the state once they have been secured. Thus in *H.R. 10 Master Plan & Group Trust of Maryland National Bank*,[126] the SEC Staff re-affirmed their position taken under the basic exemption[127] that the purchase of commodities or securities on a national exchange outside the state of issue does not prevent the issuer from meeting this test so long as the certificate of ownership of these commodities or securities are held in the state as well as any proceeds or profits from dealing in them.[128]

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121. *See* Hicks, *Intrastate Offerings Under Rule 147*, 72 MICH. L. REV. 463, 479 (1974).
122. Rule 147, ¶ c(2).
123. Rule 147, ¶ c(2)(iv).
124. Rule 147, ¶ c(2)(iii).
125. *Id.*
126. BNA SEC. REG. & L. REP. (No. 285), at C-2 (SEC NAL Dec. 5, 1974).
127. Robert Enright, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,714 (SEC NAL Jan. 10, 1974).
128. *See also* Coin Vest, Inc., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,823 (SEC NAL Apr. 8, 1974); Pilgrim Inns, Inc., BNA SEC. REG. & L. REP. (No. 296), at C-1 (SEC NAL Feb. 21, 1975). In *Coin Vest, Inc.*, the firm was going to deal in silver coins and bullion which was to be purchased from various sources inside and outside the state of issue, but was going to be brought to and stored at the company's only office in the state of issue. In *Pilgrim Inns*, the company had purchased several pieces of equipment and leased others, financing the purchases and leases through an out-of-state bank. The equipment had been brought into the state and used in the company's business. The lease and mortgage payments are now overdue, and the company wants to issue additional stock under Rule 147 to raise the funds necessary to pay off the out-of-state bank. Obviously in this situation, the actual monetary proceeds of the sale would be going to an out-of-state concern, but the Staff indicated that this did not violate the use of proceeds provision *because the money was used to pay off the indebtedness on property presently*

The third test is more difficult and deals with the assets of the issuer and its subsidiaries treated on a consolidated basis. On this basis, 80 percent of the issuer's assets must be located within the state of issue.[129] As to when this test has to be met, the Rule indicates the critical date is the end of the issuer's most recent semi-annual fiscal period prior to the beginning of the offering of this issue.[130] Thus if the corporation operated on a fiscal year beginning July 1 and it wished to make the offering in February, it would have to meet this asset location test as of January 1 of the year in which the offering is made. By setting the requirement at the end of a fiscal period like this rather than at the date of the initial offering the Commission has given the issuer some flexibility in planning its offering. Thus, if the corporation in our last example realized that it could meet the assets test at the end of its fiscal year, but could not meet the test in January due to an increase in its assets in other states or destruction of assets in the state of issue, it could still take advantage of the exemption by advancing its first offer to sometime in December rather than waiting until February.

The fourth test is the gross revenues test. Again this test is based upon the gross revenues of the issuer and its subsidiaries on a consolidated basis. The issuer must have received 80 percent of its gross revenues from the operation of a business or the use of real estate within the state of issue.[131] This test must be met at one of two times depending upon when the offering is made. If the offering is made in the first half of any of the issuer's fiscal years, then the gross revenue test is applied for the last fiscal year.[132] To return to our example above, if the corporate issuer wished to begin the offering in September 1974, it would then have to meet the gross revenue test for its fiscal year 1973-74 running from July 1, 1973 to June 30, 1974.

If on the other hand, the issuer elects to begin the offering during the last half of its fiscal year, then there are alternative requirements as to this gross revenue test. It must meet the revenue requirement for the first six months of the present fiscal year or the revenue requirement must be met for the entire year ending with this most recent six-month's period.[133] Again using our illustration of the corporate issuer on a July 1 fiscal year, if the company wished to begin its offering in February of 1975, it would have to meet the gross revenue test *either* for the 6-month period from July 1, 1974 to December 31, 1974 *or* for the 12-month period from January 1, 1974 to December 31, 1974. Again this alternative test gives some flexibility to the issuer. It is possible that the issuer might have had too much out-of-state revenue during the last half of this

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being used in the state. Thus again the point is made that it is not where the money raised goes which is important, but rather where the property or assets that the money is used to buy are located which is controlling.

129. Rule 147, ¶ c(2)(ii).

130. Keep in mind the integration problem when determining when the offering of the present "issue" first began.

131. Rule 147, ¶ c(2)(i).

132. Rule 147, ¶ c(2)(i)(A).

133. Rule 147, ¶ c(2)(i)(B).

period, but could average the revenue out for the entire year and meet the test. Alternatively, if the excessive out-of-state income comes in the first half of that year, it could elect to stand merely on the last six months. Again however I think that it is important to realize that this requirement does not date from from the day of the original offer under the issue, but rather from a determinable date at which normally this type of financial information will be available. Finally it should be noted that the gross revenue test has no application to an issuer who has not received $5,000 in gross revenue during its most recent 12-month fiscal period. Thus in our last example, if the issuer had not received $5,000 from January 1, 1974 to December 31, 1974, it would not have to determine the source of its gross income by state.

These last two tests, the location of assets in the state and the generation of gross income within the state, have been the source of one very important "no-action" letter. In *North American Acceptance Corp.*[134] the company had for a number of years been raising capital for its operations through the sale of promissory notes to Georgia residents. It had not registered these notes for sale with the Commission, but had been relying upon the basic exemption. However it felt that it could not meet what it considered to be the more stringent "doing business" requirements of Rule 147. The company's main business appears to have been the making of consumer loans secured by real estate. However it also purchased bulk mortgage notes from other lenders, improvement contractors, and developers. The company's main office was in Atlanta and negotiation of the consumer loans and the purchase and sale of the mortgage notes were handled through the Atlanta office and appear to be largely, if not exclusively, generated from Georgia sources.

However in the late 1960's the company began to finance land purchase contracts for developers outside the state in Mississippi, Arizona, Hawaii, Washington, and California. When these developers began to run into financial difficulty, North American set up subsidiary corporations to take over the developers' operations as a means of salvaging its investment. Its general counsel took the position that these subsidiary activities outside the state did not prevent North American from meeting the existing "doing business" standards under the basic exemption, but he felt that North American could not meet the gross revenues test or the assets test of Rule 147. Therefore, North American proposed to transfer all of its interest in the subsidiaries operating the land developments to its parent corporation in exchange for a promissory note. This transfer was to take place before the effective date of the Rule. The general counsel then argued that the fiscal year provisions of both the assets and gross revenue tests should be treated as prospective only and that the Rule should not be denied to a company which could not meet the 80 percent test in the current fiscal year which began before the adoption of or the effective date of the Rule.

134. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,724 (SEC NAL Feb. 18, 1974).

The Commission Staff disagreed, indicating that if a company wants to rely upon the Rule immediately after its effective date, then it will have to meet the 80 percent requirements for the current fiscal year even though such fiscal year began *before* either the adoption of or effective date of the Rule. The Staff's position appears to be based upon the conclusion that the 80 percent requirement as set out in these tests does not constitute a departure from the previous requirements under the basic exemption. If this is true, then North American was not entitled to the basic exemption after it set up the subsidiary corporations to take over the land development.

The permanent significance of this letter lies in the fact that it highlights that there may be a substantial lag between the time when a company first meets the 80 percent gross revenue requirement and when it can use the Rule. For example, assume that the company did not meet the 80 percent gross revenue test at the beginning of its fiscal year because 50 percent of its revenue came from operations outside of the state. At the end of the first quarter, it took affirmative action to reduce this out of state income by 35 percent, so that during the second quarter 85 percent of its income was from sources inside the state. Obviously under this factual situation, if the 50 percent condition existed in the prior fiscal year, the company could not use the Rule during the first half of the present fiscal year.[135] Further assuming that the gross revenue of the company was roughly the same for the first and second quarter of this fiscal year, the company most likely would not be able to use the Rule during the second half of the fiscal year because the 80 percent gross revenue test must be met on an *average* basis for the *entire* first half of this fiscal year or the entire year consisting of the last half of last fiscal year and the first half of this.[136] This disability might extend to the first half of the next fiscal year if there is not sufficient in-state revenue to bring the average for the entire current fiscal year up to the required 80 percent. Thus conceivably it could be well over a year after the company first begins to receive 80 percent of its revenue from within the state before it can qualify to use the Rule.

The problem is not nearly as severe with the 80 percent assets test. There, if the company took affirmative action to reduce its out-of-state assets to less than 80 percent anytime in the first half of the fiscal year, it would be able to use the Rule, assuming the other tests are met, during the second half because the Rule only requires that the test be met at the *end* of the most recent semi-annual fiscal period.

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135. It would appear, however, that the company could continue to use the exemption provided for by the Rule during the first half of this fiscal year, if the 50 percent gross revenue from out-of-state sources only began with the beginning of this fiscal year or late enough in the prior year that on a fiscal year average, the 80 percent gross revenue test was met.

136. Rule 147, ¶ c(2)(i)(B). It is also possible for a company which had a large amount of out-of-state revenue during the last half of the last fiscal year to be entitled to use the Rule during the first half of this fiscal year because the out-of-state revenue during the last half could be averaged against the high in-state revenue in the first part of the last fiscal year, and then lose the use of the Rule for the second half of the current fiscal year because the high out-of-state revenue continued into the first half of this fiscal year.

The SEC realized that these four tests would generate a large number of questions from its experience under the basic exemption and from the number of comments that it received about the rules during the comment period on the Proposed Rule 147. Therefore it attempted to anticipate some of these questions by publishing a number of hypothetical situations with comments as to whether the situations would meet the Rule in the release adopting the Rule.[137] The first of these hypotheticals deals with a corporation which is incorporated, has its administrative headquarters and only manufacturing and storage facilities within the state of issue, but is engaged in a catalog mail order business with purchasers throughout the United States and Canada. The company manufactures all the products that it sells, and they are shipped from its manufacturing and storage facility in the state of issue. The Release indicated that such an operation met all four of the "doing business" and "use of proceeds" tests. The second hypothetical differs from the first only in that the firm does not manufacture its own goods, but buys them and ships them to its central warehouse for subsequent distribution. Again the SEC concluded that the company had complied with all the Rule 147 "doing business" tests.[138]

The third hypothetical involves a land development corporation which is incorporated in one state and has its principal office there, but is in the business of selling undeveloped land located in several other states. The SEC took the position that this situation did not present enough facts on which to render a judgment. It did however indicate that the assets and gross revenue tests might not be met if the developer owned the land outside the state as opposed to acting as the agent for the owner.[139] Further the SEC indicated that the company could not use more than 20 percent of the proceeds from the offering to buy the land in the foreign state and still meet the "use of proceeds" test.

The fourth and fifth hypotheticals involve an engineering consultant firm. This firm is organized under the laws of the state of issue and has its only office there. However it does consulting work on projects located outside the state of issue. Seventy-five percent of the work on these foreign projects is done in the

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137. SEC Securities Act of 1933 Release No. 5450, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,617 (Jan. 10, 1974).

138. The "no-action" letter of *Coin Vest, Inc.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,823 (SEC NAL Apr. 8, 1974), presents an actual factual pattern which does not differ substantially from the SEC hypothetical. There the company was engaged in selling gold and silver coins and bullion to various purchasers throughout the United States through advertisements carried in national publications. The coins and bullion were going to be secured from many sources including the company's own customers located outside the state of issue, but they were going to be brought to the company's only office and sold and shipped from there. The Staff indicated that the company could sell its common stock under the Rule, indicating, however, that there was a substantial question whether the coin and bullion sales contracts might not also constitute the sale of securities under certain circumstances which would require that the issuance of common stock and the sale contracts be integrated under Rule 147, ¶ b. This prediction that the coin sales could involve the sale of securities appears to have come true. *See* SEC v. Brigadoon Scotch Distrib., Ltd., CCH FED. SEC. L. REP. ¶ 94,980 (S.D.N.Y. Feb. 11, 1975); *In re* Pacific Coast Coin Exchange, (Ont. Sup. Ct. Jan. 10, 1975).

139. This statement would seem to be confirmed by the Staff position in *North American Acceptance Corp.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,724 (SEC NAL Jan. 18, 1974).

home office where all the company's employees are located. The professional employees, however, are required to visit the project sites in other states, and approximately 50 percent of the firm's income comes from these out-of-state projects. There is little question that this firm meets the principal office, assets and use of proceeds tests, the only question is whether it can be said to have received 80 percent of its gross income from within the state. The SEC took the position that this test also is met, apparently on the basis that the majority of the work on the foreign projects was done in the state of issue. Thus the answer might have been different if the firm sent employees to the project site and had the employees perform the substantial portion of the work at the foreign site.

The fifth hypothetical merely adds that the engineering firm has 25 percent of its assets at the end of the last fiscal period in the form of accounts receivable from clients located outside the state, raising the question of whether it can be said that these assets are located in the state for the purpose of assets test. The SEC indicated it felt that these assets could be considered as being located within the state of issue. However this response must be read in conjunction with the previous hypothetical. There it was stated that the work generating the accounts receivable was performed substantially within the state of issue. Therefore as a result, the SEC was willing to take the position that the accounts receivable which resulted from this work were also located in the state. This leaves open the very important question of whether the same position would apply had the accounts receivable been considered to be located in the state if they had resulted from sales or work performed *outside* the state. The inference would seem to be no. This could have substantial impact on a mail-order business such as outlined in hypotheticals one and two.[140]

By disseminating these hypotheticals, the SEC may have decreased the number of no-action requests that it has received concerning these "doing business" tests. However there are still a number of requests received and I think two are worth noting here. In *Jones, Crouch, McCarty, and Bannasch*,[141] the person seeking the letter wanted to form a limited partnership to purchase and operate one or more tuna boats. The boats were to be purchased in California and title to them was to be held there. The boats were to operate out of a California port, and fishing, for the first year at least, was to be restricted to waters off the California coast. The partnership would be organized under California law and have its principal office there, and the catch from the boats

140. In this regard, the reader should consider *Insurance Finance Co.*, BNA SEC. REG. & L. REP. (No. 275), at C-1 (SEC NAL Sept. 18, 1974). In this letter the company and its three subsidiaries appear clearly to meet all the tests, except that more than 20 percent of their assets on a consolidated basis consisted of accounts receivable generated from sales of insurance policies sold outside North Carolina, the state of issue. The companies execute all their premium contracts in North Carolina even though they are with non-residents. The Staff indicated that it felt that the assets test was met and the company could rely on the Rule.

141. [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,822 (SEC NAL May 3, 1974).

would be sold in California. The Staff held that the "doing business" and "use of proceeds" test were satisfied.

The second letter is *Sentry Financial Services Corp.*[142] Here Sentry Financial Corporation, a wholly owned subsidiary of the Sentry insurance complex, wished to offer investment notes having varying maturities from one to ten years. Sentry Financial had one wholly owned subsidiary, Sentry Agency, Inc. Both Sentry Finance and Sentry Agency were Wisconsin corporations and had their principal offices there. On a consolidated basis, the corporations met the 80 percent assets test and the 80 percent gross revenue test in that their income consisted of premium finance operations conducted solely in Wisconsin. Finally more than 80 percent of the proceeds from the notes were to be used in the Wisconsin operation. The Staff indicated that the Rule was available to this corporation even though it was only one of a number of subsidiary corporations some of which had extensive business outside Wisconsin.[143]

It is probably too early to attempt to draw many generalizations from these hypotheticals and "no-action" letters. But it would appear that there are several generalizations which seem to be emerging. First, it seems that revenue is to be treated as earned in the state where the headquarters of the organization is and from whence the goods or employees come to fulfill the contractual obligations so long as the employees do not perform a substantial amount of the work at the foreign site. Such will be true even of the mail-order merchandiser who buys his products for sale outside the state so long as they are shipped into the state to his warehouse facility and then re-shipped from there to the customer in or out of the state.[144] Second, it is interesting to note that none of the hypotheticals and only one of the "no-action" letters[145] discuss where the contract giving rise to the revenue is made. Apparently, in a majority of cases, this factor is considered as having no significance. Finally, it appears clear that if the revenue is considered to have been generated inside the state, then the accounts receivable which are generated by the performance of that work will be considered as assets located inside the state for the assets test even though the debtor is located in another state.

Paragraph d[146] deals with the question of residency from the standpoint of the purchaser. Here the residency rules are quite simple. A corporation or other business organization is considered to be a resident of the state in which it has its principal office as distinguished from its principal business operation.

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142. SEC. REG. COMPL. SERV. § J 1118 (SEC NAL Aug. 30, 1974).

143. Contrast this letter with *Citicorp*, BNA SEC. REG. & L. REP. (No. 259), at C-1 (SEC NAL May 24, 1974) and *Liberty Loan Corp.*, BNA SEC. REG. & L. REP. (No. 284), at C-1 (SEC NAL Nov. 26, 1974), where the availability of the Rule was denied where two or more subsidiaries operating in different states, but in the same line of business, sought to use the Rule in each state.

144. Query, why should there be a distinction here if for convenience sake a portion of the goods, especially bulky ones, are shipped directly from the manufacturer to the purchaser upon the mail-order company's direction?

145. Insurance Finance Co., BNA SEC. REG. & L. REP. (No. 275), at C-1 (SEC NAL Sept. 18, 1974).

146. Rule 147, ¶ d.

For the individual we look to his principal place of residency. The Rule however does eliminate the problem of the purchaser who moves from the state after his purchase, but before the issuer has completed the offering.[147] In order to prevent holding companies or investment clubs from being formed by the issuer or others in an attempt to circumvent the residency requirement, subsection 3 contains a provision indicating that the entity of any organization formed especially for the purpose of investing in this issue will be disregarded and the residency of all the beneficial owners will be considered. This provision is similar to that found under Rule 146 dealing with the number of offerees. It would not seem to cover the existing investment club which has members in a number of states which decides to invest in the offering. The question remains whether the provision can be avoided by having the newly formed holding company or investment club make several other investments at or about the same time as the investment offering. However substance should govern over form here and prevent this type of maneuver.[148]

Paragraph e deals with the question of resale by the original purchasers. It places a nine-month restriction on transfer to non-residents. The nine months, as under the basic exemption, begins after the last sale in the offering by the issuer. Dealers are required to satisfy the requirements of Rule 15c2-11 before they can publish any quotations or submit any quotations for publication.[149] The note to the section deals with the problem of convertible securities. It indicates first that sale of the underlying securities within the nine-month period would also cause the exemption to fail. Further it indicates that in determining the beginning of the nine-month period the conversion of the se-

147. This problem was recently raised in *First National Bank*, BNA SEC. REG. & L. REP. (No. 287), at C-2 (SEC NAL Dec. 10, 1974). The Bank had set up collective investment funds for self-employed retirement plans for Minnesota residents. Under these plans both the self-employed and certain of his employees had to be covered. The plans represent on-going investments and therefore constitute a continuing offer under Rule 147 or the basic exemption. The problem presented dealt with what to do with the interests of a self-employed when one of his employees covered by the plan moved from the state. The Bank had gotten an earlier "no-action" letter from the SEC that under the basic exemption, the exemption would not be lost if the funds of the self-employed and his other employees including the one who moved from the state were withdrawn from the collective fund and invested separately, when an employee moved out of state. The Bank now wanted to change its procedure so that only the funds allocated to the particular employee who moved from the state had to be withdrawn and invested separately. The SEC Staff agreed that Rule 147 would not be lost if only this was done. This problem also arises in an installment purchase context where the purchaser moves from the state before the purchase is complete. United States v. Kormel, 230 F. Supp. 275, 278 (D. Nev. 1964). For a discussion of the problem in this context, see Cummings, *The Intrastate Exemption and the Shallow Harbor of Rule 147*, 69 NW. U.L. REV. 167, 176-78 (1974). It seems clear, however, that if the purchase was complete while the purchaser was a resident of the state of issue, but delivery of the certificate did not take place until after he became a non-resident then the exemption would not be lost. Radio Station KFH Co., 11 PIKE & FISCHER RADIO REG. 1, 138-39. *See also* Comment, *A New Approach to the Intrastate Exemption: Rule 147 vs. Section 3(a)(11)*, 62 CALIF. L. REV. 195, 212 n.66 (1974); Comment, *SEC Rule 147—Distilling Substance from the Spirit of the Intrastate Exemption*, 71 DICK. L. REV. 18, 27 (1974).

148. *Cf.* ContROLL Awnings, Inc. [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,333 (SEC NAL Apr. 4, 1974).

149. 17 C.F.R. § 240.15c(2)-(11) (1974).

curity by the original purchaser or any other person properly purchasing from him who is exempt from registration as an exchange of securities with an existing securities holder[150] will not be treated as a sale of a part of the issue so as to start a new nine-month period.

Finally, paragraph f sets out certain precautions which the issuer must take to insure that the securities are not traded in interstate commerce before the nine-month restriction has run out. Up to this point most of the requirements have been favorable to the issuer. It is in this paragraph that the issuer must return some of the favors and do several things that it may not consider desirable. Again however it must be remembered that the issuer cannot take the good part of the Rule and omit the undesirable aspects and claim its protection. The Rule must be strictly followed. Subparagraph 1[151] outlines the three things that must be done. First, the issuer must legend the securities, stating that they are not registered and cannot be traded to non-residents for a period of nine months after the issuer's last sale.[152] This is often the bitter pill to the issuer because such a legend, at least in the case of a private placement, has always caused the restricted securities to sell much below similar securities which are transferable without restriction. What little empirical evidence that is available suggests that the mark-down for the inability to sell to non-residents is not nearly as great as the private placement restriction. This fact is probably due to the wider market available to the purchaser as well as the fact that the holding period is not nearly as long.[153]

Beyond this the issuer is required to enter a stop transfer order[154] if it does not handle its own stock transfers. If it does handle its own transfers then an appropriate note must be made on the securities stub to prevent inadvertent transfer by a corporate employee.

Finally, the issuer is required to get a statement similar to the old investment intent letter under the private placement.[155] Here the letter must contain representations by the purchaser as to the state of his residence. Subparagraph (ii) requires the issuer to re-legend any stock which is transferred and presented for reissuance during the period of the restriction and also to get the same type of letter concerning the purchaser's residence as it was required to get from the original purchaser.

Subparagraph (iii) here is important and may have a chilling effect upon sales. It requires the issuer to disclose in writing to any potential purchaser or offeree the restrictions on resale contained in the Rule.

While these requirements may seem onerous to some issuers, they are really beneficial to the issuer who is attempting to follow the law and stay out

150. Section 3(a)(9) of the Securities Act of 1933, 15 U.S.C. § 77c(a)(9) (1970).
151. Rule 147, ¶ f(1).
152. Rule 147, ¶¶ e, f(1)(i).
153. Nine months under Rule 147 as opposed to two years under Rule 146.
154. Rule 147, ¶ f(1)(ii).
155. Rule 147, ¶ f(1)(iii).

of trouble. For example, the failure to apprise the original purchaser of the restricted nature of the securities would certainly be a misrepresentation of a material fact which would be grounds for the purchaser's rescission under section 12(2)[156] or for a fraud suit under either section 17(a)[157] or Rule 10b-5.[158] Likewise, the restrictive legend is important to the issuer's protection. Under the Uniform Commercial Code,[159] no restriction on alienation is effective against a purchaser who takes without knowledge of the restriction.

Recently the Tenth Circuit, in *Edina State Bank v. Mr. Steak, Inc.*,[160] considered the problem of failure to transfer restricted stock in connection with a private placement. The stock was unlegended but was restricted. The stock had been bought by a purchaser who was unaware of the restriction and was seeking to have the stock transferred. When the company refused, the purchaser sued on the basis that the failure to transfer constituted a conversion under Section 8-401 of the Uniform Commercial Code.[161] The court agreed that the failure to transfer was a conversion. Thus the issuer who does not legend its stock is faced with the unpleasant alternative of breaking the federal law or converting the stock if it is presented for transfer by a person unfamiliar with the restriction.[162]

VII. Conclusion

Many observers feel that Rule 147 contains some good progress toward certainty in construing the intrastate exemption, but that it did not go far enough and therefore provides a very shallow "safe-harbor" for those companies which elect to use it. I would agree with the conclusion that the Rule provides only a shallow "safe-harbor," but I think it is unfair to blame the SEC or say that it could have gone further in the Rule. The basic problems with the intrastate exemption and Rule 147 lie in the language of the basic statutory exemption. In drafting its Rule the SEC cannot override the statutory requirements. It has long recognized and disliked some of the limitations that it feels are found in the exemption, but it is not free to subvert the legislative language.

Further I think a large part of the discontent with the exemption and the Rule stems from lawyers and companies attempting to use the exemption for something that it was never intended. It was meant to be a very limited exemption, covering a very limited group of companies which were truly local in nature and which were seeking local community financing. Today the exemption may be largely obsolescent because in our modern society with its mass com-

156. 15 U.S.C. § 77*l*(2) (1970).
157. 15 U.S.C. § 77q(a) (1970).
158. 17 C.F.R. § 240.10b-5 (1974).
159. Uniform Commercial Code § 8-204; 12A Okla. Stat. § 8-204 (1971).
160. 487 F.2d 640 (10th Cir. 1974). For a discussion of this case, see Recent Developments, 27 Okla. L. Rev. 141 (1974).
161. 12A Okla. Stat. § 8-401 (1971).
162. The mere fact that the non-resident has purchased the stock means that the intrastate exemption already has been lost.

munication and transportation, few companies can claim to be really local in nature or seeking financing on truly a local basis. Many companies and lawyers have tried to make the exemption into something more like a limited public offering exemption. This is not and was not intended to be. The SEC has recognized the usefulness of such an exemption on a limited scale and has provided for one in Regulation A[163] and more recently in its new Rule 240.[164] Lawyers and commentators should not be angry with the SEC when it will not cooperate with them in their attempt to make the intrastate exemption into something other than what it was intended to be. If they want a limited public offering exemption without the limitations and restrictions of Regulation A or Rule 240, then they should attempt to persuade either the SEC or Congress that it is in the public interest to create one. I for one am not sure that such an exemption is in the public interest.

Therefore the intrastate exemption remains after Rule 147 pretty much as it was before, a very dangerous exemption which can be easily lost and which should not be used unless no other viable alternative is available. However, being realistic, I realize that many firms and their lawyers will feel that the intrastate exemption or Rule 147 is the only practical way to market their securities. Therefore I hope that this article will be of some use to them in attempting to reduce the danger of liability to the bare minimum. All too often in the past the potential for liability has been greatly increased by the failure of the lawyer or his client to appreciate the limitations and restrictions of the exemption.

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163. Rules 251 through 263, 17 C.F.R. §§ 230.251-.263 (1974).

164. SEC Securities Act Release No. 5560, CCH FED. SEC. L. REP. ¶ 80,066 (Jan. 24, 1975). The text of the Rule can be found at 1 CCH FED. SEC. L. REP. ¶ 5741B. For a discussion of the Rule as proposed, see 3 H. BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW § 4.05 (1975).

APPENDIX A

Rule 147. "Part of an Issue," "Person Resident," and "Doing Business Within" for Purposes of Section 3(a)(11)

Preliminary Notes

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

2. Nothing in this rule obviates the need for compliance with any state law relating to the offer and sale of the securities.

3. Section 5 of the Act requires that all securities offered by the use of the mails or by any means or instruments of transportation or communication in interstate commerce be registered with the Commission. Congress, however, provided certain exemptions in the Act from such registration provisions where there was no practical need for registration or where the benefits of registration were too remote. Among those exemptions is that provided by Section 3(a)(11) of the Act for transactions in "any security which is a part of an issue offered and sold only to persons resident within a single State or Territory, where the issuer of such security is a person resident and doing business within . . . such State or Territory." The legislative history of that Section suggests that the exemption was intended to apply only to issues genuinely local in character, which in reality represent local financing by local industries, carried out through local investment. Rule 147 is intended to provide more objective standards upon which responsible local businessmen intending to raise capital from local sources may rely in claiming the Section 3(a)(11) exemption.

All of the terms and conditions of the rule must be satisfied in order for the rule to be available. These are: (i) That the issuer be a resident of and doing business within the state or territory in which all offers and sales are made; and (ii) that no part of the issue be offered or sold to non-residents within the period of time specified in the rule. For purposes of the rule the definition of "issuer" in Section 2(4) of the Act shall apply.

All offers, offers to sell, offers for sale, and sales which are part of the same issue must meet all of the conditions of Rule 147 for the rule to be available. The determination whether offers, offers to sell, offers for sale and sales of securities are part of the same issue (i.e., are deemed to be "integrated") will continue to be a question of fact and will depend on the particular circumstances. See Securities Act of 1933 Release No. 4434 (December 6, 1961) (26 FR 9158). Securities Act No. Release 33-4434 indicates that in determining whether offers and sales should be regarded as part of the same issue and thus should be integrated any one or more of the following factors may be determinative:

(i) Are the offerings part of a single plan of financing;

(ii) Do the offerings involve issuance of the same class of securities;

(iii) Are the offerings made at or about the same time;

(iv) Is the same type of consideration to be received; and

(v) Are the offerings made for the same general purpose.

Subparagraph (b) (2) of the rule, however, is designed to provide certainty to the extent feasible by identifying certain types of offers and sales of

securities which will be deemed not part of an issue, for purposes of the rule only.

Persons claiming the availability of the rule have the burden of proving that they have satisfied all of its provisions. However, the rule does not establish exclusive standards for complying with the Section 3(a)(11) exemption. The exemption would also be available if the issuer satisfied the standards set forth in relevant administrative and judicial interpretations at the time of the offering but the issuer would have the burden of proving the availability of the exemption. Rule 147 relates to transactions exempted from the registration requirements of Section 5 of the Act by Section 3(a)(11). Neither the rule nor Section 3(a)(11) provides an exemption from the registration requirements of Section 12(g) of the Securities Exchange Act of 1934, the anti-fraud provisions of the federal securities laws, the civil liability provisions of Section 12(2) of the Act or other provisions of the federal securities laws.

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

4. The rule provides an exemption for offers and sales by the issuer only. It is not available for offers or sales of securities by other persons. Section 3(a)(11) of the Act has been interpreted to permit offers and sales by persons controlling the issuer, if the exemption provided by that Section would have been available to the issuer at the time of the offering. See Securities Act Release No. 4434. Controlling persons who want to offer or sell securities pursuant to Section 3(a)(11) may continue to do so in accordance with applicable judicial and administrative interpretations.

Rule 147

(a) Transactions Covered.

Offers, offers to sell, offers for sale and sales by an issuer of its securities made in accordance with all of the terms and conditions of this rule shall be deemed to be part of an issue offered and sold only to persons resident within a single state or territory where the issuer is a person resident and doing business within such state or territory, within the meaning of Section 3(a)(11) of the Act.

(b) Part of an Issue.

(1) For purposes of this rule, all securities of the issuer which are part of an issue shall be offered, offered for sale or sold in accordance with all of the terms and conditions of this rule.

(2) For purposes of this rule only, an issue shall be deemed not to include offers, offers to sell, offers for sale or sales of securities of the issuer pursuant to the exemptions provided by Section 3 or Section 4(2) of the Act or pursuant to a registration statement filed under the Act, that take place prior to the six month period immediately preceding or after the six month period immediately following any offers, offers for sale or sales pursuant to this rule, *Provided* That, there are during either of said six month periods no offers, offers for sale or sales of securities by or for the issuer of the same or similar class as those offered, offered for sale or sold pursuant to the rule.

NOTE: In the event that securities of the same or similar class as those offered pursuant to the rule are offered, offered for sale or sold less than six months prior to or subsequent to any offer, offer for sale or sale

pursuant to this rule, see Preliminary Note 3 hereof as to which offers, offers to sell, offers for sale, or sales are part of an issue.

(c) Nature of the Issuer.

The issuer of the securities shall at the time of any offers and the sales be a person resident and doing business within the state or territory in which all of the offers, offers to sell, offers for sale and sales are made.

(1) The issuer shall be deemed to be a resident of the state or territory in which:

(i) It is incorporated or organized, if a corporation, limited partnership, trust or other form of business organization that is organized under state or territorial law;

(ii) its principal office is located, if a general partnership or other form of business organization that is not organized under any state or territorial law;

(iii) his principal residence is located, if an individual.

(2) The issuer shall be deemed to be doing business within a state or territory if:

(i) the issuer derived at least 80 percent of its gross revenues and those of its subsidiaries on a consolidated basis

(A) For its most recent fiscal year, if the first offer of any part of the issue is made during the first six months of the issuer's current fiscal year; or

(B) For the first six months of its current fiscal year or during the twelve month fiscal period ending with such six month period, if the first offer of any part of the issue is made during the last six months of the issuer's current fiscal year from the operation of a business or of real property located in or from the rendering of services within such state or territory; provided, however, that this provision does not apply to any issuer which has not had gross revenues in excess of $5,000 from the sale of products or services or other conduct of its business for its most recent twelve month fiscal period;

(ii) The issuer had at the end of its most recent semi-annual fiscal period prior to the first offer of any part of the issue, at least 80 percent of its assets and those of its subsidiaries on a consolidated basis located within such state or territory;

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

(iv) the principal office of the issuer is located within such state or territory.

(d) Offerees and Purchasers: Person Resident.

Offers, offers to sell, offers for sale and sales of securities that are part of an issue shall be made only to persons resident within the state or territory of which the issuer is a resident. For purposes of determining the residence of offerees and purchasers:

(1) A corporation, partnership, trust or other form of business organization shall be deemed to be a resident of a state or territory if, at the time of the offer and sale to it, it has its principal office within such state or territory.

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

(3) A corporation, partnership, trust or other form of business organization which is organized for the specific purpose of acquiring part of an issue offered pursuant to this rule shall be deemed not to be a resident of a state or territory unless all of the beneficial owners of such organization are residents of such state or territory.

(e) Limitation of Resales.

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

NOTES: 1. In the case of convertible securities resales of either the convertible security, or if it is converted, the underlying security, could be made during the period described in paragraph (e) only to persons resident within such state or territory. For purposes of this rule a conversion in reliance on Section 3(a)(9) of the Act does not begin a new period.

2. Dealers must satisfy the requirements of Rule 15c2-11 under the Securities Exchange Act of 1934 prior to publishing any quotation for a security, or submitting any quotation for publication, in any quotation medium.

(f) Precautions Against Interstate Offers and Sales.

(1) The issuer shall, in connection with any securities sold by it pursuant to this rule:

(i) Place a legend on the certificate or other document evidencing the security stating that the securities have not been registered under the Act and setting forth the limitations on resale contained in paragraph (e);

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

(iii) Obtain a written representation from each purchaser as to his residence.

(2) The issuer shall, in connection with the issuance of new certificates for any of the securities that are part of the same issue that are presented for transfer during the time period specified in paragraph (e), take the steps required by paragraphs (f)(1)(i) and (i).

(3) The issuer shall, in connection with any offers, offers to sell, offers for sale or sales by it pursuant to this rule, disclose, in writing, the limitations on resale contained in paragraph (e) and the provisions of paragraphs (f)(1)(i) and (ii) and subparagraph (f)(2).