ADDRESS OF

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before the

NATIONAL ASSOCIATION OF SECURITIES COMMISSIONERS

Kansas City, Missouri

September 20, 1938

The question of regulating the sale of interests in oil or gas rights is of comparative recent origin and presents many new and interesting problems. That there are such problems is evidenced by the fact that of the 47 states which have enacted legislation to regulate the sale of securities, only 8, in defining the types of securities covered by the respective statutes, have failed to mention oil and gas leases or interests. Thus, at the present time, there are 39 states definitely declaring such interests to be securities.

The rapid and spectacular development of the oil industry has had the tendency to center the interest of the investing public upon the profit possibilities of oil investments. As a result, in the past few years there has been a marked increase in the number of persons dealing and investing in this type of security. For example, it is estimated that during the past fiscal year oil royalties and kindred securities valued at approximately $20,000,000 were offered for sale in interstate commerce. It is thus apparent that transactions in such securities are no longer, as in the past, confined to localized areas adjacent to oil production, but have spread over the several states and, in many instances, are beyond the effective control of local regulation. Therefore, the Securities Act of 1933 and the General Rules and Regulations promulgated thereunder are of primary importance in the

regulation of such transactions. By this I do not wish to infer that the Securities Act is in derogation of any state Blue Sky Law. To the contrary, the Securities Act is complementary to such state statutes. In fact, an intention to that effect is expressly asserted in Section 18 of the Act. Because of this intimate and direct relationship between these laws and their mutual objectives, it would appear that a discussion of the application of the Securities Act and the action which the Securities and Exchange Commission has taken under its authority in connection with such matters is in order before this convention.

The express purpose of the Securities Act of 1933 is to provide a full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails and to prevent frauds in the sale thereof. However, it should be noted that, unlike some of the state Blue Sky Laws, the Securities and Exchange Commission, which is the agency charged with the administration and enforcement of this Act, may not pass upon the merits of, or give approval to, any security. Therefore, to accomplish its purpose, Section 5 of the Act requires that every issue of securities, with the exception of those exempted by reason of Sections 3(a) and 4, to be offered for sale to the public through the mails or by any means or instruments of transportation or communication in interstate commerce, must first be registered with the Securities and Exchange Commission. Such registration is

accomplished by filing with the Commission a registration statement which contains, in condensed and summarized form, certain factual data and pertinent information necessary for a full disclosure of the character of securities to be offered.

In addition to the exemptions provided by the statute itself, the Commission has, pursuant to the authority granted it by Section 3(b) of the Act, adopted rules and regulations whereby, because of the small amount involved or limited character of the public offering, certain classes of securities are exempted from the registration provisions of the Act upon compliance with certain specified conditions. Such exemptions are, however, limited by a provision that no issue of securities shall be so exempted where the aggregate amount of the public offering exceeds $100,000. Inasmuch as the majority of issues involving oil or gas rights are less than $100,000, I shall devote my remarks primarily to the Rules and Regulations adopted by the Commission which are applicable to such interests.

Offerings of interests of the type under discussion may be grouped in three general classifications; namely, (1) fractional undivided interests in oil or gas rights (which include oil royalties); (2) certificates of interest in a trust or unincorporated association, the assets of which primarily consist of oil or gas leasehold interests or rights or fractional undivided interests in oil or gas rights; and (3) assignments of subdivided portions of oil and gas leases.

As originally enacted, the Securities Act did not specifically define deeded oil royalties. As a result, there were many who questioned whether it was the intention of Congress at the time of the enactment of the Statute to include oil royalties within its scope. This contention was made regardless of the fact that the courts in most jurisdictions had upheld the classification of such interests as a security. In 1934, however, Congress, to dispel any doubt, amended the Act by specifically defining "any fractional undivided interest in oil, gas, or other mineral rights" as a security. Since the effective date of that amendment, there can be no doubt that this type of interest in oil or gas rights, if offered through the mails or by any means or instruments of transportation or communication in interstate commerce, is subject to the Act. Therefore, every person offering to sell royalty interests, with the exception of certain expressly exempted transactions, must either register the offered securities with the Commission or obtain an exemption from registration by reason of compliance with Regulation B. This is the Regulation under which most issues of oil royalties are offered. It prescribes the terms and conditions to be fulfilled in order to obtain an exemption from registration for fractional undivided interests in oil or gas rights as defined in Rule 300 thereof. In substance, this Regulation provides an exemption from registration for landowners' royalty interests, overriding royalty interests,

participating royalty interests, working interests, and oil and gas payments. Among other things, to obtain this exemption, it is required that an offering sheet on the prescribed schedule shall be filed with the Commission prior to its use and that a copy, as filed, be delivered to the purchaser at the time of the initial offer to sell any security for which an exemption is sought under said Regulation, and that sales shall be reported to the Commission on the appropriate form not later than fifteen days after the conclusion of the contract of sale.

In the event it is found that the offering sheet filed is incomplete or inaccurate in any material respect, or includes an untrue statement of a material fact or omits to state any material fact necessary to make the statements therein contained not misleading, or fails to comply with any of the requirements of Regulation B, the Commission may, within 7 days after the date upon which the offering sheet was filed, enter an order temporarily suspending the effectiveness of the filing pending a final hearing thereon. If the effectiveness of the offering sheet is suspended, the person making the filing may do one of two things -- he may request permission of the Commission to withdraw the offering sheet, which request is, in the usual course of events, granted, provided none of the securities

described therein has been sold, or he may undertake to amend the offering sheet to cure the defects cited as grounds for the suspension. If withdrawn, the offering sheet is, or course, deemed never to have become effective; if amended, neither the offering sheet nor the amendment becomes effective for any purpose whatever until the Commission so orders and gives notice to that effect.

In addition, the Regulation provides that the purchaser is entitled to demand and receive satisfactory evidence of title to the interest purchased, and it is obligatory upon the person making the sale to deliver to the purchaser such satisfactory evidence of title prior to the making of any contract of sale with and prior to the payment of any part of the consideration by the purchaser. There is, however, no rigid requirement as to the character or type of evidence of title which must be submitted.

One of the most difficult problems in regulating oil royalty transactions has arisen in connection with the use of estimations of recoverable oil which, in too many instances, have grossly exaggerated the amount of oil underlying the tract and in other respects have been entirely unreasonable. In attempting to solve this particular problem, the Commission has, under Regulation

B, provided that an estimation of recoverable oil or gas may or may not be included in an offering sheet at the option of the person making the filing. If, however, such estimation of the amount of oil or gas recoverable from a specific tract or from any other tract for comparative purposes is used in connection with an offer to sell any interest for which an exemption is sought under that Regulation, it must be included in and furnished as a part of the offering sheet. Otherwise, the exemption provided is not available. The use of misleading estimations of recoverable oil is a practice which can not be condoned. Realizing this, the Commission has accumulated considerable data on various oil properties for the purpose of determining whether any estimation filed is incomplete, inaccurate, or misleading. If it is found deficient in any of these respects, the proper action -- to suspend the effectiveness of the filing -- is immediately taken. The effect of this Rule is self-evident. Any estimation which meets the standards indirectly fixed by the Rule and which may be lawfully used must be reasonable as adjudged by orthodox engineering methods.

It is my understanding that some state commissions require that before an issue of producing oil interests may be qualified for sale by them that an estimation of the amount of oil recoverable from the properties involved

be filed and passed upon. In this connection, may I suggest that the Securities and Exchange Commission can be of material assistance in supplying to the state commissions information concerning a great many oil properties and particularly those located in the Mid-Continent area. Although I speak only for myself, and the views which I express are not necessarily those of the Commission, I feel quite certain that, upon request, the Securities and Exchange Commission will gladly furnish any state agency such data as it may have available.

In regulating the sale of interests in what are commonly termed oil royalty trusts, the Commission has, through the adoption of Regulation B-T, sought, in so far as possible under the law, to eliminate the principal defects and objectionable features so common in many of the indentures under which the interests are offered. These indentures generally vest in the trustee broad discretionary powers, particularly in regard to the sale, substitution, and encumbrance of the underlying properties, and, as a rule, fail to restrict in any manner the acquisition of the properties from, or other transactions between, the sponsor and the trustee. As a result, many of the assets of an oil royalty trust are acquired by the trustee

from the sponsor at prices far in excess of the cost price to the sponsor. In addition, the trustee is very often directly or indirectly controlled by the sponsor or manager of the trust. Thus it is that the Commission has set up certain minimum standard specifications for trust indentures in those cases where an exemption from the registration provisions of the Act is sought under Regulation B-T. This Regulation is applicable to certificates of interest or participation in trusts or unincorporated associations, a substantial portion of the assets of which consist of oil or gas leasehold interests or rights, or fractional undivided interests in oil or gas rights, where the aggregate offering price to the public of such certificates does not exceed $100,000. The exemption from registration provided by this Regulation is available only upon fulfilment of the conditions set forth therein and, as in Regulation B, specifies the minimum of information which must be included in the prospectus used in connection with the sale of securities. To obtain such an exemption, three copies of the trust indenture, together with three signed copies of the prospectus describing the securities to be offered, must be filed with the Commission prior to their use, and a copy of the prospectus, as filed, must be delivered

to the purchaser at the time of the initial offer to sell any interest for which an exemption is sought under the Regulation.

To meet the requirements of Regulation E-T, the trust indenture must, among other things, provide that it may be modified or amended only with the written consent of the persons owning not less than the majority of the outstanding certificates. Likewise, the consent of the majority of the certificate holders must, subject to certain exceptions, be obtained before any sale, assignment, transfer, conveyance, mortgage, or alienation of the underlying securities may be effected.

If the trust indenture provides for the redemption of any of the certificates of interest, it must further provide that all certificates outstanding at the time of each redemption shall be redeemed proportionately. This requirement precludes redemption by lot. Although redemption by lot is frequently applied, it is wholly inappropriate for the redemption of certificates in a trust, the assets of which are of a depleting nature. Redemption by lot, at best, is a matter of chance. Furthermore, an examination of a great many trusts whose assets are primarily oil royalties has indicated an additional element of hardship upon the certificate holders created by redemption by lot. In many instances, it has resulted in certain

certificate holders receiving back their original investment plus a stipulated profit while others in the same venture receive only a small fractional portion of their investment.

Trustees' fees and other charges to fiduciaries and sponsors of the trust are limited to 7½% of the gross earnings to the trust for any consecutive 12-month period, and each fiduciary must be subject to the supervision of some federal, state, or territorial banking commission. The appointment of a trustee subject to governmental supervision tends, in some degree, to place the assets of the trust in the hands of an impartial and disinterested party who is not so likely to be subject to the domination and control of the sponsor or manager of the trust.

The offering price of any certificate of interest is limited to the cost price of the underlying securities to the trust, and the make-up of each underlying security acquired by the trust from the sponsor thereof is limited to 30% over either the lowest actual cost of such security to any sponsor or the market value at the time of its deposit in the trust, whichever is lower.

Regulation B-T is similar to Regulation B in that if it is found that the prospectus filed is incomplete or inaccurate in any material respect, or

includes any untrue statement of a material fact, or omits to state any material fact necessary in order to make the statements therein contained not misleading, or fails to comply with any of the requirements of Regulation B-T, the Commission may, within 10 days after the date upon which the prospectus was filed, enter an order temporarily suspending the effectiveness of the filing of such prospectus, pending a final hearing thereon. If the effectiveness of the prospectus is suspended, the person making the filing may request the withdrawal of the prospectus, or he may undertake to amend the prospectus to cure the defects cited as grounds for the suspension.

As I have indicated, most issues of interests in oil or gas rights subject to the jurisdiction of the Securities and Exchange Commission are offered under one of these exempting regulations which, in accordance with the expressed purposes of the Securities Act, are designed to require a full disclosure of the character of securities offered and thus provide a maximum of protection for the investing public. However, experience has shown that not only has the public benefitted by compliance with these measures but that oil royalty dealers in general are enjoying improved business due to the enforced elimination of many unscrupulous competitors. All

of the unscrupulous have not, however, been eliminated, and there are still those engaged in the sale of oil and gas interests whose purpose appears to be evasion rather than compliance with the law. This attitude has resulted in the adoption of many plans of promotion which, prior to the enactment of the Securities Act, were not in general usage. Perhaps the one most commonly employed at the present time by those who attempt to circumvent the Act is the transfer by assignment of interests in an oil and gas lease covering specifically described tracts of land. It is, of course, the contention of those promoters dealing in this type of interest that, under this method of operation, a security is not involved.

In general, such promotions involve the acquisition by the promoter of an oil and gas lease covering several hundred acres of land in "wildcat" territory which may or may not be possibly oil or gas bearing. Subdivided portions of the leasehold covering specific tracts in this major block are then offered for sale to the public at prices greatly in excess of the cost to the promoter. The mere assignment of such leaseholds in the majority of instances has no attractive sales possibility and so, to overcome sales resistance, the promoter must perforce use sales literature of such nature as will distract the prospective purchaser's

attention from the lease itself to the entire program, particularly the drilling activities of the promoter. As an inducement to the prospective purchasers, various promises and representations are made. These, as you know, range from the adroitly-worded implication that an investment in the enterprise will return a 2500% profit to the promise that the oil underlying the tract has medicinal properties which will cure all ills.

It is true that such transactions consist, in part, of a conveyance of title to an oil and gas lease covering a certain tract of land and that the purchaser is vested with title to the portion conveyed and is at liberty to develop or market the portion assigned at his will. If these were the only elements to be considered, the term "security" would, in my opinion, have no application. Other factors, however, must be considered. As indicated, the promoter, by collateral agreement or otherwise, undertakes to drill a well on the major block for the purpose of proving the oil bearing potentialities of the entire tract and, in this manner, assure profit for all who invest in the venture. He thus constitutes himself as one to conduct an enterprise calculated to redound to the mutual benefit and

profit of all who purchase leases in the surrounding acreage controlled by him. He also often binds himself to aid in the realization of profit by participants by promises to make an attempt in good faith to market the interests of purchasers who desire to sell. It is hardly probably that the individual purchaser of an oil and gas lease on a small tract invests his money with the view in mind of realizing profit from his own efforts. This probability is further weakened by the fact that the investor, in the majority of cases, is not at liberty to choose the particular interest to be acquired but must depend upon the issuer to select it for him. In this manner, the issuer dominates and controls the venture and in his hands rest the fortunes of the investors. The apparent purpose of such offerings is to provide capital to be employed in a highly speculative enterprise, to distribute the burden of financing as widely as possible, and to provide a chance for investors to realize vast profits in event the enterprise meets with success. The success or failure of the project is largely a matter within the control of the promoter, and if the promoter should fail to drill and develop the property, it is doubtful that individual participants would be capable of realizing anything from the venture. It is my opinion that such retention of control in the promoter prevents classification of such transactions as an ordinary form of bargain and sale

and clothes the promoter with the power to control the realization of profits. The investor can not be considered to be entirely interested in the purchase or acquisition of an oil and gas lease to be individually exploited and, in the great majority of such promotions, the conditions of the transfer preclude such an interpretation. Rather, the plan is designed to attract capital of private investors who are induced to participate in anticipation of profit to be secured through employment of the capital so obtained by the promoter for the benefit of each.

In addition, Congress, in enacting this legislation, evidently intended to include all interstate transactions which were the legitimate subject of its regulation of the sale of securities and, in view of its purpose, the terms "Investment contract" and "certificates of interest or participation in any profit-sharing agreement" as used in the Act in defining a "security" can not be construed narrowly. Such has been the uniform holding of the courts that have construed the Act, and I think it is also worthy of note that similar contracts of widely varying content have been held under many of the state Blue Sky Laws to be securities.

Proceeding on the theory that the promotions of the type under discussion involve the sale of a security within the meaning of the Act, the Commission has, on three different occasions, sought to enjoin the sale of leasehold

interests because of the failure of the issuers to comply with the provisions of the Securities Act and, in each instance, it has been successful in obtaining a consent decree.

The measures adopted by the Securities and Exchange Commission to regulate the sale of oil and gas interests in interstate commerce pursuant to the power vested in it by the Securities Act are, in my opinion, sound, and the experience of the past several years has shown that they are practical and fair. The Act imposes certain civil liabilities and also provides for punishment by fine or imprisonment, or both, for violations of its provisions. Aggressive enforcement under these provisions has done much to eliminate the more objectionable elements in the oil royalty business and has, I think, strengthened the better points. However, careful administration and aggressive enforcement must continue if the announced objectives are to be attained and, in this respect the cooperation of the various state agencies will be of material assistance in making a success of the program if those cases involving non-resident violators against whom, as a practical matter, it might be difficult for the state to enforce the penal provisions of its statute are referred to the Securities and Exchange Commission. I assure you that full consideration and cooperation will be extended by the Commission in such matters.