PURSUIT OF TWO OBJECTIVES IN SUPERVISING THE SECURITIES MARKETS *

by

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The regulatory posture of the Securities and Exchange Commission in supervising the securities markets might be described as "objective firmness."

What are the most important manifestations of this attitude? First, it impells the Commission to administer a vigorous and aggressive program to strike down any attempts - particularly by issuers, promoters, broker-dealers, and securities salesmen - to defraud the public. Second, it urges constant vigilance in securing fair and adequate disclosure in all offerings of securities which are not exempt from the registration requirements of the Securities Act and by companies required to file reports under the Securities Exchange Act. And, third, it stimulates the search for realistic solutions to Securities Act problems posed by complex financial transactions.

This discussion of the two principal objectives of the Commission will embrace, first, a brief examination of its enforcement record, and, second, a review of some of the difficult interpretative problems involving the statutory requirements for registration.

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Prevention and Prosecution of Fraud

An important component of the Commission's program is the prevention and prosecution of fraud in securities transactions.1/ The Commission is currently investigating approximately 1,000 matters that appear to involve violations of the securities laws. During the fiscal year 1957 a total of 26 cases were referred to the Department of Justice for criminal prosecution compared with 17 referrals during the previous year.2/ A total of 71 proceedings were instituted in the federal courts during the fiscal year 1957 to enjoin illegal activities in the securities markets compared with 35 injunctive actions during the previous fiscal year.3/ The enforcement record for 1957 fiscal year further shows that the Commission issued 132 denial or

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1/ 68 Stat. 686 (1954), 15 U.S.C.A. Sec.77q(a), amending 48 Stat. 84 (1933), reads as follows:

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

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

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

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

Also see 15 U.S.C.A. Secs.77q(b) (written descriptions of securities without disclosure of consideration), 78i (manipulation of security prices), 78j (manipulative and deceptive devices), 78o(c) (over-the-counter markets, fraudulent, deceptive or manipulative acts), 77w and 78z (unlawful representations as to the Commission passing upon the merits).

2/ 48 Stat. 86 (1933), as amended, 15 U.S.C.A. Sec.77t(b) (1951), and 48 Stat. 899 (1934), as amended, 15 U.S.C.A. Sec.78u(e) (1951) provide that the Commission may transmit evidence to the Attorney General who may institute criminal proceedings under the Securities Act of 1933 and the Securities Exchange Act of 1934. Also see corresponding provisions in the other acts administered by the Commission, namely, Public Utility Holding Company Act of 1935, Trust Indenture Act of 1939, Investment Company Act of 1940 and Investment Advisers Act of 1940.

3/ See note 2 supra for statutory sections which authorize the Commission, in its discretion, to bring actions in the federal district courts to enjoin acts or practices which will or do constitute violations of the Securities Act of 1933 and the Securities Exchange Act of 1934. The Commission has similar powers under the other four acts which it administers.

suspension orders for non-compliance with the small offerings exemption,4/ revoked 29 broker-dealer registrations, denied the applications for registration of 6 broker-dealers,5/ and instituted 10 stop-order proceedings to prevent registration statements of securities from becoming effective.6/

This acceleration of the Commission's enforcement program has been caused primarily by the record volume of capital formation required by American industry.7/ The public appetite for corporate securities as a medium for investing individual savings has expanded with the increasing tempo of the economy. The intensified activity in the financial markets has attracted to the securities industry a fringe element of stockateering promoters and securities salesmen. These persons are the principal subjects of the Commission's investigative attention.8/

4/ See 17 C.F.R. Sec.230.261 (Supp. 1957) for the grounds of suspension or denial.

5/ See 48 Stat. 895 (1934), as amended, 15 U.S.C.A. Sec.78o(b) (1951) for the denial and revocation provisions. Also see 52 Stat. 1070 (1938), 15 U.S.C.A. Sec.78o-3(b)(4) (1951) which provides that if the Commission finds specified persons connected with a registered broker-dealer to be the cause of any suspension, revocation or denial order, the rules of the registered national securities association must provide that such broker or dealer cannot be continued in or admitted to membership in such association except by the approval of the Commission. There is only one such association registered with the Commission.

Section 78o-3(l)(2) of title 15 U.S.C.A. authorizes the Commission to suspend for a period not exceeding 12 months or to expel from a registered securities association any member thereof whom the Commission finds to have violated either the Securities Act of 1933 or the Securities Exchange Act of 1934 or any rule thereunder.

6/ See 48 Stat. 79 (1933), 15 U.S.C.A. Sec.77h(d) (1951), which provides that if it appears that a registration statement includes any untrue statement of a material fact or omits to state any material fact, the Commission may, after opportunity for hearing, issue a stop-order suspending the effectiveness of the registration statement.

7/ The aggregate dollar amount of securities registered with the Commission under the Securities Act of 1933 in the fiscal year 1955 was 11.0 billion; 13.1 billion in fiscal year 1956; and 14.6 billion in fiscal year 1957.

The market value of sales of securities effected on registered and exempted exchanges in calendar year 1954 was $29,156,725,158; in calendar year 1955 it was $39,260,611,043; and in calendar year 1956 it was $36,359,779,496.

8/ In the fiscal year 1956 the Commission instituted 13 injunctive actions against broker-dealers under the Securities Exchange Act of 1934 and 46 such actions in the fiscal year 1957. At the end of the fiscal years 1956 and 1957 there were registered, respectively, 4591 and 4771 broker-dealers. In the same respective fiscal years the Commission's staff made 952 and 1214 broker-dealer inspections, and in the same periods there were 44 and 74 proceedings instituted to deny or revoke broker-dealer registrations.

The schemes of some stockateers are whimsical. In March of this year the promoter of a company represented to own a patent for a wingless aircraft that was capable of carrying 4,000 persons a distance of 25,000 miles non-stop at half the cost of any other plane was convicted of securities fraud and sentenced to three years imprisonment. More than 800 stockholders lost approximately $200,000 in this fraudulent venture. In selling the securities, the promoter claimed that the development of this wingless airplane was comparable to the achievements of the Wright Brothers, Leonardo da Vinci, Sikorsky, Billy Mitchell and Charles Lindbergh and that this plane was the greatest advance in aviation since the advent of flying. However, he omitted to disclose, among other things, that the prototype simply consisted of a remodelled small standard airplane from which he had sheared all but eight feet of each wing, that it was less efficient than existing types of planes, and that it had not been successfully test flown.9/

Recently an oil promoter was sentenced to seven years imprisonment for fraudulently selling investment contracts in oil and gas interests through making false promises of great wealth to prospective investors. He falsely represented that the lands covered by the leases had already been proved for oil and were highly productive and that there was no risk in making the investment. The promoter represented himself to be a highly qualified and successful oil operator who had never drilled for oil without bringing in a producing well. The indictment alleged, however, that the defendant had never been successful as an oil operator and that his profits had been made wholly as a result of promotional activities.10/

9/ U.S. v. Wm. E. Horton, et al., U.S.D.C. S.D. Calif. C.R. No. 24615.

The Commission's experience with Horton commenced prior to April 23, 1954 when it filed a complaint to enjoin him from violating the registration and anti-fraud provisions of the Securities Act. A final injunction as to both provisions was issued September 14, 1954. On October 21, 1954, a criminal contempt action was instituted against Horton for violation of the preliminary injunction and temporary restraining order which had been issued only as to the sales without registration. Horton pleaded guilty and on January 5, 1955 he was sentenced to ninety days imprisonment. Subsequently, he was allowed to withdraw his plea of guilty and on April 7, 1955 Horton was found guilty of criminal contempt by the court and he was fined $1,000 and placed on probation for five years.

Horton Aircraft Corporation filed two registration statements. Stop-order proceedings were instituted and on October 29, 1957, a stop-order was issued (Securities Act Release No. 3855) as to both of them.

10/ U.S. v. Price, et al., U.S.D.C. N.D. Ga. C.R. No. 20862.

Price has a long record of alleged violations of the securities laws. On March 9, 1945, he was indicted in the District of Kansas for violations of the registration and anti-fraud provisions of the Securities Act and the Mail Fraud Statute (U.S. v. Price, D.Kans. C.R. No. 2571). He successfully resisted removal of trial to the Western District of Texas. However, it was later removed to Texas for trial but the principal witness for the government was killed in an automobile accident and the delay and the death of the witness

Securing Fair and Adequate Disclosure

The second principal aspect of the Commission's program is to exercise constant vigilance in securing fair and adequate disclosure of material business and financial facts in reports filed under the Securities Exchange Act and through the registration process in all offerings of securities not exempt from the requirements of registration under the Securities Act. During the fiscal year 1957, 943 registration statements, offering to the public a record volume of 14.6 billion dollars of corporate securities, were processed by the Commission.11/ However, investigations conducted by the Commission have disclosed that a considerable quantity of capital was raised by the sale of unregistered securities in transactions where substantial doubt exists whether the exemptions from registration relied upon by the issuers were available.12/

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caused the government to dismiss the indictment in 1949. He was again indicted for violation of the registration provisions in 1951 (U.S. v. Price, N.D. Ohio C.R. No. 9760) and he caused the indictment to be remanded to Texas for trial. He was convicted on all four counts and sentenced to 13 months imprisonment and $1,000 fine. Price appealed and the conviction was reversed on January 6, 1953 (Price v. U.S., 200 F. 2d 652 /C.A. 5 1953/) for a technical error in charging the jury and the case was remanded for retrial. Prior to retrial he pleaded *nolo contendere* and was fined $5,000.

Price is presently out on $10,000 bail pending appeal on his conviction and sentence to 7 years imprisonment.

11/ See note 7 supra.

12/ Sections 3 and 4 of the Securities Act of 1933, 15 U.S.C.A. Secs. 77c and 77d (1954), exempt certain securities and securities transactions from the registration provisions. Among the more problematical of the securities exemptions is that of exchanges by the issuer with its existing security holders and the so-called "intrastate" exemption. Other securities exemptions include securities issued or guaranteed by federal and state governmental instrumentalities; commercial instruments of indebtedness used for current transactions with maturity dates not exceeding nine months; securities issued by persons exclusively organized for religious, educational, benevolent, fraternal, charitable or reformatory purposes; certain securities of savings institutions and securities of qualified farmers' cooperatives; securities issued by common or contract carriers subject to Section 20(a) of the Interstate Commerce Act; insurance and annuity contracts subject to local supervision; and certain exchanges subject to the approval of various governmental authorities.

The more frequently encountered problems in connection with the transaction exemptions are those where it is claimed that either an underwriter or a public offering is not involved.

It should also be noted that the "no sale" theory of Rule 133, 17 C.F.R. Sec. 230.133, is sometimes considered to be an exemption. Actually, it is an interpretative rule of the definition of the term "sale" found in Section 2(3) of the Act, 15 U.S.C.A. Sec.77b(3) (1954).

In some of these cases the nature of the business transactions raises close legal questions respecting the necessity for registration. Others clearly involved illegal schemes to evade the registration requirements of the Securities Act. The effect, in both instances, has been to place in the channels of commerce large blocks of stocks without providing public investors with adequate business and financial facts on which an informed investment judgment can be predicated.13/

Regulatory Approach

What fundamental principles should guide the Commission in performing its important function of deciding the necessity for registration of securities issues? In interpreting the various statutory provisions the Commission must, first, carefully adhere to the language of the statutes, supplemented by an analysis of the legislative history in cases where the application of the statute to a particular situation may not be clear; second, give attentive consideration to the growing body of securities jurisprudence - such as court decisions, Commission opinions, orders, rules and administrative determinations - which have evolved over the past 23 years; and third, find reasonable and practical solutions to the disclosure problems involving legitimate business activities, within the framework of the statutory language and financial and administrative precedents.

The Commission has been diligent to require the registration of securities in all transactions brought to its attention where some exemption is not available. Frequently, however, complex interpretative problems are created for the financial bar and the Commission by particular factual situations and by various statutory provisions relating to the registration requirements.

Who is an Underwriter?

The definition of "underwriter" in the Securities Act has far-reaching implications to issuers and purchasers of securities in solving registration problems. In the context of the Act, the term "underwriter" has a scope far broader than its common meaning in financial circles. It is defined to include "any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security . . , or participates . . . in any such undertaking."14/ This definition is closely related to the exemption from registration afforded by the first and second clauses of Section 4(1) of the Act.15/ These provisions exempt "transactions

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13/ The intendment of the Securities Act of 1933 is "to provide 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 . . " as recited in the title of the Act.

14/ 68 Stat. 684 (1954), 15 U.S.C.A. Sec.77b(11), amending 48 Stat. 74 (1933).

15/ See note 16 infra.

by any person other than an issuer, underwriter or dealer" and "transactions by an issuer not involving any public offering."

The basic concept of the Securities Act is to require registration of securities offered for sale by the issuer to the public unless some exemption is available. The Commission has long regarded the term "distribution" as used in defining underwriter, to be essentially equivalent to the term "public offering."16/ A "public offering" has been broadly defined by the United States Supreme Court to include transactions in which the purchasers or offerees need the protection afforded by registration.17/ Consequently, a person who buys unregistered securities from an issuer with a view to reselling them,18/ or who participates 19/ in the transaction by which the securities move from the issuer to ultimate investors, may, unwittingly, be acting as an underwriter, in the statutory sense, if the resales are deemed to be a public offering.

In order to carry out the registration objectives embodied in the Act, the Commission is compelled to examine the stream of transactions in which securities flow from the issuer to the ultimate purchasers. Thus, where a private sale of securities by an issuer is made to a person who intends to resell them to others, the circumstances involving the resales are included in

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16/ It is important to note that a person becomes a statutory underwriter by definition when he has the requisite intent to distribute the acquired securities or intends to participate in such a distribution. Therefore, under the first clause of Section 4(1) of the Securities Act of 1933 (15 U.S.C.A. Sec. 77d(1)), the mere offering of unregistered securities by such a person is in violation of the Act.

17/ Securities and Exchange Commission v. Ralston Purina Co., 346 U.S. 119 (1953).

18/ In regard to resale of an issuer's securities, the Commission has defined the term "distribution," as found in 15 U.S.C.A. Sec.77b(11), in its Rule 140, 17 C.F.R. Sec.230.140, to include situations where a person primarily engaged in the purchase of the securities of any one issuer sells its own securities to furnish the proceeds with which to acquire the securities of such issuer.

19/ See Rule 142, 17 C.F.R. Sec.230.142, for the definition of "participates" and "participation" as used in Section 2(11) of the Securities Act of 1933 in relation to certain transactions. Note the inclusion in this rule of the phrase "who purchases such securities for investment and not with a view to distribution."

"Participation" in an underwriting means participation in the underwriting as such and does not include a person merely furnishing another with money to act as an underwriter. Conference Report on Securities Act, H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933) 24.

determining whether or not the whole transaction constitutes a public offering.[20/]

The converse of taking securities "with a view to distribution" is purchasing for investment and not for resale.[21/] Where a purchase of securities is made from an issuer by a person, or a small group, who takes the securities for investment, no public distribution is involved, and registration is not required.[22/] The application of the expression "purchasing for investment" must be ascertained by reference to the intention of the purchaser at the time of acquisition. A person's intent can ordinarily be discovered only by weighing objective evidentiary factors and not by relying on self-serving statements - such as contained in so-called investment letters - that a particular purchase was made for investment. One of the most significant, although not necessarily conclusive, of the relevant evidentiary factors to be considered would be the length of time elapsing between the acquisition and resale of the securities. The longer the period of retention, the stronger might be the inference that the securities had been purchased for investment. The concept of taking for investment does not, of course, preclude for all time the right of the purchaser to resell without becoming an underwriter. However, it does impose a heavy burden on the purchaser to establish that when the securities were acquired, he, in fact, did not have a premeditated plan to make a distribution.[23/]

20/ It is believed that reliance upon the exemptions afforded by Sections 3(a)(9), (10) and (11) and 4(1) (first and second clauses) of the Securities Act of 1933, 15 U.S.C.A. Secs.77c(9), (10) and (11) and 77d(1), must be considered in the light of the definition of "underwriter" contained in Section 2(11) of the Act, 15 U.S.C.A. Sec.77b(11).

21/ Apparently the phrase "purchase (take, acquire, etc.) for investment," as related to the Securities Act of 1933, had its origin in an interpretative inquiry to the Chief of the Securities Division, FTC, in October, 1933, in which it was stated that a person would take shares "solely for an investment and not for the purpose of resale." The reply of the Division stated, in part: "And since the agreement . . to purchase all shares of the new issue not taken up by the old stockholders is for the purpose of investment and not for resale . . it is apparently not to be considered an underwriter."

22/ Second clause, Section 4(1) of the Securities Act of 1933, 15 U.S.C.A. Sec.77d(1).

23/ See Opinion of General Counsel, Securities Act Release No. 1862 (1938). Although this opinion relates to Rule 142, which in effect excludes the so-called "old-fashioned" underwriter from the statutory definition of an underwriter, the considerations relating to purchases for "investment" should be the same in all situations.

Another evidentiary factor indicated in Release No. 1862, which deserves to be mentioned, relates to the character of the purchaser's business. The opinion stated that "in the case of a securities dealer or an investment banking house, the nature of the business ordinarily carried on would create an extremely strong presumption of purchase for resale." In order to overcome this presumption "it would be necessary to establish by the clearest kind of evidence that the scope and character of the person's business were consistent with the purchase of large blocks of securities for investment rather than with a view to distribution."

A recent administrative decision of the Commission illustrates the type of case where the existence of a premeditated plan to make a distribution negated the representation of taking for investment. A limited number of large purchasers acquired subordinated debentures and common stock in a company organized to engage in a speculative venture. The securities had been purchased with the intent to hold them until the business would become established. Since the purchasers had the preconceived intention, at the time of acquisition, to liquidate their holdings when this point in the development of the company would be reached, the Commission determined that registration would be required prior to any public offering.

Another significant ruling by the Commission interpreting the phrase "with a view to distribution" involved a sale by a controlling person of a large block of common stock in an unseasoned, highly speculative oil venture to a single purchaser in a private transaction. Some months later, the financial condition of the purchaser became critical and it desired to make a public offering of its holdings. Although the purchaser represented that the company was unwilling to register the securities to be sold, the Commission denied a request for assurance that it would not take action if the securities were sold without registration. The Commission was not persuaded that the purchaser had not acquired the securities with a view to their distribution. The speculative character of the securities, the nature of the purchaser's business and its precarious financial condition at the time of acquisition were relevant objective facts that negated investment intent.

The Commission recently pointed out the dangers of making or relying on vague representations of investment intent by persons who do not have a clear understanding of the meaning of that term under the Securities Act. An exemption for an alleged private offering originally made to a restricted group of persons may be destroyed and the original purchasers may be transformed into statutory underwriters where the participations are subdivided or resold to others. In the Crowell-Collier Publishing Company financing of convertible debentures in 1955-56, the issuer had secured commitments from 27 persons who executed investment letters stating they had no present intention of distributing the securities. However, prior to the closing date, approximately one third of these purchasers subdivided and resold their allotments, resulting in at least 79 purchasers. The Commission concluded that the issuer could not rely on the exemption from registration provided for transactions not involving a public offering in the sale of the debentures.24/

24/ Securities Act Release No. 3825 (Aug. 12, 1957) wherein it was more fully stated:

"It has been and is the Commission's position that an issuer or an underwriter may not separate parts of a series of related transactions comprising an issue of securities and thereby seek to establish that a particular part is a private transaction if the whole involves a public offering of the

Convertible Securities

From time to time, the issuance of convertible securities becomes a popular medium, with both sellers and buyers, for capital formation and investment. During the fiscal year 1957, $1,273 million of convertible securities were registered with the Commission, compared with $1,361 million in 1956, and $369 million in 1952.

The issuance and sale of convertible securities involves a simultaneous offering of two securities: the convertible security itself and the security into which it is convertible.25/ Where the issuer makes a public offering of the convertible security and the conversion privilege is immediately exercisable, registration of both securities is required.26/

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securities.

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"An issuer may not establish a claim to an exemption under Section 4(1) merely by collecting so-called 'investment representations' from a limited group of purchasers if in fact a distribution by such persons occurs. Counsel and their issuer and underwriter clients cannot base a claim to exemption from registration under the Securities Act upon the mere acceptance at face value of representations by purchasers that they take for investment and disclaim responsibility for investigation and consideration of all relevant facts and circumstances pertinent to a determination that the transactions do not involve a public offering. A representation by a purchaser that he is taking for 'investment' when in fact he concurrently is dividing a participation among others or reselling a portion of a commitment to others is worthless. Issuers, underwriters or counsel cannot claim that a transaction does not involve a public offering if they do not know the identity and number of initial offerees or purchasers or whether such purchasers offer and sell to others."

25/ Ibid. "It has long been a matter of common knowledge based on the clear meaning of the statute that an offering of a security convertible immediately into another security involves a simultaneous offer of both securities."

The reasoning underlying the quoted statement stems from the last sentence of the definition of the term "sale," etc., in 15 U.S.C.A. Sec.77b(3). If a right of conversion not exercisable until some future date is not an offer of a security when originally issued, then it is implicit that a right of conversion immediately exercisable is an offer of a security when originally issued.

26/ Ibid at page 6, Release No. 3825.

For the historical aspect of the problem of registration of convertible securities, see Loss, Securities Regulation 366 (1951) and Throop and Lane, Some Problems of Exemption under the Securities Act of 1933, 4 Law and Contemp. Prob. 89, 98-100 (1937).

Upon completion of a public distribution of registered convertible securities, the Commission does not consider that the delivery of an up-to-date prospectus in connection with the issuance of the underlying securities upon exercise of the conversion privilege is required by the statute. The rationale of this position is that where the distribution of the convertible securities has been completed through the public offering, the transaction of conversion is exempt as an exchange made "by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."27/ In this situation the exempt transaction is considered not to be a device to achieve a distribution since that has already occurred.

Difficult problems concerning the statutory requirements for registration are frequently raised, however, where issuers sell convertible securities in transactions which purport not to involve any public offering. In a number of instances coming to the attention of the Commission, purchasers in these transactions have exchanged the convertible securities within a relatively short period after the original take-down and have made a distribution of the underlying securities to the public when no registration has been effected. Even though the initial sale of the convertible securities might have been so limited as to qualify for the exemption afforded for transactions not involving any public offering as to the convertible securities, an appropriate exemption must be found for the subsequent resales in order to avoid violations of the registration requirements.28/

One exemption which has been relied upon for the conversion and the subsequent sales of the underlying securities is the exchange exemption. It would seem, however, that the exemption provided for exchanges of securities by an issuer exclusively with its exsiting security holders where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange is available only for the transaction of conversion. This exemption does not afford a permanent exemption for the securities received upon conversion. It does not clothe such securities with an exempt status in subsequent transactions. It applies only to the transaction of exchange. The rationale of this conclusion is that securities which are issued in exchange for convertible securities do not possess any intrinsic qualities that should cause the extension of the exemption afforded by the

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27/ The quoted exemption is 48 Stat. 906 (1934), 15 U.S.C.A. Sec. 77a(9) (1951), amending 48 Stat. 75 (1933).

28/ "Any other construction of Section 3(a)(9) would encourage wide-scale evasion of the registration and prospectus provisions of the statute by the simple expedient of so-called private sales of convertible securities looking to the public distribution of the underlying security on conversion." Securities Act Release No. 3825.

transaction of exchange to subsequent resales.29/

Another theory is relied upon to relieve subsequent sales of the underlying securities from the registration requirements. It has been urged that since the convertible securities were acquired in a private offering transaction, this exemption continues to be available for the securities issuable upon conversion. Reliance on this exemption, however, overlooks the fact that a person who converts a security is, in fact, purchasing a new security from the issuer.30/ If the purchaser's intent, at the time of conversion, is to resell the underlying securities to the public, he appears to fall within the statutory definition of underwriter, for the reason that he has purchased the securities from the issuer with a view to distribution.31/

Not all the perplexing implications of these types of transactions have been satisfactorily resolved. The view that the existence of an exemption

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29/ The contention is sometimes made that because the "exchange" exemption is found in Section 3(a) of the Act, which relates to exempted securities, the securities received pursuant to such an exchange are not required to be registered when reoffered by persons who acquire with the intention to make a distribution. Prior to an amendment of the Act in 1934, Sections 3(a)(9) and (10) were found in Section 4(3), which related to exempted transactions. The relocation of the exemption in Section 3(a) was merely to make certain that dealers dealing in the securities within a year were subject to no restrictions. H.R.Rep. 1838, 73d Cong., 2d Sess., 40. "The sale to the public of a large block of securities previously exempted from registration when they were exchanged for other securities possesses all the dangers attendant upon a new offering of securities to the public by the issuer. Section 3(a)(9) does not, therefore, permanently exempt securities offered in a transaction of exchange." In the Matter of Thompson Ross Securities Co., 6 SEC 1111, 1118 (1940).

The view that Section 3(a)(9) continues to be a transaction exemption was reaffirmed by the Commission in its Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934 (1941) 56.

As to the necessity of bona fides in relying upon the exemption, it was stated in Opinion of General Counsel of the Commission, Securities Act Release No. 646 (Class C)(1936) that "the mere fact that the exchange . . . might comply with the literal conditions of Section 3(a)(9) would not avail to defeat the necessity for registration . . ." where merely a step in a plan to evade the registration requirements of the Act.

30/ This theory, which is known as the "package theory," basically urges that a sale of the underlying security occurs at the time of sale of the convertible security.

31/ See discussion of "Who is an Underwriter" and note 14 supra.

for subsequent resales of the underlying securities depends upon the circumstances surrounding the original acquisition of the convertible securities is consistent with the concept that an ordinary investor who acquires securities in an exempt private transaction does not become an underwriter merely because at some future time he disposes of his investment.32/ On the other hand, if the status of exemption is not related to the purchaser's intent at the time of conversion, the private placement of convertible securities might become a medium for publicly distributing, without the protections afforded by registration, the securities into which they are convertible.33/

Rule 133

During the course of the Commission's administration of the securities statutes a vast volume of unregistered securities have been issued in connection with corporate reorganizations. Under Rule 133 securities issued in mergers, consolidations, recapitalizations and transfers of assets effected pursuant to state statutes providing that a favorable vote by a majority of stockholders will bind all stockholders (with appraisal rights for dissenters) are not subject to the registration provisions.34/ On the other hand, voluntary exchanges made by a person or corporation to the public security

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32/ In 1941 the Commission concurred in a proposal by representatives of the securities industry that the definition of the term "underwriter" be amended to make it clear that the "ordinary private investor" exercising a warrant or conversion privilege would not be an underwriter as to the securities acquired although he intended to resell. Securities and Exchange Commission Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934 (1941) 20.

33/ See note 28 supra.

34/ 15 C.F.R. Sec.230.133 reads as follows:

"For purposes only of Section 5 of the Act, no 'sale,' 'offer,' 'offer to sell,' or 'offer for sale' shall be deemed to be involved so far as the stockholders of a corporation are concerned where, pursuant to statutory provisions in the State of incorporation or provisions contained in the certificate of incorporation, there is submitted to the vote of such stockholders a plan or agreement for a statutory merger or consolidation or reclassification of securities, or a proposal for the transfer of assets of such corporation to another person in consideration of the issuance of securities of such other person or voting stock of a corporation which is in control, as defined in Section 368(c) of the Internal Revenue Code of 1954, of such other person, under such circumstances that the vote of a required favorable majority (1) will operate to authorize the proposed transaction so far as concerns the corporation whose stockholders are voting (except for the taking of action by the directors of the corporation involved and for compliance with such statutory provisions as the filing of the plan or agreement with the appropriate State authority), and (2) will bind all stockholders of such corporation except to the extent that dissenting stockholders may be entitled, under statutory provisions or provisions contained in the certificate of incorporation, to receive the appraised or fair value of their holdings."

holders of another company are subject to registration. Voluntary exchanges, however, have constituted only a small fraction of the total offerings registered under the Securities Act, and are insignificant in relation to the total amount of securities involved in corporate acquisitions and mergers.

From the present time back to the enactment of the Securities Act contrariety of opinion among practitioners, regulators and other students of the securities laws has existed as to the soundness of the legal theory relieving securities issued in these types of statutory reorganizations from the registration requirements.35/

Rule 133 qualifies the definition of "sale" contained in the Securities Act by stating that, for purposes of registration, the issuance of securities in these statutory reorganizations does not involve a sale.36/ The legal theory supporting this "no sale" interpretation is that the securities transactions in such a reorganization occur through corporate action by stockholders exercising their franchise to vote as members of a corporate body.37/ The voting rights of stockholders to accept or reject, as a class, a proposed reorganization plan are created, and the procedures to consummate the transactions are governed, exclusively by the laws of the interested states. The exercise of voting rights by stockholders, acting as a class, does not have the same legal effect as making a choice as an individual to accept or reject a security offered in exchange for another security. The prime elements of a contract, namely, mutual assent between the corporation and the individual stockholder, are lacking.

35/ The legal theory is criticized by Louis Loss, former Associate General Counsel of the Securities and Exchange Commission, as "unforgivably formalistic." Loss, Securities Regulation, (1951) 336. Also see Field, Some Practical Aspects of a Merger, 60 Harv. L. Rev. 1092, 111-2 (1947), where the author refers to a passage contained in H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933) to the effect the exemption afforded to judicially supervised reorganizations is not broad enough to include reorganizations without such supervision and concludes that the Commission's interpretation "ignores the substance of the transaction."

36/ Rule 133 was promulgated in 1951. It was amended to its present form in 1954 to reflect a change in the Internal Revenue Code. The "no sale" theory was originally adopted as a note to Rule 5 of registration Form E-1 by Securities Act Release No. 493 in 1935. The form was discontinued in 1947; however, the "rule" was considered to be "interpretive" rather than "substantive" and was administratively adhered to by the Commission until its formal adoption.

37/ A thorough exposition of the theory is treated of in Brief of SEC., National Supply Co. v. Leland Stanford, Jr. University, 134 F. 2d 689 (C.A. 9, 1943), cert. denied, 320 U.S. 773. Also see Proposed Amendments to the Securities Act of 1933 and to the Securities Exchange Act of 1934, 3 Hearings before the House Committee on Interstate and Foreign Commerce (1941) 842-845, where the "no sale" theory and problems involved were presented to the Congress.

The repeal of Rule 133 has been urged on the ground that the Act broadly defines the term "sale" to include every disposition of a security for value, and that many of these reorganization transactions involve the disposition of a new security for value to at least some of the stockholders of the constituent companies.38/

This approach, however, oversimplifies the problem. It would appear to be rudimentary that the interpretation of the word "sale," as used in the context of "disposition for value," should follow its historical legal meaning, absent an express Congressional mandate to the contrary. A solicitation of stockholders to vote on a proposed reorganization plan does not have the connotation of an "offer to sell." Furthermore, an equally artificial construction of the term "sale" would be involved by deeming that a sale of securities has occurred when the approval of stockholders to a merger, consolidation, reclassification or transfer of assets is obtained.

The no-sale theory, respecting the inapplicability of the registration provisions to these types of corporate reorganizations, has received 23 years of administrative acceptance by the Commission as well as some judicial sanction.39/ While the doctrine has been described as "unforgivably formalistic,"40/ the legalistic justification for holding that an offer to sell or a sale of securities is involved where a proxy is solicited or voted is subject to the same criticism. The conclusion that the present structure of the Securities Act was not designed to encompass the registration of securities issued in inter- and intra-corporate transactions of this kind is not unreasonable.

During the past year the courts and the Commission have clarified the legitimate limitations of the no-sale rule. These decisions have reemphasized the interpretation that the rule does not have the effect of "freeing up" from the registration requirements the securities issued in merger transactions, which are merely a maneuver to effect a public distribution of securities. The articulation of this sound proposition should effectively preclude further attempts to use the rule as a loop-hole to avoid registration.

38/ 68 Stat. 684 (1954), 15 U.S.C.A. Sec.77b(3), amending 48 Stat. 74 (1933) reads in part as follows:

"The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security, for value. 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."

39/ See notes 36 and 37 supra. The court in its opinion stated: "without going into the matter, we may say that we are in accord with the views of the Commission."

40/ See note 35 supra.

In SEC v. Micro-Moisture Controls, Inc.,41/ decided last year by the United States District Court for the Southern District of New York, defendant issued more than 2,000,000 shares of its stock in exchange for the assets of another corporation. The shares were distributed as a liquidating dividend to the shareholders of the merging corporation, who signed powers of attorney appointing the largest stockholder of Micro-Moisture as their attorney-in-fact to sell the shares. The shares were sold without having been registered and in purported reliance on Rule 133. In granting the Commission's petition for a preliminary injunction, the Court held that Rule 133 could not be relied upon to exempt the subsequent resales from registration "for the reason that the shareholders of (the merging corporation) were and are in control of Micro-Moisture and that the 'exchange' of (the merging corporation's) assets for Micro-Moisture stock was but a step in the major activity of selling the stock." The sellers of the stock were also held to be statutory underwriters.

The Great Sweet Grass Oils Limited and Kroy Oil Limited case,42/ decided by the Commission in April 1957, was a proceeding to delist the securities of the two companies on the ground that they had filed false and misleading reports with the Commission and a national securities exchange. The Commission found that respondents had issued their stock in exchange for the oil and gas properties of a number of ostensibly independent corporations. These corporations were, in fact, under the common control of respondents. The stock was then sold without registration to the public through the use of flamboyant literature and high-pressure sales techniques. The reports filed by respondents stated that registration was not required by reason of Rule 133. In rejecting this claim, the Commission said: "Where there is a pre-existing plan . . to use stockholders merely as a conduit for distributing a substantial amount of securities to the public, Rule 133 cannot be relied upon by the issuer . . In any event, where the persons negotiating an exchange, merger or similar transaction have sufficient control of the voting stock to make a vote of shareholders a mere formality, Rule 133 does not apply."

Just two months ago the Commission rendered a further important interpretation under Rule 133 in a case not involving any of the aspects of fraud, such as were involved in the Micro-Moisture and Great Sweet Grass cases. In a proposed merger transaction, a substantial stockholder of the merging company contemplated selling the shares to be received upon consummation of the merger. The Commission decided that while registration would not be required for the issuance of shares of the surviving company to the security holders of the merging company, the substantial stockholder would be a statutory underwriter if he effected a public distribution of the shares received. Following the receipt of this interpretation, a registration statement was filed to cover the shares to be issued in the merger transaction.

41/ Civ. No. 116-190 (S.D.N.Y.).

42/ Securities Exchange Act Release No. 5483 (April 8, 1957).

Conclusion

The Securities and Exchange Commission assumes an important responsibility for preserving public investor confidence in the securities markets. While continuing its diligent policing of the securities industry, the Commission must attempt to clarify further its interpretations of the statutory requirements applicable to the registration of securities. The issuance of convertible securities in private transactions must be adequately controlled so that the practice does not become a subterfuge for the distribution of the underlying securities without registration. Likewise, the Commission should continue to be vigilant to prevent the use of the "no-sale" rule as a means of effecting unregistered public distributions of securities.

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