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The Intrastate Exemption in the Light of the Securities Act Amendments of 1964*

James E. Newton**

Many companies have utilized the "intrastate" exemption¹ to avoid the need for complying with the registration requirements of the Securities Act of 1933.² For a company organized and doing business in Montana or in a state having a comparable securities law, the only practical reason to so use the intrastate exemption disappeared with the enactment of the Federal Securities Acts Amendments of 1964. These amendments require certain companies which have no securities listed on a national exchange, and which might otherwise consider use of the intrastate exemption,³ to register under the Securities Exchange Act of 1934.⁴ Such companies may be designated "12(g)" companies.

SCOPE OF THE FEDERAL ACTS

Required Registration of Unlisted Companies

The Securities Exchange Act of 1934, as amended, requires such unlisted issuers to file a *registration statement* with the Commission,

*This article is the third in a series by the author dealing with the Montana and federal securities acts. See Newton, *A Look at the Montana Securities Act*, 26 MONT. L. REV. 31 (1964); and Newton, *Problems in General Practice Under the Federal Securities Act*, 18 MONT. L. REV. 33 (1956).

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¹The Securities Act of 1933 § 3(a) (11), 48 Stat. 74, as amended, 15 U.S.C. § 77c(a)11 (1964) provides:

Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities: . . . 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.

²48 Stat. 74, as amended, 15 U.S.C. § 77 (1964), sometimes referred to as the Federal Blue Sky Law.

³The Securities Exchange Act of 1934 § 12, 48 Stat. 892, as amended, 15 U.S.C. § 781(g)1 (1964) provides that the Act will apply to an issuer having total assets exceeding \$1,000,000 and a class of equity security (other than an exempted security) held of record after July 1, 1964 by 750 persons, or 500 persons after July 1, 1966.

As defined by the Commission, 30 Fed. Reg. 6114, 17 C.F.R. § 240.3a11-1 (1964) an "equity security" includes all securities in which there is an equity interest:

The term "equity security" is hereby defined to include any stock or similar security, certificate of interest or participation in any profit sharing agreement, preorganization certificate or subscription, transferable share, voting trust certificate or certificate of deposit for an equity security, limited partnership interest, interest in a joint venture, or certificate of interest in a business trust; or any security convertible, with or without consideration into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right.

⁴The Securities Act of 1933, *supra* note 2, requires disclosure of certain information in connection with the distribution of securities to the public by the issuer and control persons, unless exempt; whereas, the Securities Exchange Act of 1934, *supra* note 3,

registering each class of non-exempt "equity securities"⁵ held of record by a specified number of persons.⁶ The registration statement, which resembles the application for registration or listing on a national securities exchange, must be filed with the Commission within 120 days after the end of the first fiscal year during which the issuer qualifies with respect to assets and record holders of a class of equity securities.⁷ Such registration subjects the issuer to the same obligations as those imposed upon issuers having securities listed on a national exchange.⁸

Prior to the amendments of 1964, "registration" with the Securities and Exchange Commission, as applied to any unlisted company,⁹ could only mean compliance with the registration provisions of the Securities Act of 1933 in connection with a proposed public offering.¹⁰ Under the Securities Acts Amendments of 1964, "registration" by an unlisted company with the Commission can now also mean compliance with the registration provisions of the Securities Exchange Act of 1934. The terminology "registration" by the filing of a "registration statement" with the Commission, being applicable to compliance with both Acts, can be confusing. However, irrespective of the similar nomenclature and compliance procedures, they are separate and distinct. One does not suffice for the other.

regulates the trading in securities by members of the public and seeks to have available to them information for their use in determining whether to buy, sell, or hold. Prior to 1964, such regulation under the Securities Exchange Act of 1934 was generally applicable only to issuers having securities listed on a national securities exchange.

"Security" has been given a broad interpretation under the federal Acts. Many devices not commonly regarded as securities are included: e.g., evidence of indebtedness, certificates of interest or participation in profit sharing plans, and investment contracts. See further Newton, *A Look at the Montana Securities Act, and its Relation to the Federal Securities Act*, 26 MONT. L. REV. 31, 35-38 (1964).

A "control person" is defined as "any person controlling, controlled by, or under common control with the issuer of securities," 17 C.F.R. § 230.154 (1964). 17 C.F.R. § 240.12b-2f (1964) defines the term "control" (including the terms "controlling," "controlled by" and "under common control with") to mean "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

⁵Defined *supra* note 3.

⁶750 or more at a fiscal year ending after July 1, 1964, and 500 or more at a fiscal year ending after July 1, 1966.

⁷15 U.S.C. § 78 1(g)1 (1964). This statement becomes effective sixty days after filing.

⁸The issuer is required to file current and annual reports pursuant to the Securities Exchange Act of 1934 § 13, 48 Stat. 894, 15 U.S.C. § 78m (1964), and comply with the proxy and other rules adopted by the Commission pursuant to § 14 of that Act, 15 U.S.C. § 78n. In addition, officers, directors, and persons beneficially owning, directly or indirectly, more than 10% of a class of registered equity security of the issuer are required to file ownership reports with the Commission of the amount of each class of the issuer's equity securities which are beneficially owned, and any changes in ownership, pursuant to § 16(a) of the Act, 15 U.S.C. 78p(a). Such persons also become subject to the so-called "insider trading restrictions" provided by §§ 16(b) and (c) of the Act, 15 U.S.C. 78p(b) and (c).

⁹Also referred to as "over-the-counter" companies.

¹⁰The mechanics of filing under the federal Act are outlined by Newton, *supra* note 4,

What Is a 12(g) Company?

The definition of a "12(g)" unlisted company¹¹ is quite inclusive. The asset test, which requires "total assets of one million dollars" has been interpreted to mean *gross* total assets.¹² A company which might not be regarded as particularly substantial, or even an insolvent company, might be held to qualify under this interpretation. Accounting problems involving methods of evaluation of assets can well be expected. Even though gross total assets may be reduced to less than one million dollars at some time subsequent to registration, this alone will not permit the registration to be terminated.¹³

The "holders of record" test is also very broad.¹⁴ Limiting the number of purchasers can be onerous, but limiting the number of holders of record can be impossible. A company must meet this test on the last day of every succeeding fiscal year. Having once avoided registration the company is not thereby relieved of further responsibility. When the requisite number of holders of record of a class of equity security is reduced from 750 to 500 on July 1, 1966,¹⁵ the situation of a borderline company will become ever more precarious.

Pre-Amendment Advantages of Filing Under Regulation A for Small Offerings

Even prior to the 1964 Amendments, companies making public offerings of less than \$300,000 in any twelve month period were wise to comply with the Federal Securities Act rather than to rely on the intrastate exemption. The small offering exemption from registration, Regulation A, has been available to these companies.¹⁶ Compliance with this exemptive regulation is expeditious and inexpensive: the filing is made and the processing handled in a nearby regional office; and certified financial statements are not required. Under Montana law, filing with the Securities and Exchange Commission under Regulation A, subject to the veto of the Montana Investment Commissioner, constitutes compliance with the state law.¹⁷

¹¹An issuer which falls within § 12(g) of the Securities Exchange Act of 1934, as amended, 15 U.S.C. 78 l(g) (1964), is frequently referred to as a "12(g) company."

¹²30 Fed. Reg. 483, 17 C.F.R. § 240.12g5-2 (1964), provides:

For the purpose of section 12(g)(1) of the Act, the term "total assets" shall mean the total assets as shown on the issuer's balance sheet or the balance sheet of the issuer and its subsidiaries consolidated, whichever is larger, as required to be filed on the form prescribed for registration under this section and prepared in accordance with the pertinent provisions of Regulation S-X.

¹³Contrary to the asset test, registration can be effected by future diminution of holders of record. Termination of registration may be effected when the number falls below 300, upon certification of this fact to the Commission. However, termination is not automatic, 15 U.S.C. § 78 l(g)4.

¹⁴See 30 Fed. Reg. 483, 17 C.F.R. § 240.12g5-1 (1964).

¹⁵See *supra* note 4.

¹⁶For an outline of the filing procedure under "Regulation A", 17 C.F.R. § 230.251, see Newton, *supra* note 4, at 49-50.

¹⁷Securities Act of Montana, REVISED CODES OF MONTANA, 1947, § 15-2009 (Supp. (1965)) (REVISOR: CODES OF MONTANA are hereinafter cited R.C.M.)

For public offerings in excess of \$300,000 the Regulation A exemption is not applicable, and registration with the Commission's office in Washington, D. C., is necessary unless the intrastate exemption is available.¹⁸ All too frequently issuers have inadvisedly attempted to utilize the intrastate exemption rather than register with the Commission.

REQUISITES OF COMPLIANCE

Accounting Information Required

One of the common deterrents to registration under the Federal Act by a company contemplating a large offering to the public has been the furnishing of the required financial statements.¹⁹ Only financial information certified by an independent accountant is acceptable. Thus, re-auditing of prior years' transactions is frequently required by the lack of independence of the accountant who has in the past handled the company's accounting work.²⁰ This situation has the immediate appearance of expensive repetition, to be avoided if possible even though avoidance may require the assumption of the risks involved in relying on the intrastate exemption.

Even if this method of avoiding the disadvantages of registration was justifiable before, certainly the Amendments of 1964 render such rationale unsound. By the time an offering of more than \$300,000 is completed, or shortly thereafter, the company making the offering may reasonably be expected to have *gross* total assets of one million dollars and a class of equity securities held of record by 750 (or 500) persons. It will then be required to register under Section 12(g) of the Securities Exchange Act of 1934. This entails furnishing practically the same certified financial statements required by a registration of the offering under the Securities Act of 1933.²¹ The company thus becomes subject to substantially the same financial reporting requirements it earlier sought to avoid by assuming the limitations and risks incident to an offering under the intrastate exemption.

¹⁸See *supra* note 1.

¹⁹The requirements include profit and loss statements for each of the three fiscal years preceding the date of the latest balance sheet and for the period, if any, between the close of the latest fiscal year and the date of the latest balance sheet filed. The statements must be certified up to date of the latest certified balance sheet filed. Regulation S-X, 17 C.F.R. § 210.1-01 (1964).

²⁰17 C.F.R. § 210.2-01(b) and (c) (1964) state:

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents or subsidiaries in whom he has, or had during the period of report, any direct financial interest or any material indirect financial interest; or with whom he is, or was during such period, connected as promoter, underwriter, voting trustee, director, officer, or employee.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

²¹Compare the information required by form 10, 17 C.F.R. § 249.210 (1964) for registering under § 12(g) of the Securities Exchange Act of 1934 with form S-1, 17 C.F.R. § 239.111 (1964), for registering under the Securities Act of 1933.

If the company probably will not become a "12(g) company" for several years, it may seem advantageous to defer furnishing certified financial statements until that time. However, any benefit of deferring certified "financials" by avoiding registration under the Securities Act of 1933 could be negated by the requirement that a "12(g) company" file certified financial statements for the preceding *three* years. With a background of statements certified by an accountant not deemed independent, compliance with this requirement could be costly.

Other Information Required

The expense of furnishing certified financial statements is not the only deterrent to registration under the federal Securities Act. The filing of a registration statement under either the 1933 or 1934 Act can seem forbidding. However, assuming such apprehension to be warranted, avoidance of registration may be but an instance of inadvisedly postponing the inevitable. Any benefits incident to delaying registration are more than offset by the benefit of compliance with the state securities law through the summary procedure of registration by coordination.²² Although modern state Blue Sky Laws have eliminated the need to provide unimportant and unduly burdensome information, compliance with the registration by qualification procedure does involve considerable time and expense which is avoided through registration by coordination.²³

Registration under the Securities Act of 1933 is comparable to registration under the Securities Exchange Act of 1934 which is required by the 1964 Amendments for "12(g) companies."²⁴ The type and scope of information required, including accounting information, is in most respects identical. Since the purpose of both Acts is the same—disclosure for the benefit of the investing public—the information deemed adequate will likewise be comparable.²⁵

HAZARDS OF THE INTRASTATE EXEMPTION

In examining the use of the intrastate exemption in the light of the Securities Acts Amendments of 1964, it is also well to consider some of the more practical limitations and risks which might not be readily apparent.²⁶ The requirements of this exemption are strictly construed against the issuer.²⁷ A sale to a single non-resident can have the effect of rendering the exemption unavailable not only for future sales, but also

²²Exemplified by § 9 of the Securities Act of Montana, R.C.M. 1947, § 15-2009 (Supp. 1965).

²³Exemplified by R.C.M. 1947, § 15-2010 (Supp. 1965).

²⁴See *supra* note 21.

²⁵See Newton, *supra* note 4, at 31.

²⁶The issuer who wishes to claim the intrastate exemption has the burden of proving that he is entitled to it. SEC v. Ralston Purina Co., 346 U.S. 119 (1953); SEC v. Sunbeam Gold Mines Co., 95 F.2d 699, 701 (9th Cir. 1938); Gilligan, Will and Co. v. SEC, 267 F.2d 461, 466 (2d Cir. 1959).

²⁷Hunt v. SEC, 158 F.2d 981 (9th Cir. 1947); Hillsborough Investment Corp. v. SEC, 276 F.2d 665 (1st Cir. 1960).

for previous sales made in reliance upon it.²⁸ Thus a *retroactive* contingent liability can result.²⁹ Immediate termination of the offering may prevent future violative sales. This, unfortunately, will not by any *nunc pro tunc* effect eradicate, or even mitigate, the contingent liability resulting from those sales already made in reliance upon the intrastate exemption.

The undesirable and costly effect of any preemptory termination of an offering is obvious. A less obvious hazard is that since the sale of the entire *issue* must be so restricted, a different issue must be available for sale before the same financing program may be renewed. If the plan of financing is to continue unchanged, another issue³⁰ will usually require another class of securities.³¹ In the case of a company having a single class corporate structure, this may necessitate amendment of the articles of incorporation. The possible time lag makes such a procedure hardly feasible in the midst of a selling campaign.

No company can use the intrastate exemption with absolute certainty of its continued availability. There is always the danger of inadvertent violations of the registration requirements creating contingent liability.³² Although the statute of limitations restricts liability to a period of one year from the day of sale,³³ sizeable amounts can be involved through sales made during that year. The company may feel assured that no purchaser would seek such relief; but it could not reasonably expect a financial institution from which the company may seek credit to feel so assured of the company's immunity. Such an institution would probably be constrained to defer granting credit until one year from the last sale made in reliance on the intrastate exemption, unless the company's financial position could accommodate as a liability an amount equal to all sales of the preceding year. This would be difficult for any company, particularly a new one.

Since the "residence" requirement of the intrastate exemption has been held to mean "domicile,"³⁴ sales would be very difficult to control in

²⁸This is now and has been for some time past the position of the Securities and Exchange Commission. See Opinion of the General Counsel of the Commission, May, 1937; Brief for Plaintiff, pp. 3, 10, SEC v. Capital Funds, Inc., Civil No. A-46-60, D. Alaska, Sept. 29, 1960. This has been construed by a federal court of appeals, in *Hillsborough Investment Corp. v. SEC*, *supra* note 29, at 668, to represent the intent of Congress:

Under the statutory scheme as construed, an entire issue must be sold only to residents or the exemption is lost. . . . An issuer that has lost the exemption as to one issue of securities by a non-resident sale, does not have the opportunity to regain the legal use of interstate facilities or the mails by halting the non-resident sales and confining itself to sales to residents.

²⁹A discussion of the express and implied civil liabilities under both federal and state Acts may be found in Newton, *supra* note 4, at 50-52.

³⁰See 1 LOSS, SECURITIES REGULATION 77-78, 591-95 (2d ed. 1961), for a discussion of the meaning of "issue."

³¹This definition of "class" is included in the Securities Exchange Act of 1934 § 12, 48 Stat. 893, as amended, 15 U.S.C. § 78 l(g)(5) (1964): "For the purposes of this subsection the term 'class' shall include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges." For a discussion of the meaning of "class" see *Ellerin v. Mass. Mutual Life Insurance Co.*, 270 F.2d 259 (2d Cir. 1959).

³²Securities Act of 1933 § 12(1), 48 Stat. 84, as amended, 15 U.S.C. § 77 l(1) (1964).

³³Securities Act of 1933 § 13, 48 Stat. 84, as amended, 15 U.S.C. § 77m (1964).

³⁴*Domicile* may be defined as a residence at a place accompanied by an intention

those states where members of the military services are sufficiently numerous to provide a tempting, enthusiastic group of prospective investors.³⁵ The risk of violation is equally great in affluent areas adjacent to a state border, particularly if the offering has more than local appeal. Situations of this nature require that personnel in the sales organization of companies relying on the intrastate exemption be limited to individuals on whom the issuer can with confidence rely, or whose activities it can with certainty supervise. Salesmen whose only interest is in their commissions can render a company extremely vulnerable.³⁶

CONCLUSION

For companies in Montana and states having comparable securities laws, use of the intrastate exemption to avoid registration under the federal Acts would not appear to justify the restrictions and risks involved. If the offering is less than \$300,000, exemptive Regulation A, together with the coordination procedure provided under such state laws, allows compliance with both the federal and the state laws. If the offering is more than \$300,000, registration under the Securities Act of 1933 will facilitate future registration under the Securities Exchange Act of 1934 when the issuer becomes a "12(g) company."

to remain there indefinitely. For the purposes of the intrastate exemption the Commission construes "residence" to mean "domicile." See Brief for Plaintiff, p. 4, *SEC v. Capital Funds, Inc.*, *supra* note 28. This position has been concurred in by Congress: "Thus the exemption provided by this section of the Act [Section 3(a)(11)] has not been considered available unless the entire issue of securities was offered and sold exclusively to persons domiciled in the one state." H.R. Rep. No. 1542, 83d Cong., 2d Sess. 2 (1954). In *SEC v. Capital Funds, Inc.*, *supra* note 28, a decree of permanent injunction was entered by consent in the District Court of Alaska, where the defendants had claimed an exemption under § 3(a)(11) for sales to servicemen stationed in Alaska.

³⁵In *Seegers v. Strzempek*, 149 F. Supp. 35, 36 (E.D. Mich. 1964) the court said, "A citizen of a state does not change his citizenship by entering military service even though he is assigned to duties in another state or country, and regardless of the term of service, unless he indicates an intent to abandon such original domicile and adopt a new one."

³⁶Whether or not the exemption is construed to make the issuer an "absolute insurer" of the domicile of every offeree, the use of subscription blanks warranting the "bona fide" residence (or domicile) of the buyer is, without more, inadequate to assure availability of the exemption. In *Godinez v. Jones*, 179 F. Supp. 135 (D. P.R. 1959), a formal declaration filed with the Commissioner of Motor Vehicles of Virginia that the declarant intended to make his permanent home in Virginia was held not to be conclusive of intent to establish domicile. Similarly, in *Wise v. Bolster*, 31 F. Supp. 856, 859 (W.D. Wash. 1939), the court held that statements by a member of the military services in marriage and auto license applications that he was resident of the state were not sufficient to establish domicile.

