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BOOK REVIEW

EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933.† By J. William Hicks. New York: Clark Boardman Company, Ltd., 1979. Pp. xxvi, 792. $60.00

MORGAN SHIPMAN*

This excellent book is a part of the Securities Law Series published by the Clark Boardman Company. The author, a professor at the Indiana University School of Law in Bloomington, covers most of the transactional exemptions from registration under the Securities Act of 1933. Included are recapitalizations under section 3(a)(9), reorganizations with court or agency approval under section 3(a)(10), intrastate offerings under section 3(a)(11) and most of the small issues exemptions under section 3(b) (*e.g.*, Regulation A). This book excludes exempted securities, such as those issued by banks, and also does not cover the private offering transaction exemption of section 4(2), which is the subject matter of another volume.

The author designed the book "both for practitioners and students."[1] Also, the book is in sufficient depth to be of great value to the scholar. In addition to reporting the "is" of the exemptions in detail, the author compares extensively the various exemptions for numerous transactions, including a number of sophisticated ones, examines uncertainties and probes the policy considerations at length.

Several of the author's techniques make this work a solid, valuable practice and learning aid. First, the author widely cites and discusses the relevant no-action and interpretive letters issued during the last

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† [Eds. Note] This book is the first of three promised volumes by Professor Hicks dealing with the Securities Act of 1933. All three volumes will be included in the Securities Law Series published by the Clark Boardman Company. The second volume (to be numbered 7A in the Series), part of which initially appears as a supplement to this volume (number 7), will include Regulation B (fractional undivided interests in oil or gas rights), Rule 237 (resale of restricted securities by nonaffiliates), Rules 240 & 242 (small business exemptions), miscellaneous exemptions covered by §§ 3(b) & 3(c) and the exemption under § 4(1) and Rule 144. The third volume (to be numbered 7B) will cover the exemptions allowed under § 4(2) (private placement), § 4(3) (broker-dealer transactions), § 4(4) (broker transactions based on customers' orders), § 4(5) (real estate mortgages) and § 4(6) (offers to accredited investors).

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[1] 7 J. HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933 X-XI (1979).

decade. Induction is nicely used to order and analyze this mass of informal lawmaking, which is a formidable, invaluable undertaking. Second, the author appreciates the significance of the arcane theology often used by the courts and the SEC in applying the exemptions and clearly identifies the resulting traps for the unwary. Third, he states and analyzes the policy issues surrounding each exemption. Last, the constant comparison of the various exemptions and the discussion of the exemptions as they apply to both sophisticated and everyday transactions keep large portions of the book quite concrete and specific.

The usefulness of the volume is enhanced by a detailed table of contents at the beginning of each chapter and the liberal use of captions and subcaptions. The tables of contents quickly reveal the author's organization and coverage. In each chapter, furthermore, extensive introductions immediately record all major considerations and questions, such as the constantly troubling concept of integration. The continual citation to primary and secondary authorities provides a guide for the reader wishing to do further research.

The policy discussions are pragmatic enough to guide the practitioner and sufficiently in depth, both theoretically and historically, to aid significantly a scholar, legislator or staff official considering proposed legislation or regulations. By wisely refusing to dilute the policy material, the author has greatly increased the value of the work for everyone. The exemptions contain many more nice questions and counterintuitive results than the antifraud or registration provisions. Overlooking a legal trap is a constant hazard in attempting to structure an exempted transaction.

The book largely shares the prevailing judicial and SEC bias, which construes exemptions narrowly and declares them unavailable unless the claimant clearly demonstrates total compliance in all respects. The SEC especially feels that true absolution comes only by the registration statement. For example, under the SEC's Rule 147, a single offer outside its scope will destroy the whole of an otherwise qualifying section 3(a)(11) intrastate offering.[2] For the practitioner and the student, the author performs a valuable service by constantly emphasizing this prevailing Old Testament view of exemptions. Careful advance battle plans and documentation are needed if an exemption is challenged in court: the claimant of the exemption must prove that all the books were kissed in just the right way.[3] That is the current law, and lawyers should be alerted.

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[2] Under Rule 147, 17 C.F.R. § 230.147 (1979), all conditions must be met, and Rule 147(d) requires that all offers and sales that are part of the issue must be made to persons resident within the state.

[3] *See, e.g.*, Lively v. Hirschfeld, 440 F.2d 631, 633 (10th Cir. 1971) (evidence by claimant of an exemption must be "explicit, exact, and not built on conclusionary statements of the defendants").

By standards of macropolicy, however, this reviewer believes current legislative, judicial and SEC attitudes are significantly wrong. The present strict construction of exemptions presupposes that exemptions are antagonistic to the legislature's design in enacting a remedial statute such as the Securities Act of 1933. It is submitted, however, that the opposite is true. A reasonable legislator realizes that application of any statute often imposes more costs than benefits and that the size of the administrative agency can be kept within desirable bounds only if the statute does not attempt to monitor the flight of every sparrow in every forest. Exemptions keep the statute in balance and in bounds. The restrictive application of exemptions thus is as contrary to the purposes of remedial legislation as a restrictive application of the coverage provisions.

A restrictive application of exemptions is especially indefensible in securities registration statutes such as the Securities Act of 1933, which invariably impose highly disproportionate penalties for a proscribed failure to register. These statutes' antifraud provisions, which apply both to offerings required to be registered and those exempted from registration, usually supply a remedy for material informational deficiencies that actually cause injury. On the other hand, the statutory rescission rights flowing from loss of an exemption do not require injury caused by the failure to register; rescission rights are created simply by the plaintiff's proof of no registration statement coupled with the defendant's failure to prove total compliance with an exemption.[4]

Now that the antifraud remedies in securities statutes have attained so much notice and force,[5] legislators, courts and administrators such as the SEC should take several steps toward the correct application of exemptions. First, although there is nothing wrong with placing the burden of proof on the claimant of the exemption, who is close to the totality of the facts rather than the plaintiff, the burden of proof should be the usual preponderance of the evidence standard[6] and the legal construction of exemptions should be neutral, rather than restrictive or expansive. This canon of construction has recently been applied by the

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[4] This statement is slightly oversimplified. There is, of course, always a statute of limitations. Moreover, proof of use of the mails or means of interstate or foreign commerce is required under § 12(1) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2) (1976).

In addition, defenses such as estoppel may be available where the plaintiff's conduct is egregious, although the courts have been highly reluctant to allow such defenses. *See, e.g.*, Lawler v. Gilliam, 569 F.2d 1283 (4th Cir. 1978).

[5] The antifraud provisions have "steadily built up a coral reef of law for the protection of the individual investor and the minority shareholder." Manning, *Thinking Straight About Corporate Law Reform*, in CORPORATIONS AT THE CROSSROADS 25 (D. DeMott ed. 1980).

[6] The present burden is significantly more demanding than the usual preponderance of the evidence standard. *See* note 3 *supra*.

Supreme Court, with reference to the antifraud provisions, in its decision in *Aaron v. SEC.*[7] There, the Court held that invocation of the remedial purposes doctrine does not justify reading an antifraud provision "more broadly than its language and statutory purpose reasonably permit."[8] A similarly neutral canon should be applied to exemptions.

Second, a claimant reasonably believing, after reasonable investigation, that he has complied with an exemption should always be entitled to the exemption. Denying the exemption in those circumstances is a grossly disproportionate penalty and is completely unnecessary for the enforcement of registration requirements. As an example, consider the transaction meeting Rule 147's requirement for an intrastate offering with the exception that one offeree is a resident of another state. Under Rule 147, the whole offering fails to qualify for the exemption. If the offeror at the time of the offer reasonably believed, after reasonable investigation, that all offerees were residents, the whole offering should be exempt. In Rule 146, a private offering exemption, the SEC has adopted this approach in part. Under that rule, a person reasonably believing, after reasonable investigation, that the number of purchasers does not exceed the stated maximum is protected even if the number is in fact greater.[9]

Third, substantial compliance in good faith with an exemption should be deemed total compliance. Again, one who tries to comply and does substantially comply with an exemption should not be penalized, for the registration scheme is not materially diluted by treating such a person as in compliance. By definition, the deviation is immaterial and in good faith. Yet the SEC's rules establish multiple, detailed conditions for exemptions and decree full compliance with all conditions.[10] The common law's traditional tolerances should be retained in statutes and regulations.[11]

Fourth, the integration doctrine should be greatly curbed. It is often a loose canon contributing little to statutory purposes and yet producing great uncertainty. The usual SEC tests for integration depend upon so

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[7] 100 S. Ct. 1945 (1980).

[8] *Id.* at 1955.

[9] Rule 146(g)(1), 17 C.F.R. § 230.146(g)(1) (1979).

[10] *See, e.g.*, Rule 147, 17 C.F.R. § 230.147 (1979).

[11] There is no necessary antagonism between the common law on one hand and legislation and rules on the other hand. The lessons and precedent in one area may be quite transferable to the other. In Morgane v. States Marine Lines, 398 U.S. 375 (1970), the Court held that, in creating common law, statutory patterns are proper points of precedent to consider. The converse is also true. The best wisdom of the common law, which is created after years of case-by-case experience, should be written into statutes and regulations, and, where not inconsistent with the provisions of the statutes and regulations, should be applied by the courts in construing them. The tolerances of the common law, such as for substantial performance, are special candidates for this treatment.

many surrounding circumstances that it is usually impossible to give definite advice.[12] The integration doctrine produces almost as much mischief as the now departed "fungibility" doctrine once did.[13] At times, the SEC has clearly and effectively staked out the boundaries of integration.[14] Silly questions remain, however, even in everyday transactions under Rule 240, the $100,000 tiny issue exemption.[15] State

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[12] Preliminary note 3 to Rule 147, 17 C.F.R. § 230.147 (1979), states that the determination of what offers and sales are part of the same "issue" of securities "will continue to be a question of fact and will depend on the particular circumstances." The note further states:

> any one or more of the following factors may be determinative:
>
> (i) Are the offerings part of a single plan of financing;
>
> (ii) Do the offerings involve issuance of the same class of securities;
>
> (iii) Are the offerings made at or about the same time;
>
> (iv) Is the same type of consideration to be received; and
>
> (v) Are the offerings made for the same general purpose.

Rule 147(b)(2) provides a highly limited safe harbor concerning integration. Registered offerings and offerings under § 3 or § 4(2) of the Act taking place more than six months earlier than or later than the intrastate offering are specifically excluded from integration. This dispensation, however, applies only if during both of the six month periods there are *no* offers or sales of securities of the same or similar class.

[13] For a discussion of the mischief resulting from the fungibility doctrine, see W. JENNINGS & H. MARSH, CASES AND MATERIALS ON SECURITIES REGULATION 398-407 (4th ed. 1977). In Rule 144, 17 C.F.R. § 230.144 (1979), adopted in Securities Act Release No. 5223 (Jan. 11, 1972), the SEC abandoned the fungibility doctrine.

[14] Rule 152, 17 C.F.R. § 230.152 (1979) states:

> The phrase "transactions by an issuer not involving any public offering" in section 4(2) . . . shall be deemed to apply to transactions not involving any public offering at the time of said transactions although subsequently thereto the issuer decides to make a public offering and/or files a registration statement.

This anti-integration standard sacrifices little or nothing in the way of statutory protection and yet provides considerable certainty.

[15] In many ways, Rule 240, a limited public offering exemption, deals effectively with integration problems. 17 C.F.R. § 230.240 (1979). The $100,000 exemption is a 12 month rolling figure, and registered sales are excluded in calculating the $100,000. Furthermore, many securities (*e.g.*, securities sold to promoters) issued under other exemptions are excluded from the $100,000. Thus, for example, a valid private offering to promoters of $120,000 of securities followed by a public sale of $100,000 of securities would be within the dollar limitation. This formula, however, does not cure the integration problem. If the sale to the promoters is integrated with the sale to the public, the sale to the promoters is no longer a valid § 4(2) private offering, causing the sale to the promoters to be counted in computing the $100,000 and the sale to the public to fail to qualify under Rule 240. There appears to be no answer to this pivotal issue of whether sales to promoters are integrated. *See* W. JENNINGS & H. MARSH, *supra* note 13, at 546 & nn.1 & 2. Such a core question should have been dealt with in Rule 240 and integration should have been proscribed. The promoters can fend for themselves. The sale to the public should be excluded from the determination of whether the sale to promoters is a valid private offering even when the two occur simultaneously. The $100,000 amount in Rule 240 should be computed without reference to sales to promoters.

statutes handle integration more satisfactorily. For example, the institutional investor exemption commonly states that a sale (a term used in this discussion to include an offer) to an institutional investor is exempt, a form of drafting that seemingly will exempt such a sale even if other sales not so qualifying are "integrated" into the same "issue" or "offering."[16] This is proper. An institutional investor exemption presupposes that the purchaser can fend for itself, and even if sales to persons who are not institutional investors could be "integrated" with the sales to the institutional investors, the latter sales should remain exempt.[17] The result would differ under the private offering exemption of the Securities Act of 1933 because of the "offering" concept. On the other hand, the state drafting technique of referring to a "sale" rather than an "offering" or an "issue" seemingly saves the sales to institutional investors. Moreover, the recently enacted Ohio limited sales exemption expressly precludes integration of registered sales or sales under other exemptions in determining whether the stated number of sales has been exceeded.[18] Because businesses continually issue securities, the legislator, draftsman or administrator constructing an exemption must first concentrate on the policy question of how the exemption should be affected by registered sales and by sales under other exemptions. Frequently the conclusion will be that a nearby or related registered distribution or sale under another exemption should not be integrated. Thus, careful drafting to exclude the free spirit of the general integration doctrine is essential.[19] Two of the most significant factors in determining the usefulness of an exemption are the thought given by the draftsmen in deciding the optimal application of the integration doctrine and the care taken in firmly caging the doctrine.

Last, several states' securities registration statutes expressly allow late curative registrations, in the discretion of the administrator, where the failure to timely register has not damaged anyone.[20] Such curative

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[16] For example, the Ohio Securities Act states that a "sale to the issuer, to a dealer, or to an institutional investor is exempt." OHIO REV. CODE ANN. § 1707.03(D) (Page Supp. 1979). The term "institutional investor" is defined in the Act. *Id.* § 1707.01(S). A similar transaction exemption is found in § 402(b)(8) of the Uniform Securities Act.

[17] If the seller is relying on another exemption for the sales to the purchasers who are not institutional investors, the general integration of the sales to institutional investors may cause loss of the other, apparent exemption for the noninstitutional investors (*e.g.*, a numbers limitation may be exceeded).

[18] OHIO REV. CODE ANN. § 1707.03(O) (Page Supp. 1979).

[19] The closely related problem of the "come-to-rest" doctrine is not included in this discussion of integration. Some subsequent re-offerings by initial purchasers may have to be included in determining whether the "sale," "issue" or "offering," as it finally unfolds, meets the test. "Come-to-rest" is not, at this time, nearly so serious a problem as integration. Restrictive legends are commonly used and Rule 144, 17 C.F.R. § 230.144 (1979) provides clear, workable tests for applying "come-to-rest" in many situations.

[20] *See, e.g.*, OHIO REV. CODE ANN. § 1707.39 (Page Supp. 1979). The usual *registration* fee plus $100 is payable, even if timely compliance with the exemption would have cost

provisions should always be added by legislators. The curative provisions encourage the prompt, formal correction of erroneous reliance upon an exemption when the error is discovered, and also preserve the administrator's power to deal adequately with the intentional violator and the violator who causes injury by failure to register as required by the statute.

This book contains little of this type of analysis, much of which is admittedly heretical, concerning the proper application of exemptions and the optimal sanctions for various types of failure to meet an exemption. In the 1980's, when the first order of public business should be sound deregulation, such an omission is significant. Nevertheless, the book is both useful and of high quality; it should definitely be in the working library of every securities lawyer, scholar and administrator.

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nothing or cost less than registration. And, of course, the administrator can require a full registration statement even if the exemption requires no disclosure material.