SPEECH GIVEN BEFORE CHICAGO ASSOCIATION OF CORPORATE ATTORNEYS BY JOHN I. MAYER
on January 25, 1960 at the Palmer House
Chicago, Illinois

I appreciate the invitation extended to me by your president, John Woods, to speak to you this evening and I certainly deem it a distinct pleasure and privilege to be permitted to join you at your meeting. It is necessary, however, to advise you that the Commission, as a matter of policy, disclaims responsibility for any private publication of any of its employees. The remarks I shall make here reflect my own thoughts. They do not necessarily represent the view of the Commission or of my colleagues on the staff of the Commission.

John has asked me to discuss some of the current developments involving SEC laws and regulatinns in somewhat the same way I employed at the Briefing Conference on our laws sponsored by the Federal Bar Association and the Bureau of National Affairs last year, at which some of you were in attendance. Actually, the matters I believe your group would consider most appropriate are not all current in the sense that they are of recent origin, but they are at least recurrent, being old laws or regulations with new aspects or problems arising from time to time and requiring fresh consideration periodically.

One of the most important matters which requires redusting and reconsideration at various times is that arising under the second clause of Section 4(1) of the Securities Act of 1933 which affords an exemption for transactions by an issuer not involving a public offering. For various reasons, including issuance of securities by your companies pursuant to employee stock purchase plans or financing through placement of securities in purported private offerings, this exemption would seem to warrant reconsideration and review by your group in a discussion of this type.

As several of you have discovered in consideration of this problem with us from time to time, the question whether a public offering is involved in a specific case is not always easy to answer. It is essentially a question of fact in the resolution of which all the surrounding circumstances must be considered.

Neither the number or class of persons to whom the offering is made, nor the number who actually purchase the securities can alone form the basis for the answer. In definitive terms the Supreme Court has stated that the number to whom the offering is made is not necessarily determinative. In fact, the Court pointed out that an offering to a limited number could be a public offering. However, where the offerees constitute a class of persons who are intimately familiar with, and have substantial knowledge of, the business and condition of the issuer it is more likely not to involve a public offering than one made to persons having no special knowledge in this regard. In S.E.C. v. Ralston-Purina Co., 346 U.S. 119 (1953), the Supreme Court indicated that the test should

be whether the offerees need the protection of the Act. The Court stated that "an offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering'"; that the "exemption question turns on the knowledge of the offerees..."; and that "The focus of inquiry should be on the need of the offerees for the protection afforded by registration." In short, the Ralston-Purina decision requires the conclusion that the exemption is limited to offerings to persons who are in a position to have such knowledge of the business and affairs of the issuer as would be substantially comparable to that which would be provided by a registration statement.

In determining whether a specific issue has available to it, the private offering exemption, other factors to be considered are the scope of the offering and the number of shares or units offered. Where, as often happens, a large corporation will place a substantial issue of debt securities with a relatively small number of institutional investors, such placements can be effected ordinarily within the limitations of the exemption of Section 4(1) because such institutions have the ability to insist upon and to receive, and the expertise to understand and appreciate information even more extensive than that usually contained in a prospectus and to negotiate the transaction on equal terms.

On the other hand, where a large issue of stock is placed with a relatively small group under circumstances indicating probable reoffering and resale, in whole or in part, to a much larger group, the unavailability of the exemption under Section 4(1) is strongly indicated. In such a case where the stock is reoffered and resold, the original purchasers would be underwriters within the definition contained in Section 2(11) of the Act because they would have, within the terms of the section, "purchased from an issuer with a view to....the distribution of" the securities, and, therefore, the private offering exemption would not be available for the issuer. To meet this problem, an issuer will sometimes require the purchasers in a private offering to furnish a written representation that they are taking the securities for investment and not for the purpose of distribution; but the mere fact that the issuer procures an investment intent. However, since this approach highlights the necessity of investment intent on the part of the purchaser, it constitutes a salutary precaution for both parties to the transaction. This matter of investment intent was considered carefully by the Commission in the Crowell-Collier Opinion (S.Act Release No. 3825) and its language on the point warrants repetition. The Commission said:

"Counsel, issuers and underwriters who rely on investment representations of the character obtained in these transactions as a basis for a claim to a non-public offering exemption under Section 4(1) of the Securities Act do so at their peril. It is apparent that most of the persons giving the so-called "investment representation" in this case had no clear understanding as to what it meant. The representations apparently did not reveal the real intent of the persons giving them. The persons purporting to rely upon them did not know what the person giving the representation intended. Such bare representations that securities are being purchased for "investment", obscure in their meaning and unreliable as to the intention and purpose of a purchaser, are meaningless. An exemption under the

provisions of Section 4(1) is available only when the transactions do not involve a public offering and is not gained by the formality of obtaining 'investment representations.' Holding for the six months' capital gains period of the tax statutes, holding in an 'investment account' rather than a 'trading account,' holding for a deferred sale, holding for a market rise, holding for sale if the market does not rise, or holding for a year, does not afford a statutory basis for an exemption and therefore does not provide an adequate basis on which counsel may give opinions or businessmen rely in selling securities without registration."

The importance of this element of intent to hold for investment cannot be overemphasized in connection with private offering under Section 4(1).

Another section that is old, yet ever new in its problems is Section 3(a)(11) which provides an exemption from registration for "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, incorpoated by and doing business within, such State or Territory." The legislative history and interpretation of the Securities Act clearly show that this exemption was designed to apply only to issues which in reality represent local financing by local industries carried out through local purchasing.

Moreover, since the exemption is designed to cover only those security distributions, which, as a whole, are essentially local in character, it is clear that the phrase "sold only to persons resident" as used in Section 3(a)(11) cannot refer merely to the initial sales by the issuing corporation to its underwriters, or even the subsequent re-sales by the underwriters to distributing dealers. To give effect to the fundamental purpose of the exemption, it is necessary to take the view that if the exemption is to be availabe, "it is clearly required that the securities at the time of completion of ultimate distribution shall be found only in the hands of investors resident within the state".

Any sales to a non-resident in connection with the distribution of the new issue would destroy the exemption as to all securities which are a part of that issue. This is true regardless of whether such sales are made directly to non-residents or indirectly through residents who purchased witha view to resale and thereafter sold to non-residents.

As many people fail to appreciate, the so-called "intrastate exemption" is not in any way dependent upon absence of use of the mails or instruments of transportation or communication in interstate commerce in the distribution. Section 3(a)(11) provides in effect that if the residence of the purchasers, the residence or place of incorporation of the issuer, and the place in which the issuer does substantial business

are all confined to a single state, the securities are exempt from the operation of Section 5 of the Act. Securities thus exempt may without registration be offered and sold through the mails, may be made the subject of general newspaper advertisement (provided the advertisement is appropriately limited to indicate that offers to purchase are solicited only from, and sales will be made only to, residents of the particular state involved) and may even be delivered in interstate commerce to the purchasers, if such purchasers, though resident, are temporarily out of the state.

Proper understanding of the elements of the exemption requires the consideration of several terms used in the statute. Since the exemption by its language applies only to a security which is "part of an issue" offered and sold wholly intrastate, the term "issue" warrants a few words of comment. A determination of the question whether an offering is "a part of an issue" involves a consideration whether it should be integrated with another offering previously made or proposed to be made. A few situations which frequently arise should be mentioned.

Where a company is engaged in distribution of its securities in reliance upon an intrastate exemption and subsequently forms the intent to offer securities of the same class under Regulation A, the securities encompassed by both offerings might be deemed integrated and the exemption for the intrastate portion might be lost. In such a case the intrastate offering should be discontinued as soon as the Regulation A filing is definitely in prospect. Moreover, sales made within the past year, if in violation, would be a charge against the amount permitted under Regulation A and should be shown as a contingent liability in a note to the balance sheet. Again, along the same line where a company offers and sells stock in reliance on the intrastate exemption and then files a registration statement for the purpose of making a public offering interstate, the intrastate offering under Section 3(a)(11) normally can no longer be relied upon and the offering thereunder should be discontinued.

Now let us consider the expression "doing business" as used in Section 3(a)(11). The doing of business requirement of Section 3(a)(11) must be met by the performance of substantial operational activities in the state of residence in addition to bookkeeping, stock record and similar functions normally incident to being incorporated in the particular state or offering securities there. For example:

A corporation with uranium properties in another state performed no activities in the state of its incorporation other than having its principal office, bank accounts and business records there. The opinion was expressed that a Section 3(a)(11) exemption was not available to raise funds for uranium properties since the company had no substantial operational activities in the state of its incorporation.

We now pass to the troublesome word "resident". Section 3(a)(11) requires that the offering be confined to a single state in which the offerees and the issuer are residents. For the purpose of Section 3(a)(11) "residence" might be deemed equivalent to "domicile". Insofar as a corporation is concerned, its residence is deemed to be the state of its incorporation. Thus, despite the fact that many states hold a foreign corporation to be resident wherever it is admitted to do business and consents to be sued, such usage is not considered applicable in Section 3(a)(11) offerings to foreign corporations.

Finally, two caveats are in order in relation to Section 3(a)(11): (1) the fact that residence and investment representations are signed should not be accepted without question as establishing the availability of the exemption; and (2) reliance upon this exemption is usually dangerous for anything but an offering which is relatively small in number of units and in dollar amount.

I previously mentioned Section 2(11) in discussing private offerings, and it would seem appropriate to devote a few moments to elaborate on that section which defines the term "underwriter" in a somewhat different context. In your positions as corporate attorneys you are sometimes faced with the question of propriety of offerings by dominant officials and principal shareholders of your companies. Consequently, consideration must be given to the last sentence of Section 2(11) which reads as follows:

"As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer."

Thus a broker-dealer is on notice if he would sell for a controlling person. In this regard Section 4(2) becomes important. It provides an exemption for "brokers' transactions, executed upon customers' orders on any exchange or in the open or counter market, but not the solicitation of such orders."

However, as a result of a Commission decision in 1946,[1/] doubt arose as to the scope of the exemption provided by Section 4(2) for brokers' transactions effected on behalf of controlling persons, and the Commission adopted Rule 154. This rule as now amended defines the term "brokers' transactions" as used in Section 4(2) to include transactions of sale executed by a broker for the account of any person controlling, controlled by, or under common control with the issuer where the broker performs no more than the usual and customary broker's

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1/ In the matter of Ira Haupt & Company (23 S.E.C. 589).

function; receives no more than the usual and customary commission; neither he nor, to his knowledge, his principal solicits orders to buy; and he is not aware of circumstances indicating that his principal is an underwriter or engaged in a distribution of securities. For the purposes of this rule, the term "distribution" is defined as not applying to transactions which involve amounts not substantial in relation to the outstanding securities of the same class and the aggregate volume of trading in the security.

To provide a ready guide for routine cases involving trading as distinguished from distributing transactions, the term "distribution" is further defined by the rule as not including a sale or series of sales of securities which, together with all other sales of securities of the same class by or on behalf of the same person within the preceding 6 months will not exceed approximately 1% of the outstanding shares or units of the security in the case of a security which is traded only otherwise than on a securities exchange and, with respect to a security which is admitted to trading on a securities exchange, the lesser of either 1% of the outstanding securities of the class or the aggregate reported volume of trading during any one week within the preceding 4 calendar weeks.

This statement of the substance of the provisions in Rule 154 would seem to require supplementation to cover areas where confusion sometimes arises. First of all, the sales must in fact be agency transactions executed in the usual manner, and, therefore, as a corollary, it is noted that the rule does not apply to principal transactions. Secondly, there may be no solicitation by the seller's broker seeking orders to buy the security. For example, in the case of securities traded over-the-counter, the broker may not attempt to procure purchasers by communicating with his customers or by inserting offers to sell in the National Daily Quotation sheets. The broker may, however, "hit the bids" of others in the sheets, [illegible] unsolicited orders for the security that may come to him. Moreover, the rule was intended to apply to random sales in small amounts and consequently its advantages may not be available where a controlling person formulates a plan of distribution to be carried out by selling the limit allowed by the rule every six months.

It is important to note that in defining the maximum number of shares or units which shall not constitute a distribution, the rule includes not only the current sales but "all other sales of securities of the same class by or on behalf of the same person within the preceding period of six months..." This provision means literally what it says, and the total that may be sold thereunder within the six-month period encompasses all sales, including transactions for which an automatic exemption was available, and even sales of securities covered by Regulation A or a registration statement.

In your positions as corporate attorneys you undoubtedly are interested in the anti-short swing profit provision of the Securities Exchange Act of 1934. Section 16(b) of that Act was adopted for the purpose of discouraging the unfair use of information in short-term trading

by persons owning beneficially more than 10% of any class of equity security which is registered on a national securities exchange, and by directors and officers of the issuers of such security.

In an attempt to limit the use of inside information to obtain unconscionable profits, and in order to obviate the necessity of proving intent on the part of insiders to speculate on such inside information, a rule of thumb was incorporated in Section 16(b) whereby profits from any purchase and sale or any sale and purchase of a class of equity securities within a six-month period are recoverable by or on behalf of the corporation. This was intended to prevent short-swing speculation without discouraging long-term investment.

I should like to offer for your special consideration a few thoughts on Rule 16B-3 adopted by the Commission. It provides an exemption from Section 16(b) for shares of stock acquired pursuant to bonus, profit sharing, retirement, thrift or similar plans meeting specified conditions and for acquisitions of non-transferable options and stock acquired under such options pursuant to a stock option plan meeting similar conditions. However, it has become the basis for considerable litigation. In 1957 the Court of Appeals for the Second Circuit, in Green v. Dietz, 247 F(2) 689, expressed doubt as to the validity of the Rule insofar as it related to the acquisition of shares through the exercise of restricted stock options, but stated that the defendants should not be held liable for their profits because of Section 23(a) which provides that no provision of the Act "imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission." However, the Court warned against future reliance on the Rule in its present form.

Subsequent decisions of Federal District Courts relating to the validity of the rule have not been consistent in their conclusions. In this regard compare Gruber v. Chesapeake & Ohio Ry. Co., 158 F. Supp. 393 (N.D. Ohio, 1957) and Continental Oil Co. v. Perlitz, 176 F. Supp. 219, (S.D. Texas, Aug. 4, 1959) with Perlman v. Timberlake, 172 F. Supp. 246 (S.D.N.Y., 1959). In Perlman v. Timberlake the District Court for the Southern District of New York flatly declared Rule 16B-3 invalid. Corporate attorneys have informed the staff that in consequence, although it seems clear the holding in the Perlman case is limited to the exemption for stock acquired upon the exercise of options, they have hesitated to give an unqualified opinion that it is now safe to rely upon the exemption granted by the Rule, even in respect of acquisitions under bonus and similar plans. The staff shares the view that the opinion in the Perlman case was intended to relate only to option exercises. We believe, however, that deletion of the option stock exemption from the Rule would remove any doubt created by that opinion as to the continued availability of the defense for non-option exercise transactions of Section 23(a) where reliance is placed in good faith upon a rule or regulation of the Commission. Therefore, the staff has recommended to the Commission that Rule 16b-3 be amended to delete the exemption afforded for the acquisition of securities upon the exercise of stock options. However, it has been suggested by interested persons that an insider who acquires stock pursuant to the exercise of an option has

an interest in the stock prior to its exercise and his profits from a sale within six months after the exercise may not be exclusively of a short-swing nature. This is recognized by Rule 16b-6 which limits the profits recoverable to "the difference between the proceeds of sale and the lowest market price of any security of the same class within six months before or after the date of sale."

In November 1959 the Commission invited all interested persons to submit their views and comments in writing and extended the time for submission to January 15, 1960. For corporate attorneys, particularly those associated with listed companies, this matter can at any time become a matter of immediate importance requiring an important and authoritative opinion. I suggest consideration of the matter, including especially the rules under Section 16(b), Securities Exchange Act Release No. 6111 relating to Rule 16b-3 and cases mentioned therein.

You will remember in this regard that Section 16(b) creates private rights of action and corresponding private liabilities, and that the ultimate decisions in cases predicated upon the section or its implementing rules must come from the Courts and not from the Commission, although its interpretations may be persuasive with the Courts.

Another current and recurrent problem I should now like to mention is that created by the publication of information about an issuer prior to or after the effective date of a registration statement. The problem is almost as old as the Commission itself. It was formally considered in a General Counsel Opinion as far back as 1935, and was recently reconsidered with the same conclusions which I have here expressed in Release No. 3844 to which I strongly invite your attention.

Questions frequently are presented to the Securities and Exchange Commission and its staff with respect to the impact of the registration and prospectus requirements of Section 5 of the Securities Act of 1933 on publication of information concerning an issuer and its affairs by the issuer, its management, underwriters and dealers, and it is felt that the importance of the matter warrants our devoting a few minutes for its consideration.

One of the basic purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 is to procure the dissemination of correct and adequate information concerning issuers, their management, their financial condition and their securities in connection with the offer and sale of securities to the public and the publication periodically of material facts relating to the issuer's business and finances, knowledge of which is essential to an informed trading market in the securities.

Actually, an increasing tendency has developed, particularly since World War II, to give publicity beyond the statutory requirements concerning corporate affairs. Although the dissemination of publicity should be encouraged, it is essential to point out that corporate management, underwriters, dealers, public relations firms and counsel for them recognize that publicity and public relations activities may under certain circumstances

involve violations of the Securities Acts and cause serious embarrassment to issuers and underwriters in connection with the timing and marketing of an issue of securities. In addition to posing enforcement and administrative problems for the Commission, such violations may also form the basis for civil liabilities against the seller of the securities.

To appreciate the problem fully, certain of the basic requirements and prohibitions of the registration provisions of the Act should be mentioned. It is illegal to offer a security prior to the filing of a registration statement. A security may be offered legally after filing and before the effective date of a registration statement, provided that any prospectus employed for this purpose meets the standards of Section 10 of the Act. Thus, in general during this period (after the filing and before the effective date), no written communication offering a security may be transmitted through the mails or in interstate commerce other than a prospectus authorized or permitted by the statute or relevant rules thereunder. After the effective date, sales literature in addition to the prospectus may[1/] be employed legally, provided the Section 10(a) prospectus precedes or accompanies the supplemental literature.

The broad sweep of the prohibition against a premature "offer to sell" is made clear by reference to the definition of that term. It is defined in the Act to include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value. These carefully chosen words reflect the Congressional mandate that the term "offer to sell" shall not be construed to apply narrowly to communications which include express words of "offer" in the sense in which it is used in common parlance. It follows that an issuer, underwriter or dealer may not legally begin a public offering or initiate a public sales campaign prior to the filing of a registration statement. It apparently is not generally understood, however, that the publication of information and statements, and publicity efforts, generally, made in advance of a proposed financing, although not couched in terms of an express offer, may in fact contribute to conditioning the public mind or arousing public interest in the issuer or in the securities of an issuer in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.

Nor is it generally understood that the release of publicity and the publication of information between the filing date and the effective date of a registration statement may similarly raise a question whether the publicity is not in fact a selling effort by an illegal means.

Many of the cases have reflected an unawareness of the problems involved or a failure to exercise a proper control over research and public relations activities in relation to the distribution of an issue of securities.

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1/ Rule 230.434 provides in certain cases for the use of cards prepared by independent statistical organizations which fairly summarize the information contained in the prospectus. Rule 230.434A permits the use of a similar summary prospectus.

Nevertheless, from what has been said, it would seem clear that an issuer or an underwriter is not privileged to engage in a publicity campaign prior to the filing of a registration statement in connection with a public offering of a non-exempt security. However, this does not require that a corporation which proposes to bring an issue to market should gag its officials and employees, its advertising department and its public relations people. Clearly an issuer may continue its normal and usual publications prior to the filing of a registration statement and even during the waiting period between filing and the effective date. For example, it may continue to advertise its products and services. It may send out its annual and other periodic reports to security holders. It may publish its proxy statements, send out its confidential notices and make routine announcements. On the other hand, however, when public statements begin to appear shortly before the filing of the registration statement which treat of such aspects of the issuer as its finances, its earnings or its growth prospects in glowing and optimistic terms, stressing in alluring fashion the favorable over unfavorable, it seems reasonable to conclude that an attempt is being made to condition themarket for the anticipated sale of the issue and that such statements are therefore a part of the selling effort and are in violation of the law.

Frequently questions are asked relating to press releases by issuers of securities and speeches by officials of the company before the filing of the registration statement or during the subsequent period prior to effectiveness. No particular problem would seem to be presented by a press release announcing some newsworthy event in its business. For example, announcement of the receipt of a contract, the settlement of a strike, the opening of a plant, or any similar event of interest to the area in which the business operates has never been the subject of criticism. However, purported news items which in fact boost the company's securities or which feature the financial condition or other aspects of the corporation usually associated with the promotion of the sale of securities will receive critical consideration.

Often inquiry is made of the Commission or the staff regarding the propriety of speeches by corporate officials before financial analysts' societies, trade organizations, or similar groups. Our understanding is that such an address is ordinarily scheduled by the group a substantial period of time in advance of its delivery, when the offering of securities is not as yet even in contemplation. Thus, on occasion it happens that the date scheduled for the speech is in such chronological proximity to the filing of the registration statement as to give pause to counsel for the issuer or the underwriter. I do not believe that the Commission has ever taken the position that such a speaking engagement made in advance with a financial analysts' society or a similar group, should be cancelled or even rescheduled. However, it is clearly incumbent upon the speaker not to focus his talk in such manner as to constitute a selling effort. In this regard it should be noted that the Commission has on a number of occasions expressed the view that any public distribution of the speech or of the supporting material employed in connection with it might well raise a serious problem under Section 5.

In connection with a determination of the many problems arising in this area, the Commission has employed a constant and simple logic. If under all of the circumstances the publication, speech or other material in question is reasonably to be deemed part of the selling effort, it comes within the prohibition of Section 5. If not, it is innocuous in terms of the statute. The ultimate determination must be made on a case-to-case basis, and must involve the exercise of sound judgment in evaluating the facts of each particular situation presented.

My time is running out, and I anticipate that the bank of the Chairman's gavel will terminate my remarks unless I sooner gracefully retire. The topics tonight were chosen as items of current interest or recurrent importance to your fine group of corporate lawyers. Many of you have been in communication with the Commission's Chicago office from time to time in the past and know that we give to attorneys and others what amounts to an interpretative service. I invite you to contact us in the future in regard to subjects of interest to you which could not be reached this evening and also in regard to definitive problems in the securities field which you feel come within the purview of our functions. Thank you kindly for your patient attention.